

## Quarterly Market Commentary – 1<sup>st</sup> Quarter 2007

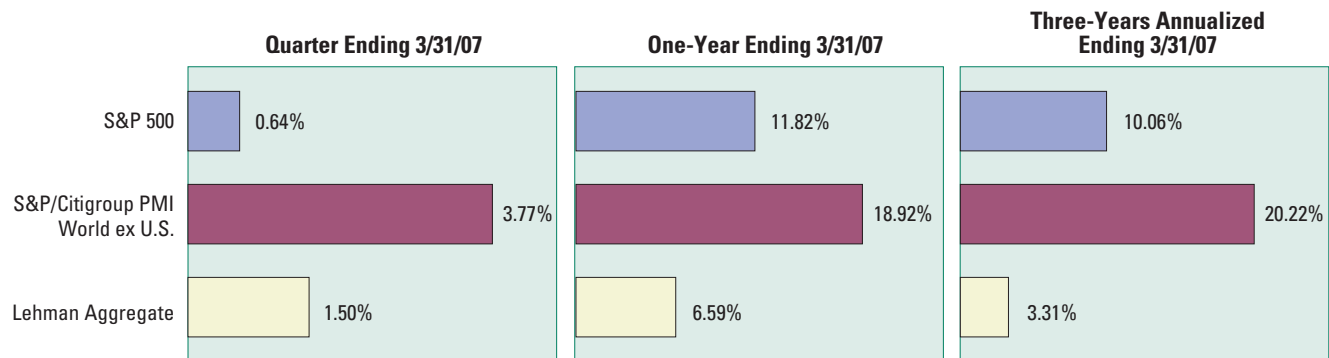
### Review and Outlook

Major world markets posted gains for the three-month period ended March 31, 2007. International equity markets – both developed and emerging – fared better than the U.S., but posted comparable returns in fixed income. There were some dramatic turns during the quarter, which included actions taken by the Chinese government; inflationary pressures, signs of slowing economic growth and warnings of a possible recession in the U.S.; sub-prime mortgages; and, tensions surrounding British soldiers in Iran which added to rising oil prices.

While several factors contributed to the worldwide sell-off in equity markets on February 27th, it was primarily led by the Chinese government increasing interest rates and raising bank reserve requirements in its attempt to rein-in economic growth. In this one day, the Shanghai market plummeted more than 9%, which caused other markets to falter as investors became skittish that the engine of global economic growth was shifting into lower gear. In the U.S., the market reaction ended with a 3.46% decline for the S&P 500. In addition to the Shanghai market downturn, other concerns that negatively affected U.S. investors included a larger-than-expected rise in the core Consumer Price Index (CPI); a warning by the former Fed Chairman, Alan Greenspan, of the possibility that the U.S. economy could slip into a recession by year-end; and, fears that the first revision of the preliminary Q4 2006 real gross domestic product (real GDP) report would be severely downgraded from the initial announcement of 3.5% (which was released a day later at 2.2%, reflecting sharp deceleration). Two weeks later, on March 13th, the U.S. stock market dropped another 2% reacting to news by the Mortgage Bankers Association's report of an increase in sub-prime and prime delinquencies, plus a weaker-than-expected retail sales report. The dollar weakened on market risk aversion, and all ten sectors in the S&P 500 took a hit with the S&P 500 Financials sector down the most for the day (-3%).

The Federal Reserve left the federal funds rate unchanged, at 5.25%, following both January and March Federal Open Market Committee (FOMC) meetings. After the March 20-21 meeting, Fed comments reflected a pessimistic view on both growth and inflation, but more importantly, that the bias toward tightening appeared to have been removed. The market interpreted this as greater chance of an impending rate cut and the stock market rallied, recovering most of the previous losses. Treasury yields increased in January due to increased inflationary measures and producer costs, supplemented by strong employment, but then fell in both February and March, as investors fled to safety from the equity market downturns. At the end of March 31, 2007, Treasury yields had modestly declined from their December close, and the yield of the 10-year Treasury note fell six basis points to end the quarter at 4.65%. Outside the U.S., monetary regulators increased rates during the quarter, which caused yields of 10-year issues to climb from their year-end 2006 numbers.

In the near-term, S&P believes the combination of higher inflation and weaker economic growth will keep the Federal Reserve on hold with interest rates. Yet, the economy is slowing. The weak first quarter 2007 economic growth and expected rise in unemployment will force the Fed to cut rates, most likely in the third quarter. However, if inflation fails to subside as S&P expects, the Fed could delay a rate cut or even raise rates again before reversing course.

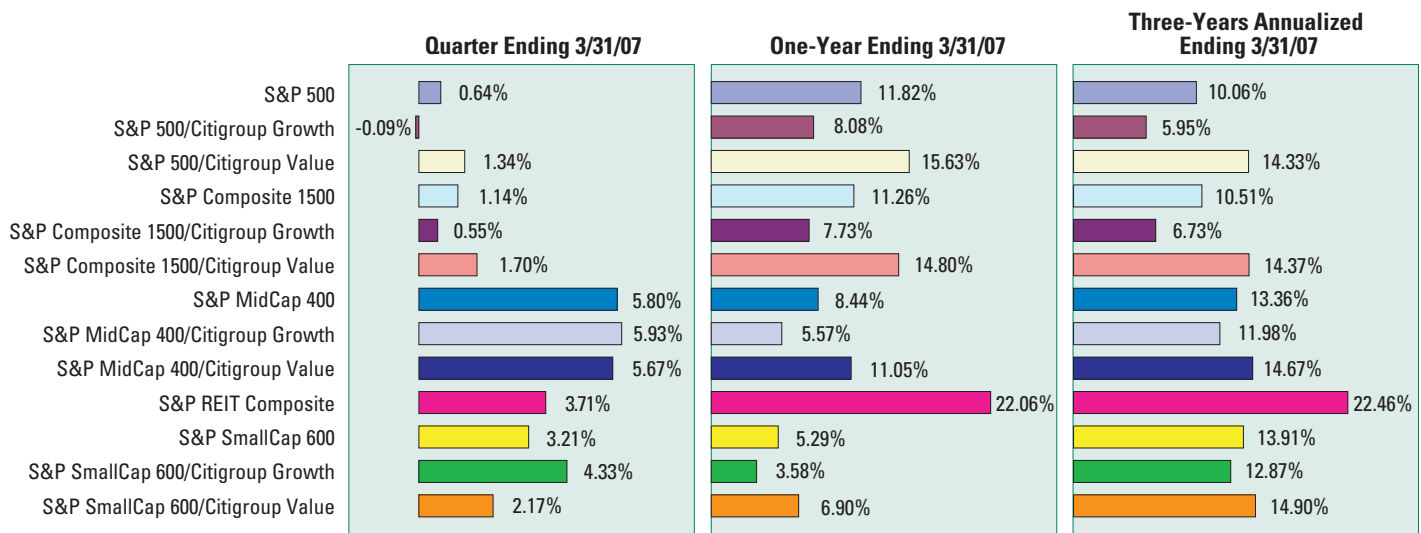


*Index returns shown are total returns, which assumes the reinvestment of dividends paid on the securities constituting the index.*

## 1<sup>st</sup> Quarter U.S. Equity Review and Outlook

Despite the February and March sell-offs, the U.S. equity market gained over the three-month period. Mid caps led the charge, followed by small caps then large caps. Growth exceeded value in mid and small, yet the reverse applied to large caps. REITs gained for the quarter, benefiting from a strong January that exceeded February and March corrections.

In the near-term, S&P Equity Strategy believes that the S&P 500 Index appears likely to trade sideways over the coming months as numerous macroeconomic factors will combine to prevent a major break in either direction. Supporting equities are low valuations and, in S&P's opinion, the Federal Reserve's slightly more dovish March 21 policy statement has reassured investors that should rising sub-prime delinquencies spread to the broader prime mortgage market (85% of the mortgage market), the FOMC is prepared to ease interest rates in order to stimulate the economy, assuming core inflation remains relatively contained. On the flipside, in S&P's estimation, significant near-term upside is limited by a dramatic deceleration in corporate earnings growth. Additionally and apart from the Fed's more dovish leanings, year-over-year core inflation of 2.7% is running ahead of the Fed's 2% target. Should pricing pressures fail to moderate, future interest rate cuts may be potentially delayed or limited. Finally, given the ongoing housing-driven weakness in the economy, S&P believes investors are counting on rate cuts by third quarter of 2007 (based on Fed fund futures) to ensure a soft landing. Any delay in easing interest rates is likely to be greeted negatively by investors, in S&P's view.

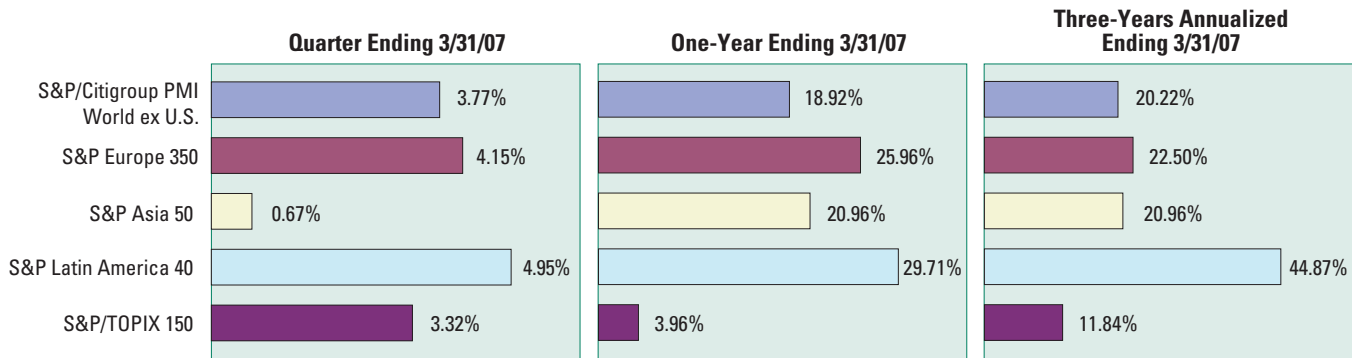


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## 1<sup>st</sup> Quarter World Markets Review and Outlook

International equity markets, both developed and emerging, fared better than the U.S. during the quarter, due to continued merger & acquisition activity plus better prospects for corporate earnings spurred by domestic demand. The S&P/Citigroup PMI World ex U.S. index rose 3.77%, prompted by gains in both European and Japanese markets. For emerging markets, Latin America was the biggest winner as the S&P Latin America 40 index climbed 4.95%. By S&P's analysis, improving European, Japanese, and emerging market domestic demand has rendered foreign companies less dependent on U.S. exports for growth, yet confidence in the health of the American economy remains a key driver of international equity performance. S&P believes confidence in the U.S. economic outlook continues to have a significant impact on international equity valuations. This is evidenced by persistently high correlations between U.S. and international markets, and the repeated inability of foreign stocks to dodge heightened risk aversion stemming from U.S.-centric issues.

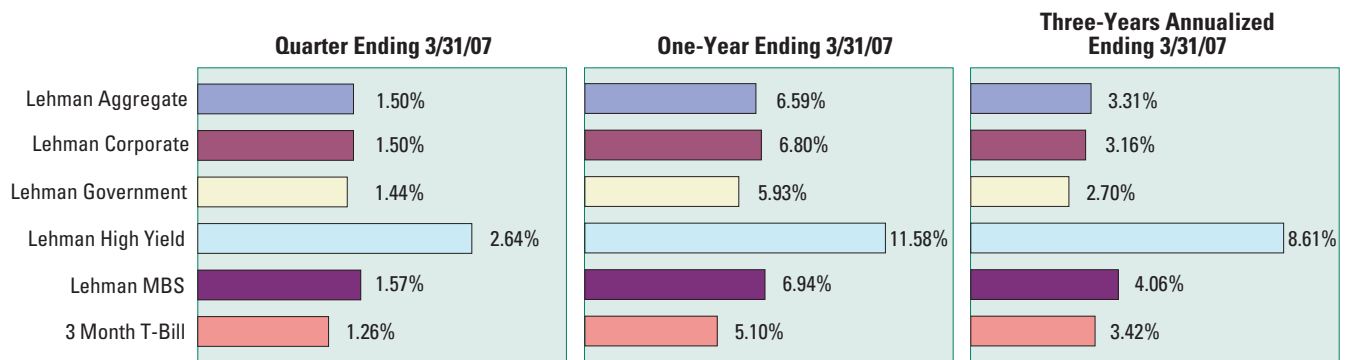
With 2007 earnings growth expected to slow dramatically in the U.S. and most developed international markets, S&P believes earnings expansion will prove difficult this year. For emerging markets, S&P forecasts a year of sideways trading, which will allow this asset class to digest its significant gains and leave it poised for further developed-market outperformance in the future. Downside appears relatively limited, in S&P's view, given ongoing robust economic growth, and earnings momentum coupled with fair valuations. Overall, S&P expects the current moderate and steady decline in the U.S. dollar to continue. A weaker dollar enhances international equity returns for U.S. investors.



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## 1<sup>st</sup> Quarter Fixed Income Review and Outlook

The modest decline in Treasury yields benefited fixed income markets as they posted positive returns for the three-month period ended March 31st. Investors flight to quality from the stock market downturns pushed yields down. The Federal Reserve held the federal funds rate unchanged, at 5.25%, following both January and March FOMC meetings. TIPS (Treasury Inflation-Protected Securities) are indexed to inflationary indicators and they benefited from the increased pricing pressures to the core CPI. Credit spreads remained tight during the quarter. Despite the seasonality of the winter months, home-loan applications and refinancing continued its downward trend, yet the 30-year mortgage rate remained relatively unchanged at 6.16% as of March 31. Global monetary regulators increased interest rates, which were reflected in the increased yields of 10-year bonds.



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