

BROOKMONT CAPITAL MANAGEMENT

“A BUGG’S LIFE”

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March 11, 2007

Optimism is Scarce

It is impossible to remove the human psyche from the health of our economy, the direction of the stock market, and from any other variable where human sentiment is involved. We can convince ourselves that anything is getting better, or worse, even if the data does not support the way we think. Many events are simply self-fulfilling prophecies as we collectively talk ourselves into it happening.

Probably more than anything else, the economy hinges on our outlook for the future. If we believe the future is uncertain, consumers will cut back on their spending, corporations will freeze additional hiring, and wage growth becomes almost non-existent. February’s monthly labor report is a prime example.

In February, non-farm payrolls declined by 63,000. That number would have topped 100,000 if not for aggressive hiring by the government. And although the unemployment rate actually declined by 0.10%, it was the result of 450,000 Americans falling out of the labor pool. Manufacturing companies cut 52,000 positions in February, which became its 20th straight month of declining employment. The construction sector shed 39,000 jobs during the month, and finance companies have now eliminated 120,000 positions in the past fourteen months.

Whether our economy is now in a recession is open to debate, and most Americans have their own opinion on this subject. But the February Employment Report is one more piece of evidence that our economy is flat on its back.

Other economic data supports the argument that if the economy is not currently in a recession, it’s not far from it. The Conference Board’s most recent report on consumer sentiment indicates a growing consensus among Americans that a recession has become a reality. The report’s findings show that consumer sentiment has reached a 15-year low, and our expectations for the future are now at a 17-year low.



As well, housing and auto sales demonstrate a very timid U.S. consumer. You might remember from a previous newsletter where we stated any economic recession in 2008 would hit consumers harder than it would investors. This would be a reverse from the 2001 recession when consumer spending remained healthy, but the S&P 500 dropped by more than 40%. This time around, consumers are faced with higher unemployment, rising inflation, stagnant wages, falling home prices, and a stricter credit environment.

As with any economic environment, there are areas of weakness and areas of strength. It’s no different this time around:

The bad news:

- Existing home sales have fallen 24% year-over-year
- Inflation has jumped from 2.1% to 4.2% in the past twelve months
- Number of unemployed Americans has risen from 7 million to 7.5 million in the past year

The good news:

- Exports have risen significantly
- Factory orders are firm
- Personal Income up 7% in twelve months
- Retail sales up 4% year-over-year
- Earnings expected to rebound in 2nd half of 2008

According to Standard and Poor’s, there are several issues we will face if the economy falls into a recession. According to their research, recessions last on average about 11 months, the stock market normally drops about 36% during an economic downturn (the Dow is off 20% from its one year high), and the rate of unemployment rises about 3% (currently up 1.4% from the most recent low). That said, if we have fallen into a “normal” recession, there is more pain to be felt.

Although economists doubt that our economy will avoid going into a recession in 2008, they do believe that it should be short and shallow for several reasons. For starters, the most recent economic expansion was more restrained than those in the past. Second, the Fed has aggressively reduced short-term interest rates, which should keep resets on adjustable-rate mortgages from skyrocketing, and has also injected millions of dollars into the economy to motivate more lending activity. Third, Congress acted quickly to add stimulus to the economy via a tax rebate.

There is still an outside chance that our economy will escape going into a recession, but time is running out. For this to occur, we would have to see a major retreat in oil prices, a rebound in the stock market, or a considerable jump in consumer spending resulting from refunds on 2007 taxes and the upcoming Stimulus Plan rebates.

Fourth Quarter Earnings

Now that fourth-quarter earnings announcements are winding down, the market's can look toward the future with the hope that we have seen the bulk of the damage from the credit markets. The Financial sector just posted a horrible quarter as earnings fell 109% year-over-year. Even worse, 59% of companies in the Financial sector reported below analyst's already-reduced expectations. In fact, the sector reported a \$51 billion decline in earnings from what was expected when the fourth-quarter got underway (October 1). The meltdown occurred quicker and more severe than what anyone expected and the sector posted an overall \$5.1 billion loss during the fourth quarter.

Whether the Financial sector will see a rebound this year is

anyone's guess. As of today, the Financial sector is expected to post another horrible quarter with earnings expected to fall 23% (year-over-year) during the first quarter of 2008. Earnings warnings continue to be a daily event and now the concern has turned toward home-equity loans.

The earnings outlook is not as bleak for the other sectors of the economy. Energy companies are expected to post a 24% increase in earnings during the first three months of 2008 as higher crude prices offset higher expenses for exploration and refining. While the outlook for energy company earnings may appear favorable, there are several risks to consider. For one, profit margins are at risk as crude oil prices are more likely to fall (from today's price of \$107/barrel) than are the expenses related to exploration and refining. Second, 46% of the companies in the Energy sector reported fourth-quarter earnings that were below analysts' expectations. And third, the Energy sector has outperformed for four years and these trends in the market generally reverse course.

Overall, earnings growth for the S&P 500 fell nearly 3% in 2007. The markets will have to suffer from two more quarters of negative earnings growth before rebounding during the second half of the year. With analysts projecting a 15% earnings growth for 2008, and negative growth projected for the first six months of the year, optimism is incredibly high for the third and fourth quarters. Currently, earnings growth projections stand at 54% for the fourth-quarter, based entirely on year-over-year improvement by the Financial sector.

The bottom line is this: earnings growth will rebound during the second half of the year simply because their year-over-year comparisons will be easy to beat. On the other hand, analysts are too optimistic about earnings for

Sector Returns as of March 10, 2008

<u>Sector</u>	<u>March</u>	<u>YTD</u>	<u>One-Year</u>
Energy	-4.51%	-9.24%	25.98%
Materials	-6.48%	-8.48%	8.61%
Industrials	-4.11%	-9.51%	0.57%
Consumer Discretionary	-4.73%	-9.77%	-20.29%
Consumer Staples	-0.86%	-6.40%	5.82%
Health Care	-4.42%	-11.36%	-4.89%
Financials	-9.01%	-19.74%	-31.77%
Information Technology	-2.15%	-17.93%	-1.70%
Telecommunications Services	-2.81%	-20.80%	-11.97%
Utilities	<u>-0.07%</u>	<u>-12.44%</u>	<u>-0.96%</u>
S&P 500	-4.18%	-13.28%	-9.54%

the latter part of 2008 and these will have to be readjusted lower.

So how has the individual investor reacted to the concerns in the market? Mutual fund investors have been bailing out of their holdings during the first two months of the year. More than \$41 billion was liquidated from stock funds in the month of January, and another \$13 billion has been sold in February. On the other hand, nearly \$20 billion flowed into bond funds in January and \$134 billion was deposited into money market funds.

While \$54 billion in liquidations may sound like a large number, keep in mind that there was more than \$6.5 trillion held in equity mutual funds at the end of 2007. Investors are also liquidating their international holdings. Nearly \$9 billion in World Equity Funds was sold in January, the second straight month of net redemptions for that market sector.

For all the talk about why the US stock market would trail other markets around the globe, the first two months of the year have proven that rock-solid predictions don't always come true. Faster economic growth in foreign countries, the declining US dollar, the mortgage crisis, and reduced foreign investment were reasons why the US stock market would underperform in 2008. Ironically, the US dollar has declined even further than expectations and is having a negative impact on countries that depend upon its exports (i.e. Japan). As a result, many foreign markets have suffered from a larger decline than the U.S.



So why is the U.S. dollar in a protracted decline against most foreign currencies? In the case of the greenback, the primary drivers of a currency's value are all currently negative. This includes declining economic growth, declining short-term interest rates, inflation fears, and lowered confidence in the financial health of the U.S.

Index Returns

<u>Index</u>	<u>March</u>	<u>Year-to-Date</u>	<u>One Year</u>
S&P 500	-4.18%	-13.28%	-9.54%
S&P Mid-Cap	-5.32%	-13.19%	-10.90%
S&P Small-Cap	-4.95%	-12.79%	-14.59%
Dow Jones	-4.14%	-11.50%	-4.74%
NASDAQ	-4.22%	-18.22%	-9.75%
EAFE (Intern'l)	-4.11%	-12.22%	-5.91%

(As of 3/10/08)

Government. Rising oil and gold prices also play a role in pushing the U.S. dollar to lower levels.

Markets Fail to Respond

There is a misconception that stock prices normally rise when interest rates are falling. If you remember back to 2001-2003, the Federal Reserve cut interest rates over and over until they reached historic lows. During that same period, the S&P 500 actually fell about 1%.

The most recent Fed cuts started back in September 2007, and short-term interest rates have fallen from 5.25% to 3%. Stock prices, however, have yet to benefit from the Fed's actions. Since the initial round of rate cuts, the S&P 500 has fallen nearly 15% and the NASDAQ is off by 16%.

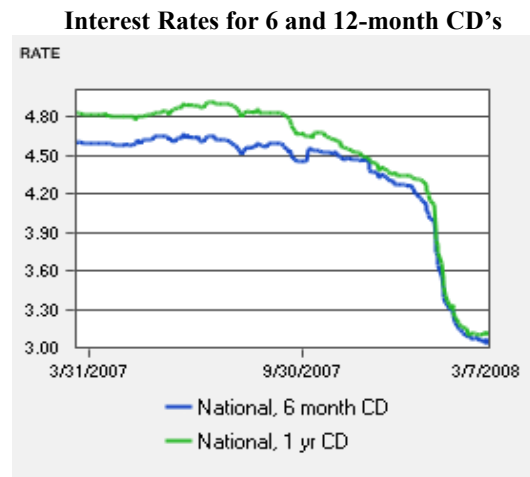
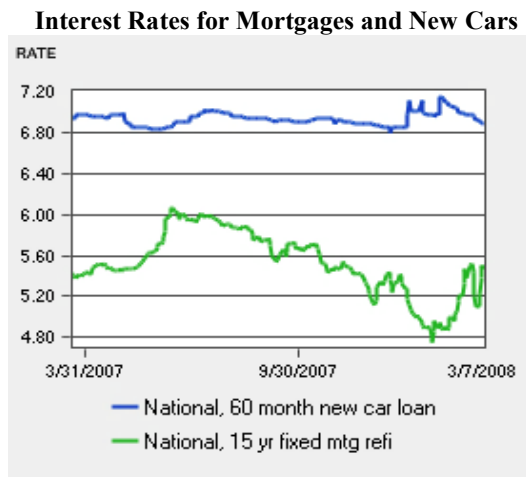
Expectations are that the Fed will continue to cut short-term interest rates at its next meeting on March 18. The Futures Market is currently forecasting a 100% probability that the Fed will cut interest rates by another 50 basis points, bringing the Fed Funds rate to 2.25%. Although it appears that the bond market has priced in an additional 50 basis reduction, Treasury yields continue to fall on a steady basis.

Treasury Yields

	<u>Yield</u>	<u>1-Yr High</u>
6-Month	1.44%	5.12%
1-Year	1.40%	5.00%
2-Year	1.49%	5.06%
3-Year	1.67%	5.09%
5-Year	2.39%	5.13%
7-Year	2.83%	5.16%
10-Year	3.46%	5.20%
20-Year	4.37%	5.37%

The Fed's Actions Hurt Savers...And Not Much Help for Borrowers

With a significant reduction in short-term interest rates, it is no surprise that the Fed's actions have come at the expense of "savers." On the other hand, it would seem realistic that "borrowers" would be the beneficiary of lower short-term interest rates. However, this hasn't been the case. While banks have been apt to reduce CD rates at a fast clip since September, the rates they charge for new mortgages and auto loans have not moved at all. The reason is simple. Most banks are not aggressively lending as they continue to charge-off existing loans.



The Brookmont Dividend Equity Portfolio

Our "core" portfolio consists of 40 individual stocks which provide a dividend yield that is much higher than the S&P 500. Year-to-date, our performance is significantly higher than the major market indices (S&P 500, NASDAQ, and Dow Jones), as well as our specific benchmarks.

We have recently added two new names to the Dividend Equity Portfolio, including our first holding in the Technology sector. McDonald's is another recent addition to the Portfolio. Yesterday, McDonald's reported nearly a 12% increase in same-store sales, a growth rate that is unheard of in such a mature and competitive industry. The company also reported a 20% increase of sales worldwide. On top of the impressive sales growth, McDonald's has raised its quarterly dividend by 45% over the past two years.

Where the Portfolio has shown its mettle, however, is during down days in the markets. This past Friday was a perfect example as the Dow Industrials fell 1.22% and the Dividend Equity Portfolio was off 0.18%. While past performance is no guarantee for future returns, it does verify that preservation of principal is a major attribute of the Portfolio. And if you are a fan of Warren Buffet, you will be happy to know that he has been a major buyer of three names that are included in the Dividend Equity Portfolio.

For more information on the performance and current holdings in the Portfolio, please call or send us an e-mail.

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