DAVIDSON CAPITAL MANAGEMENT

QUARTERLY REVIEW

FALL 2007

MARKET COMMENTARY

Since the market lows recorded in 2002, general market averages had been on a relatively stable recovery track until mid-July when they retested their all-time high valuation points as measured by the S&P 500 and the DJIA. During this period of over four years, the momentum of the market's rise ebbed and flowed but there had not been a correction of as much as 10% since the recovery began. This period of relatively low volatility came to an end this summer when the market recorded a correction of over 10% in less than a month triggered by the growing concerns over deteriorating trends reported in the sub-prime mortgage market and their gradual spread to the high-yield debt market.

The deterioration in the sub-prime mortgage area, although well contained initially, created increased investor concerns as hedge fund investors and then the credit markets were pulled into the weakness by fear and uncertainty as to the health and liquidity of the mortgage backed securities market and the fixed income markets in general. A trend that began as a well contained credit problem for a small percent of home buyers and aggressive high-yield fixed income investors soon became a drag on the financial markets that could not be ignored. As a result of these concerns, the Federal Reserve acted decisively with a 50 basis point cut in both the Federal Funds Rate and the Discount Rate at their September meeting. This rapid response restored liquidity to the financial markets over the near-term but the underlying problems created by the excesses in the sub-prime mortgage market will take some time to correct. $1.2 trillion in adjustable rate mortgages are due to be reset over the next year and the increase in monthly carrying costs will make it difficult for many recent home owners to keep up with increased monthly payments.

In spite of the recent volatility within the financial markets, our overall economic outlook for 2007 has changed only modestly over the last three months.

Estimated GDP growth for the full year 2007 is currently projected to be in the area of 2.2%. The slowdown from last year's rate of 3.3% is a result of the relatively short inventory correction experienced during the first quarter coupled with a continuing modest slowdown on consumer spending that is expected to result from the weakness within the housing and auto markets. Real Consumer Spending growth should average 2.3% for the full year while Government Spending is expected to grow by 2.2% and Corporate Spending will continue to increase at a rate above 3%. Real Disposal Personal Income is continuing to rise and we anticipate continued strong growth in foreign demand for US goods and services as the dollar remains weak and international economic growth moves along at a healthy pace.

Economic growth in 2008 is expected to show a modest pickup with Real GDP gains in the area of 2.6%. The expectation for Real Consumer Spending growth is in the area of 2.6%, which is modestly higher than current trends based on reduced interest rates and continual growth in real wages. Real Government spending should show gains in the 2.5% area as the increase in tax receipts and political positioning next year will fund spending initiatives. Business Investment Spending could once again prove to be the area of strongest relative growth during 2008 based on strong corporate balance sheet positions coupled with continuing healthy cash flow gains and the need for capacity expansion and modernization within many

industries. Housing Starts will likely bottom out by mid-year, however, any initial recovery will still be relatively modest given the high level of unsold housing inventory expected to be present.

Inflationary trends next year could prove to be an area of growing concern. The core inflation rate has only recently slowed to the high end of the Federal Reserve's comfort range of 2%. Following the Federal Reserve's seventeen quarter point increases in the Federal Funds Rate between 2004 and 2006, the rate had remained unchanged for the past fifteen months. The recent half point cut to 4.75%, though viewed as necessary to provide additional liquidity to the system, may put pressure on the US Dollar adding to inflationary pressures over the next year. Average domestic wages are running at a rate of growth of over 3.8% above last year's level and unemployment rates continue to be relatively low at 4.6%. During the seventh year of the economic recovery, increases in incremental productivity growth will be at a rate well below compensation gains resulting in growing inflationary pressure. For the full year 2008, inflation growth expectations, as measured by the Consumer Price Index, will be a gradual increase to the area of 2.8%.

EQUITY MARKET

Entering the seventh year of the current economic recovery that began in the fourth quarter of 2001, most of the fundamental supports for the equity markets remain strong. Earnings for the S&P 500 are expected to grow by 8.5% for the full year 2007 to $95.00. Current projections for 2008 call for an incremental earnings gain of 6% to the area of $100. The major equity markets have shown good appreciation over the past four years, however, earnings have recorded even sharper gains resulting in valuation levels that remain attractive based on historic averages. Based on current earnings estimates, the S&P 500 is being valued at 16.1 times 2007 results and 15.3 times projected earnings for 2008. The market's volatility over the past few months has wrung out a number of areas of "irrational exuberance" and increased the level of skepticism which should be viewed as a positive development as we move forward.

IS CHINA ABOUT TO OVERTAKE THE US

One often hears "most of the products at Target/Wal-Mart and other stores are now made in China; soon everything will be built over there." The seeming proliferation of Chinese made products, as well as this summer's product recalls of many toys made in China due to lead/quality concerns, have placed the spotlight on China's manufacturing practices. According to the National Association of Manufacturers (NAM) in 2006 the US produced $1.4 trillion in manufacturing goods, or 12% of the US Gross Domestic Product. This places the US as the number one manufacturer of the world. China is third behind Japan.

Why the perception that China is taking over? Many of the simpler manufacturing processes have shifted to Asia. The US specializes in higher valued products such as chemicals and pharmaceuticals, food, beverages, and tobacco, computer and electronics, machinery, motor vehicles and parts, transportation equipment, paper products, plastics and rubber. As noted in the table, the US holds as the #2 manufacturing exporter standing behind #1 Germany. China has now overtaken Japan as the #3 world exporter.

"What you do speaks so loudly that I cannot hear what you say." Ralph Waldo Emerson

Currently, earnings momentum is slowing, but profitability and cash flow levels remain high and balance sheets are strong with relative liquidity in most economic sectors. While domestic growth has moderated over the pace of two years ago, the US market is being increasingly influenced by global growth that continues to be healthy and provides continuing stimulus to domestic demand. The recent volatility within the mortgage and high yield markets has created a good deal of uncertainty, however, the recognition of the risk inherent within these areas of leveraged debt financing may limit the continued expansion of leveraged acquisitions and bring a healthy level of skepticism and conservatism back into both the equity and the fixed income markets.

As we move into 2008, the overall economic outlook is viewed as relatively positive with some lingering fallout from the recent sub-prime mortgage and high-yield debt markets continuing to create a degree of nervousness. In addition, with the political campaign season taking off, the rhetoric and alternative political platforms and priorities are likely to add to the near-term uncertainty of the general market. Within this type of investment environment, sound fundamental analysis and a focus on individual security valuation levels will become increasingly important in providing attractive relative investment returns.

FIXED INCOME MARKET

There are qualities of the current bond market that are reminiscent of the early 1980's and 1990's, as well as September 11th. Fear of illiquidity resulting from credit concerns has pushed the Federal Reserve and global central banks to inject more money into the system with overnight operations, including the acceptance of mortgage collateral. The recent drop of 50 basis points in the Federal Funds overnight lending rate has only moved the 3-month LIBOR (London Interbank Offered Rate) down 15 basis points vs. the average of two months ago prior to the recent credit concerns in the market. The problem is that a majority of variable rate mortgages reset off of LIBOR, as do many other securities,

S IN THE MANUFACTURING OF GOODS?

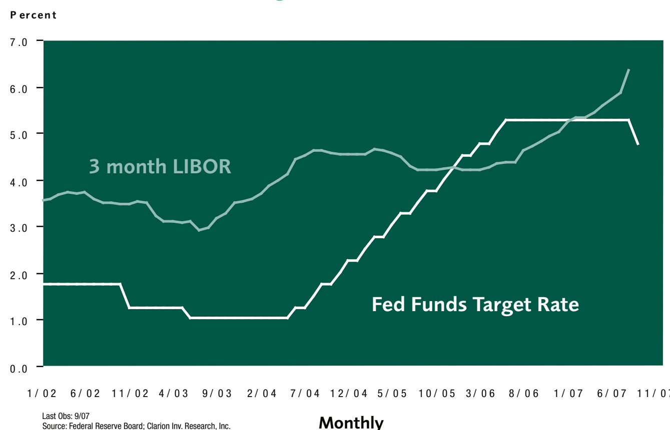
MANUFACTURING EXPORTS*	
Germany	$810 billion
United States	$730 billion
China	$680 billion
Japan	$580 billion
France	$370 billion
United Kingdom	$300 billion

*Source-Comtrade 2005

Nurturing young people to follow a career in the field is among the challenges facing US manufacturing. In the NAM Institute 2005 skills gap survey 81% of the respondents could not find workers with the necessary math skills to operate advanced machines. Another significant long-term challenge is the US business environment. It is noted that 31.7% of US manufacturing costs are comprised of taxes and health care costs.

The United States remains a manufacturing giant, paying wages and benefits approximately 25% higher than non-manufacturing jobs, and this sector of the economy multiplies every dollar spent into an additional $1.37 in economic activity, greater than many other sectors. The long-term challenge is to continue to open additional markets for US goods throughout the world.

including the very large swap market. The net effect of the Fed ease on these financial instruments will be minimal.



Remember all of the inflation we exported to China by purchasing cheaply manufactured goods? Their inflation rate has been climbing, goods will now cost us more until we find alternative suppliers, and that inflation will be imported back to the US. When the Federal Reserve puts the economic numbers together the result is a greater concern for inflation in the future.

The best performers of late are Treasuries as a result of headline risk causing a flight to quality. Agency spreads have widened an additional 20-30 basis points but are still a viable alternative in this ever changing environment. With the 50 basis point drop in the Federal Funds Rate, we have seen the commercial paper market fall a measly 25 basis points, bonds tightening an average of 10 basis points, and agencies coming in 5 basis points. The translation here is that the market itself is expecting the Federal Reserve to raise rates next year. Market projections range from no change to a 75 basis points reduction for the Fed's next move this year. Concerns of inflation and a very positive yield curve will force the Fed into raising rates a minimum of 50 basis points in 2008.

So who are the biggest losers? The concentrated pockets of sub-prime credit and any organization specializing in sub-prime lending or holding sub-prime debt in their portfolios. Unfortunately, as the true holders of this debt take the fall, they are dragging all of the credit markets with them. Corporate bonds have experienced a relative fall in prices vs. Treasury securities.

Do not be dismayed. As the cycle of the latest headlines pass, spreads will return to "normal" relative value relationships. The economy will hopefully keep the yield curve positive. The Fed will provide as much liquidity as needed to build confidence in the US credit markets.

AT THE FIRM

Stephen Burns passed the CFA Level II exam. Congratulations Steve!

Ernest Cecilia, CFA was quoted in the Philadelphia Inquirer article entitled *Opportunity: Bargain hunt on among local money managers*. To view: http://www.philly.com/inquirer/business/9213466.html

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