



<u>1st Quarter 2007</u>	<u>Close</u>	<u>Performance</u>
Dow Jones Industrial Average:	12,354.35	↓0.90%
Standard & Poor's 500 Index:	1,420.86	↑0.20%
10-Year Treasury Yield:	4.651%	

Investment Outlook

March 31, 2007

Dear Investors,

The first quarter was very eventful for global equity markets and a volatile period for stocks. The quarter began with stocks rising and oil plummeting. Stocks rose until the synchronized global “mini-crash” of February 27th, when a 9% drop in China’s Shanghai Composite led to a 416-point plunge in the Dow Jones Industrial Average and similar decline in other global markets. By the end of the quarter, however, stocks had recovered to end the quarter essentially flat since January 1st. Bonds gained slightly during the quarter as the benchmark yield of the U.S. 10-Year Treasury note fell 5 basis points to end the quarter at 4.65%.

In my view the single biggest threat to the bull market that began in 2002 is the toll that the housing downturn takes on U.S. consumer spending. (Consumer spending makes up about two-thirds of the U.S. economy.) In the first quarter, new signs of mortgage strain appeared almost daily. Many subprime loans went bad, and in the ensuing mess dozens of lenders that specialized in subprime went bankrupt. The unwinding occurred at a blistering pace. To wit, New Century Financial, the poster child of the subprime collapse, had a market value of \$1.75 billion on January 1, 2007. On April 2nd the company filed for bankruptcy. Dozens of other lenders have also filed for Chapter 11 bankruptcy protection.

The subprime segment is a small percentage of the overall mortgage market, and therefore its collapse is not of vital importance to the overall economy. In my view, what is important is that these are probably only the first signs of real financial strain for mainstream consumers since the housing market began its decline. The big question is whether or not lower home prices combined with rising adjustable rate mortgage rate does not result in a precipitous drop in overall consumer spending. By some estimates up to \$1 trillion of adjustable rate mortgages will be resetting to higher levels in 2007 and it is simply not possible to accurately estimate how consumers are going to respond as their mortgage payments rise while their home values fall.

Another point to consider about housing is that a large percentage of the economic growth we enjoyed since the recession of 2001 came from the rising housing market and its related activities, such as realty, mortgage brokerage and construction. Surely the sharp curtailment of activity in this whole food chain has to have some effect of the overall level of economic activity. Up until now, at least, the employment situation has not been adversely affected. The jobs numbers reported for March were

actually quite robust. However, because there is a lag effect between a downturn in construction activity and a rise in construction-related job losses, I believe that the employment situation will gradually worsen as we move through 2007.

Corporate profit growth is slowing noticeably so far in 2007. The growth rate of earnings in the first quarter is likely to be in the mid-single-digits—about half the growth rate of a year ago. This slowing growth does not have to mark the end of a good equity market, however. For the last several years, stocks have advanced at a slower pace than earnings. The result we see today is that even with their decent price performance in the last several years, stocks are still not trading at historically expensive levels. The bull case for 2007 is that slowing earnings growth and a slowing economy will force the Federal Reserve to cut rates later in the year, and these lower rates will help stocks trade at a higher multiple of their earnings. The key will be to see what happens with inflation, as the Fed has said it expects inflation to cool off without help from further rate cuts.

Overseas the investing climate remains stable, but much less ebullient than last year. Europe was broadly higher by a percentage point or two on strong earnings performances and continued corporate restructuring. Japan's Nikkei Index held onto a 0.4% gain for the quarter and the Japanese market continued to show increased merger and acquisition activity. (Another positive—albeit a very slight one—is that there is a new and successful TV show on in Japan called “Vulture” about a hard-line New York investment fund that is preying on ailing Japanese companies. While hardly a scientific indicator, the success of the show does point to increased acceptance of mergers and acquisitions in Japan—which have quadrupled in the past decade to 2,775 transactions in 2007 from 621 in 1996.)

My wife Janet and I have just completed the big task of re-launching the Orion website. Please check it out if you get a chance. The address is www.orioncapitalmgmt.com. We would be curious to hear your thoughts about it.

As is the case this time each year, my investment advisor registration (Form ADV) has been updated. Please let me know if you would like to receive a copy. As usual, I welcome your comments and feedback.

Best Regards,

Peter

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