



MARKET COMMENTARY

FIRST QUARTER RECAP

Following a strong run in the latter half of 2006, equities posted modest returns in the first quarter of 2007. Both stocks and fixed income investments posted low single-digit gains for the period. Market volatility increased significantly, a trend that investors have not seen for several years. Equities achieved nice gains through the middle of February, but then fell precipitously because of what appeared to be a confluence of events. The 6% decline between the February 20th peak and the March 5th trough, was allegedly caused by a sharp drop in the Chinese market, recessionary talk by former Federal Reserve Chairman Alan Greenspan, heightened geopolitical tensions in the Middle East, continued trouble in the sub-prime mortgage market, and surprisingly weak January durable goods orders. In reality, after rising steadily for eight months in a row, the market was probably “overbought” and due for a pullback. A series of generally soft economic reports, additional concern about the sharp escalation in sub-prime defaults, and whether this trend will spread to other parts of the mortgage market, caused stocks to weaken further. As a result, by mid-March the primary equity indices were slightly negative for the year. While equities around the world fell, the U.S. Treasury market rallied, in a flight to quality, during this period.

PERFORMANCE MATRIX

| Index | 2007 1Q |
|------------------------------------|---------|
| S&P 500 | 0.6% |
| Russell 1000 Growth | 1.2% |
| Russell 1000 Value | 1.2% |
| Russell Mid Cap | 4.4% |
| Russell 2000 (small cap) | 2.0% |
| MSCI EAFE (international, \$, net) | 4.1% |
| Lehman Municipal Bond | 0.8% |
| Lehman Aggregate Bond | 1.5% |

The Federal Open Market Committee’s (FOMC) decision in late March to drop its tightening bias surprised many market participants. The announcement served as a catalyst for a market rally, and stocks finished the quarter on a positive note. At the same time, the Treasury yield curve steepened with shorter maturities appreciating as investors speculated that the central bank’s next move would

be to cut rates. In their post-meeting announcement, the Fed kept its benchmark interest rate at 5.25% and said that the economy seems likely to continue to expand at a moderate pace over coming quarters, though they marked down their assessment of economic growth. Although inflationary pressures are expected to moderate gradually over time, the risk that inflation will fail to decline as expected remains the Fed's predominant policy concern. Subsequent to the quarter's close, Fed Chairman Bernanke indicated that inflation "remains uncomfortably high" and sought to dampen expectations that the Fed will cut interest rates in the near-term.

International stocks (MSCI EAFE +4.1%) outperformed most U.S. indices during the first quarter, with the weaker dollar adding about 1% to returns, even though the European Central Bank (ECB) raised their benchmark rate for the seventh time to 3.75% in March and is likely to continue increasing rates. Similar to the U.S. Federal Reserve, the ECB is concerned about inflation because of tight labor markets and increased consumer and business spending. Growth prospects in Europe remain solid. GDP forecasts have been rising, with many countries anticipating 2% or better growth, while unemployment is falling. In fact, European unemployment fell to 7.3% in February, which is the lowest level since the EU began keeping records in 1993. Similarly, the Bank of Japan is increasing interest rates, though they are still very low in absolute terms. The Japanese economy grew 4.8% in the fourth quarter of 2006, its fastest pace in three years. Economic growth also remains strong in emerging markets, with countries like China and India expected to grow 8% to 10% in 2007.

EQUITY MARKETS

The S&P 500 was marginally positive during the first quarter, but there was a wide disparity in sector performance. Utilities and materials were the best performers, each group rising 9% for the period. Utilities did well because of the increased mergers and acquisition activity in the sector. TXU's agreement in February to be acquired for \$45 billion by a consortium of private equity firms was a seminal event for the industry. Materials stocks rallied because of high commodity prices and consolidation in some industry sectors. Telecomm services stocks also performed well, generating nearly an 8% return. These three sectors, however, only account for about 10% of the S&P 500 and the much larger financials and technology sectors, which comprise more than one-third of the market, performed poorly. The flat yield curve and the associated margin pressure, credit concerns, and the growing realization that the Fed is unlikely to cut short-term interest rates in the near-term, caused financials to decline 3% during the quarter. Soft demand, excess semiconductor inventory, pricing pressure in microprocessors, and the options backdating scandal, were responsible for the weakness in the technology sector.

S&P 500 SECTOR PERFORMANCE

| Sector | Sector Wt. (3/31/07) | 2007 1Q |
|------------------|----------------------|---------|
| Energy | 10.1% | 2.1% |
| Materials | 3.1% | 9.0% |
| Industrials | 10.9% | 1.1% |
| Consumer Disc. | 10.5% | -0.8% |
| Cons. Staples | 9.6% | 2.2% |
| Health Care | 11.9% | 1.1% |
| Financials | 21.6% | -2.9% |
| Info. Technology | 14.9% | -0.9% |
| Telecomm Serv. | 3.7% | 7.6% |
| Utilities | 3.7% | 9.4% |
| S&P 500 | 100.0% | 0.6% |

Source: Standard & Poor's

Mid cap stocks were the best performing part of the market in the first quarter with value, blend, and growth returning 4% to 5% for the period. Mid cap materials and energy stocks rose in the low double-digits, while mid cap industrials were up 8% versus only 1% in the S&P 500. Small cap stocks also outperformed large caps as the Russell 2000 returned 2% compared to 0.6% for the S&P 500. Mega-caps, as measured by the Russell 50 Index, were the worst performers (-1.8%). Some of this weak performance can be attributed to the number of mega-cap financials in the index.

Unlike 2006 in which the returns of the value style beat growth significantly, the first quarter was a mixed picture. In the large cap part of the market, the Russell 1000 Value and Russell 1000 Growth indices generated identical 1.2% returns in the first quarter. Mid cap value outperformed mid cap growth by 90 b.p., while the opposite was true in the small cap sector. The Russell 2000 (small cap) Growth returned 2.5% compared to 1.5% for the Russell 2000 Value index.

FIXED INCOME

The combination of soft economic data, *initial* indications by the Fed that interest rate cuts may be on the horizon, and a flight to quality lifted fixed income returns during the first three months of the year. During January, the yield on the bellwether 10-year Treasury note reached 4.89% as inflationary pressures increased and job growth remained solid. However, as global equity markets tumbled in late February, the 10-year Treasury yield plunged as low as 4.49% before closing the quarter at 4.64%, 7 b.p. below where it started the year. During this period in which investors suddenly became risk averse, fixed income outperformed many of the riskier asset classes. The change in tone

by the Fed also caused the yield curve to shift to a more positive slope. (After the quarter ended, the yield curve subsequently flattened out and the 10-year Treasury yield rose to 4.75% when Chairman Bernanke, in his testimony before Congress, clarified the implications of the late March FOMC statement. The release of stronger than expected March employment numbers in early April also contributed to the yield curve flattening.)

Treasury inflation protected securities (TIPS) were the best performing sector of the fixed income market during the first quarter of 2007. Inflationary pressures unexpectedly increased, causing TIPS to outperform nominal Treasuries. Municipal bonds were the weakest performing fixed income sector, returning only 0.8% (Lehman Municipal Bond Index). Municipal bond demand is primarily domestic and retail-driven. As a result, this asset class typically lags Treasuries in a rally.

OUTLOOK

In our year-end 2006 market commentary, we indicated that we expected equity gains to be more modest in 2007 than in the prior year, on the order of mid-to-high single digits. We also said that we were anticipating low-to-mid single-digit fixed income returns for investment grade bonds, essentially earning the coupon. We think the same will be true for municipal bonds this year.

From what we see today, these forecasted returns still seem reasonable, but the equity return expectation is not without risk. Our forecast is based on the assumption that the U.S. economy stays reasonably healthy and is not weighed down by the housing and manufacturing sectors. However, near-term economic growth is probably trending somewhat below the 2.5% we assumed for the full year, business spending has faltered, and projected corporate earnings growth has fallen into the mid single-digits. In addition, inflation has become more of a concern to policymakers and this could prevent the Federal Reserve from reducing interest rates in the latter part of the year as many investors expect, unless core inflation abates and the unemployment rate climbs back to 5% (4.4% currently). In fact, in the March FOMC meeting minutes released on April 11th, the Fed said that “further policy firming might prove necessary to foster lower inflation.” In other words, the Fed *might* raise rates if inflation does not decline. If the Fed raises interest rates, investors would view this action as negative for equities because higher rates would likely dampen economic growth and pressure corporate earnings.

On the plus side, the economy continues to add jobs and consumer spending remains relatively healthy. Corporations are flush with cash, as are private equity firms, and credit to finance these transactions remains readily available (for now). This has caused a heightened level of mergers and acquisition activity, a trend that is very supportive of stock prices and an important market driver. In fact, over \$1 trillion worth of total transactions were announced in the first quarter of 2007 on a global basis and we are now pushing the \$50 billion individual transaction threshold. Even with slower earnings growth, valuations remain reasonable. According to consensus estimates, the S&P 500 is currently trading at about 15 times forward 12-month earnings, close to the average historically.

Outside of the U.S., international markets continue to be appealing. As discussed at the beginning of this commentary, the outlook for global economic growth remains positive and, if the dollar

continues to weaken, local currency returns of foreign equities could be higher when the returns are translated back into U.S. dollars.

OTHER MATTERS

In accordance with SEC regulations, we request that you contact us in the event that there have been any material changes in your financial circumstances or investment objectives, or if you wish to impose any reasonable restrictions on the management of your accounts or modify existing restrictions on the management of your accounts.

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