



<u>2nd Quarter 2007</u>	<u>Close</u>	<u>Performance</u>
Dow Jones Industrial Average:	13,408.62	↑8.5%
Standard & Poor's 500 Index:	1,503.35	↑5.8%
10-Year Treasury Yield:	5.034%	

Investment Outlook

June 30, 2007

Dear Investors,

In the second quarter, stocks around the world powered their way higher. The S&P 500 Index, a broad measure for the U.S. stock market, rose 5.8%. Other indexes and bourses around the world notched strong performances as well. Unexpectedly strong financial performance from companies against a tepid economic backdrop here in the U.S. was, in my opinion, the primary reason for the quarter's gains. Economic growth in the U.S. slowed considerably in the first half of 2007, but in other countries—particularly those in Asia—the recent track record of blistering growth continued unabated. As companies continue to post strong results, many market participants have abandoned their previous expectation that the Federal Reserve would lower short-term interest rates later in 2007. Along with strong growth, however, usually comes an expectation for rising inflation. One key place to observe rising inflation expectations is in the long-term bond market, where yields rise as investors fret about inflation. This quarter the yield on the benchmark 10-Year U.S. Treasury note climbed 38 basis points to 5.03%, a significant move over three months' time. Higher yields in U.S. Treasuries and larger spreads between high and low-grade fixed income instruments also hint that investors' aversion to risk is increasing slightly.

The U.S. economy, while obviously still the largest and most important economy in the world, has, of late, turned from a leader to a laggard. The second quarter gross domestic product (GDP) growth numbers are not yet in, but in the first quarter the economy limped along at 0.7% annualized growth. This was the weakest quarter since the fourth quarter of 2002, when GDP grew at a 0.2% annualized rate. Most economists expect a modest rebound in the second quarter, but it is clear that the softness in the residential housing market and expensive gasoline are beginning to have a negative impact on the economy. It is notable that despite the warnings by many economists that unemployment would rise sharply as home values fell, this theory has yet to be proven out. Nationally the housing market peaked in the fall of 2005, but the unemployment rate has yet to rise meaningfully to reflect the fewer jobs that are likely available now in the residential construction and mortgage finance industries. Some of the aforementioned economists believe that there is a 12-18 month lag from the market top to the real beginning of housing-related job losses. This means we should be seeing those job losses imminently (if they ever materialize).

The subprime segment of the mortgage market continues to garner much attention from the financial press. Recently two hedge funds at New York investment bank Bear Stearns watched their highly leveraged bets on subprime mortgage securities collapse. The bank ponied up \$3.2 billion to help the funds, but it is still unclear how much more damage the decline in dicey mortgage securities will do to pension and hedge funds around the world. Journalists know that a collapsing hedge fund always makes for a good story, but the real issue is not that some institutional investors will be disappointed with their returns. Rather it is that the home—the most valuable asset on the balance sheet of most Americans—continues to decline in value while mortgage costs go up as many recent homebuyers watch their adjustable rate mortgage payments begin to reset to higher levels. The duration and severity of this housing downturn will be critical to the direction of consumer spending in the next couple of years.

Our consumer remains important to the health of the U.S. stock market—but less important every day. The reason is that U.S. companies, particularly large-cap multinationals, are taking full advantage of the rapid economic growth overseas. To wit, nearly 40% of the sales of companies in the S&P 500 come from outside the United States. In my view the worldwide growth spurt now going on now is perhaps a once in history phenomenon. The transformation of the largest countries on earth by population, China and India, into industrialized countries with hundreds of millions of middle class consumers will only happen once. Naturally this will be a long, drawn out process with many economic booms and busts along the way, but the general upward course of those Asian economies is unlikely to change.

This transformation should not be rued or feared. The fact that global companies based in the U.S. can participate in the growth in emerging markets is very good news for our own economy. Though our companies are encountering aggressive new competitors around the world, they are also serving many nascent and rapidly-growing markets. Now, instead of being the locomotive pulling the global economic train, the U.S. finds itself as the caboose. We should be grateful that we are able to latch on for the ride.

As usual, I welcome your comments and feedback.

Best Regards,

Peter

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