

Market Commentary

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What's Really different?

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Does stock market action this week mean things are really different? We believe the most likely scenario for the market in 2007 is up. Even Federal Reserve Chairman Ben Bernanke stated he believed the economy looked on sound footing, experiencing "moderate US growth." Fundamentals for stocks remain very supportive.

Historical perspective often provides encouragement in troubling moments. **On average, the market recovers well after a sharp one-day decline. Excluding 10/19/1987 (when the market fell 30% in 2 days), the market declined more than -3% in a single-day on 37 occasions since 1980. The average single-day drop was -3.9%. Over the following month, the market averaged +3%, making most of the loss back. 42% of the time, the market made it back after a month.**

We continue to believe the most likely outcome for the market this year is a "melt-UP" rally. We offer several brief reasons for this "melt-UP" experience:

1. *The Fed* – renewed weakness in housing and troubled mortgage loans should convince investors that the Fed has finished with interest rate increases. Rate cuts are not necessary for a bullish outcome.
2. *Possible multiple expansion* – tame inflation plus moderating economic prospects plus lower oil prices (than a year ago) should keep corporate earnings moving at a moderate upward pace.
3. *Private Equity* – asset allocation shift from hedge funds (long/short) to private equity funds (leveraged longs) is very bullish as they bid up takeover target stocks.
4. *Valuation* – large-cap stocks are cheap and that means less risky.

These key factors and several others suggest 2007 should continue the current bull market we have experienced since October 2002.

As the summer rally (since July 21) developed, investors pursued usual traits of piling into higher risk assets after missing the start. The Chinese stock market is up +104% over the last year; up +150% since July and up +17% this year (before Tuesday). Other emerging markets were also experiencing "rocket ship liftoff" in their performance. A single-day attitude adjustment can reacquaint investors with FEAR. We will see \$\$ flows slow into emerging market funds or other higher risk assets as a result. We expect investors will refocus on less risky developed foreign and US domestic large-cap stocks where valuations are more attractive.

Client portfolios weathered the single-day market drop well. Even the most aggressive portfolios did not decline like the S&P 500 (which lost 3.5%). Generally, client portfolios have less market drawdown than the market (when it is falling), while having similar or higher market up-capture (when the market is rising). That equates into long term attractive returns.

In the short term (maybe several weeks), the markets will exhibit increased volatility. Long-term investors should view this interval as an unusual buying opportunity. The fundamentals for successful investing are very supportive for "time IN" the market investors. We expect 2007 will be a rewarding investment year.

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