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To: Our Friends and Clients

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Re: First Quarter 2007 - Review and Outlook

“...I would say that the overwhelming conventional wisdom is that the dollar is headed lower... However, the thought that has occurred to me is that we have a deficit, and the deficit is related to our foreign policy. I have the feeling that soon... the deficit-created phenomenon that is Iraq will be dramatically reduced. I think that will be an extremely positive force for the dollar...”

Michael Steinhardt, Founder and Retired Chairman of Steinhardt Partners in a Bloomberg News interview February 15, 2007

Review and Outlook

After a strong performance by stocks at the end of 2006, the market took a breather during the first quarter of 2007. The S&P 500 closed the quarter with an advance of 0.64% (including dividends). While the quarter started out strong, an interest rate hike by the Bank of Japan and concerns about housing led investors to become more cautious during February. The pullback reversed itself in March, as stocks drifted higher in anticipation of decent earnings reports for the first quarter of 2007.

Sectors leading the market during the quarter were Materials (+8.38%), Telecommunications (+6.36%) and Utilities (+8.43%). Laggards were Consumer Discretionary (-0.99%), Financials (-3.44%) and Technology (-1.10%).

As we write this letter, first quarter earnings have been stronger than expected. According to UBS Equity Strategist Thomas Doerflinger, with 32% of companies (as measured by market cap) having reported, earnings for the first quarter of 2007 should be up 6 to 7%, quite a bit stronger than the 3 to 4% consensus view reported by Zacks Investment Research back in early March. As a result, markets have rallied strongly early in the first few weeks of the second quarter.

Acquisition activity by hedge funds and private equity buyers continues to be robust and supportive of stock prices. With interest rates low and stock prices cheap relative to cash flow, we expect buy-out activity to remain active for the foreseeable future. Until stock prices rise and bring the spread between interest rates and cash flow yields in line with historical levels, or credit quality deteriorates to the point where lenders are unwilling to support private equity borrowing, the buyout boom is likely to continue. There is simply too much liquidity and too little risk priced into the debt markets at present.

Also, despite rising interest rates and oil prices, the U.S. consumer continues to spend, apparently undaunted by these rising costs. Extremely low unemployment and rising wage growth suggest the consumer will remain supportive of economic growth for the foreseeable future.

Two Cautionary Notes

First, in recent years, a tidal wave of U.S. money has flowed into foreign stocks in pursuit of currency-fueled high returns stemming from U.S. Dollar weakness. At this juncture, we suspect that this outflow of money is nearing a crest. We expect this for several reasons: 1) the U.S. budget deficit continues to decline as a percentage of GDP, and if the war in Iraq begins to wind down after the next election, the budget deficit could revert to a surplus quite suddenly; and 2) rapidly growing consumer spending in emerging markets like China should begin to support a stabilization (or reduction) in our trade surplus. Also, the widely held belief that the dollar is likely to fall further is so pervasive that it is reasonable to assume that it is priced into currency markets at present. In this context, new commitments to foreign stocks should be made with great caution.

Second, corporate earnings growth is slowing. While we don't expect a recession anytime soon, investors are likely to reign in their "animal instincts" and pursue more conservative investment strategies than they have in recent years. Companies with global business platforms should offer better growth potential as U.S. economic growth settles into the 2 - 2.5% range.

Final Comments

In recent years, there has been much attention given to rising global energy consumption and the United States' increasing dependence on foreign oil. Given the complexity of the issues involved and their important ramifications for the economy (and stocks), we thought it would be worthwhile to research the leading energy alternatives being discussed. Winners and losers in the energy debate will remain unclear for some time. But energy is so fundamental to the global economy that however our energy infrastructure evolves, investors need to be mindful of its impact on their investments. One thing is clear... billions (perhaps trillions) of dollars will be spent modernizing the global energy infrastructure. This quarter's Review and Outlook is a special report on energy and discusses the pros and cons of competing approaches. We hope you find it interesting.

As always, we welcome your questions and comments.

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