SKY INVESTMENT GROUP

July 2007

To: Our Friends and Clients

From: Robert Bingham, CFA
SKY Investment Group LLC

Re: Second Quarter 2007 - Review and Outlook

"Nervous energy is a great destroyer of wealth."
Fayez Sarofim, President and Founder, Fayez Sarofim & Associates, Houston, Texas

Review and Outlook

After taking a rest during the first quarter of 2007, stock prices resumed their upward trajectory during the second quarter, with the S&P 500 advancing 6.28% (including dividends) bringing full year returns to 6.96%. S&P 500 industry groups leading the advancers for the quarter were Energy (+14.32%), Information Technology (+10.18%), and Industrials (+9.24%).

With interest rates rising during the quarter and concerns about sub-prime mortgage loans continuing to make headlines, Utilities (-1.11%) and Financials (+1.49%) were the weakest among the major S&P 500 sector groupings.

The strength of global and U.S. economic growth continues to surprise investors. As a result, long-term bonds have weakened recently and the yield curve has returned to normal, with longer-term yields once again higher than those in the short-term. For the quarter, the Merrill Lynch U.S. Government/Corporate, 7-10 years, AA rated or better, bond index returned -1.29%, bringing year-to-date returns to 0.24%.

Inflation and Central Banks

The U.S. Federal Reserve has continued to hold interest rates steady at 5.25%. The Fed remains concerned about the inflation outlook, but with housing weakening, they have decided to forego further monetary tightening measures and keep interest rates steady. They must be relieved to see foreign central banks continuing to raise rates in an effort to slow the global economy, as it reduces the need for imminent U.S. tightening. While oil prices closed in on $70 a barrel at the end of the quarter (and surpassed this level in early July), other raw materials prices have stabilized or declined. Even gold stocks, generally a leading indicator of inflation expectations, weakened. Bellwether Newmont Mining (NEM) closed the quarter at $39.06, significantly below its February, 2006, high of $62.00.

Our view is that U.S. inflation is higher than commonly believed. While most economists focus on the so-called core rate of inflation, we think that focus is misplaced in the current environment. The core Consumer Price Index (CPI) ignores food and energy costs because they are volatile, but given that we are in the midst of a multi-year upward trend in energy prices, we think that the all-inclusive CPI measure is more meaningful at present. Consistent with this, we think long-term interest rates have yet to peak domestically, and that the yield on the 30 year U.S. Treasury could approach or exceed 6%, up from its current level of 5.1% and its June 12th high of 5.4% (Source: Bloomberg LP).

We wrote last year (Fourth Quarter 2006 – Review and Outlook) about the need for central banks to coordinate activities in a global economy. While we don't expect formal coordinated action anytime soon, we suspect that central bankers are keenly aware of the need for informal, coordinated action to fend off asset bubbles (like the recent U.S. bubble in real estate) in this era of global capital mobility. Despite the U.S. Fed's rate pause, our major trading partners are continuing to fight the liquidity-driven boom in raw materials that began in 2003. We expect that until the Japanese are able to cut off the supply of cheap money, global inflation will remain uncomfortably high.

Value Stocks versus Growth Stocks – Is Market Leadership Changing?

In recent years, stocks generally viewed as value stocks have led the markets higher. This has been true for small, mid and large-cap companies. But after 3 years of solid out-performance by value stocks, we think that growth stocks could be poised to lead the market. Several observations support this viewpoint:

1) **Credit for lower grade bond issuers is likely to get more expensive** – The cost of borrowing by low grade bond issuers has been falling because of the glut of global liquidity searching for yield. As the glut recedes, less creditworthy borrowers should need to pay more. This should favor larger growth companies with access to ample internally generated capital versus value stocks benefiting from cheap borrowing and buyout driven price advances.

2) **Valuations have converged** – Despite their more rapid growth, growth stocks are valued in line with the market averages.

3) **Economic growth is slowing** – As economic growth continues to slow, the higher relative growth rates of growth stocks should make them relatively more attractive. Growth stocks can support much higher price/earnings (P/E) multiples than current price levels reflect.

4) **Inflation should decline next year** – As inflation expectations recede with slower growth and higher interest rates, P/E multiples on growth stocks should expand beyond levels corresponding to the market averages.

In this environment, we expect investors focused on large, globally diversified companies offering "Growth at a Reasonable Price" to enjoy attractive returns. Many good growth companies are inexpensively priced, so that even hard-core "value investors" can be comfortable committing capital to stocks traditionally viewed as growth stocks.

We would not be surprised to see the market take a breather for the next 3 or 4 months as it digests the gains of the last 12 months. Once the fourth quarter arrives, however, stocks should resume their advance, with inexpensive, quality growth stocks leading the way as they begin to reflect 2008 earnings expectations.

Best wishes for the summer months.

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