



## The economic expansion is still showing sustainable, well balanced, positive growth trends as we move through the sixth year of the economic recovery.

During the first half of 2007, however, the financial markets have experienced increasing volatility based on several fundamental cross currents. In fact, so far this year, there have been 15 days of 1% moves in the Dow Jones Industrial Average versus 24 in *all* of 2006. In the first quarter, economic growth, as measured by real GDP slowed to 0.7% growth rate, with domestic corporations reducing their inventory levels and domestic demand grew by 2.4%. This slowdown in corporate spending came at a time when consumer spending was moderating in response to higher energy costs. Investor nervousness generated by these trends was only compounded by the weakness in the housing market that was gaining increased attention due to higher mortgage rates and tightened lending standards resulting from increased default rates among the sub-prime mortgage categories.

In spite of the pronounced slowdown in the first quarter, momentum has already begun to pick up and full-year estimates for Real GDP growth remain in the area of 2.4%. The brief inventory correction has left the corporate sector in an improved position to continue positive production momentum through the remainder of the year. Corporate balance sheets remain highly liquid in aggregate, with little risk of building credit concerns at the corporate level over the year ahead. While foreclosure rates in the sub-prime mortgage market are expected to continue to rise over the next three quarters due to the resetting of adjustable rate mortgage interest rates, this area of weakness is viewed as well contained in the high yield investment arena and sub-prime mortgage markets in general.

Fortunately, despite the recent soften of economic trends, the economy continues to enjoy many positive supports including: continued relatively low real interest rates across the maturity spectrum; a weakened dollar that increases the competitiveness of domestic goods in international markets; a continued low unemployment rate of 4.4%; consistent real wage gains over the past year; continued strong gains in corporate profits over the past five years; and historically strong corporate balance sheets with above average liquidity levels. As a result of these continuing positive trends, the economy should rebound in the second quarter and close out the full year with GDP gains along the order of 2.4%. This reacceleration of momentum should continue into 2008 with a preliminary projected gain in Real GDP of 2.6%. During the full year of 2007 Real Consumer Spending is currently expected to grow in the area of 2.6%, while Government Spending should grow by 2.2% and Corporate Spending will continue to increase at a rate above 3%.

The slowdown in economic momentum experienced in early 2007 should not be viewed as especially troubling given that we are currently in the sixth year of the economic recovery that began in the fourth quarter of 2001. This recovery has already exceeded the average duration of a post World War II recovery by a full year with little evidence of reaching its full potential. The drawdown of excess inventories in the first quarter will serve to improve corporate spending trends through the remainder of the year. Core inflation should average 2% to 2.5% over the next year as labor costs move up while commodity price increases experience some moderation.

## EQUITY MARKET

While the outlook for the economy has continued to show positive growth over the past year, the financial markets have begun to show increasing volatility based on the numerous fundamental and geopolitical trends expected to impact the investment environment over the next year. While there are still fifteen months remaining before the general election in November of 2008, the political rhetoric is already heating up as a large number of candidates compete for voter interest and media attention. Looking ahead, this increased partisanship will only intensify. This environment is likely to create increased investor uncertainty and nervousness within the market even as corporate profits continue to improve. While this near term environment is likely to create continuing volatility within the financial markets, our outlook for the equity markets for the remainder of the year stands reasonably positive.

Based on expected levels of core inflation growth, the Federal Reserve Board is not expected to lower the discount rate anytime soon nor are they expected to increase it during the next few months. It has been over a year since the Fed has raised the discount rate and our view calls for continuing stability over the remainder of this year.

## HOUSING MARKET

Following three years of record housing sales, both new and existing home sales have fallen significantly over the past year. As of the May results, new home sales have declined by 10.8% over comparable 2006 levels and existing home sales are down 15.8%. While mortgage interest rates have risen only moderately over the past eighteen months, the pressure being placed on holders of Adjustable Rate Mortgages has been much more severe.

Industry data shows that only 16% of the residential mortgage market is in floating rate debt and a smaller 8.6% is being held by mortgagees with low credit ratings, also known as sub-prime debt. While this proportion is not a large portion of the total mortgage market, it is creating concern as an estimated \$720 billion in Adjustable Rate Mortgages came due for an interest rate reset in 2006 and an additional \$1.2 trillion will come do for a reset this year. As adjustable rate mortgages were aggressively sold during 2003 through 2006, many of the mortgagees are relatively recent homebuyers with little in the way of built up equity in their property. As of year end 2006, 13% of the sub-prime adjustable rate mortgagees were delinquent in making their mortgage payments and 2.3% of these mortgage holders had started foreclosure proceedings.

Considering that the general economic environment remains positive over the year ahead, the general housing market is already in a slump that will likely last through the fourth quarter.

This recent decline in housing activity coupled with the higher interest rates and recently tightened lending requirements has resulted in lower housing demand and a sharp increase in the stock of unsold homes. On average, the number of months required to sell a new home was 7.1 months in May compared with an average of 6.4 months in all of 2006 and 4.5 months in 2005. The inventory supply data for existing homes is higher at 8.9 months representing the highest inventory level since 1992.

The current softness in the housing market is expected to continue through the fourth quarter followed by gradually improving trends as we move into 2008. This pressure, though significant to the industry, is expected to be well contained within the sub-prime lending market and should not result in overall economic weakness. However, these trends may result in the beginning of a return to more normalized risk premiums for the high yield debt market over the next few quarters.

## INTEREST RATES

The Treasury curve has had many influences over the past year including foreign demand, supply issues, mortgage portfolio rebalancing, pressure on the dollar, and shifts in the Federal Funds forecast, just to name a few. With all of this pressure on bonds we have seen the ten year Treasury trade between 4.42% all the way up to 5.32% over the past year. The average yield has been 4.76%; we have been active buyers at 5.10%. We look for a trading range of 4.60% to 5.25% through the end of 2007, with summer seasonal trends to push rates down. Good news for total return accounts!

Spreads on corporate bonds widen every time we see sub-prime mortgage headlines spreading negative news. As mentioned previously, the fact of the matter is that the actual percentage of the sub-prime market with the potential for a default is relatively small; about 1.5% of the entire mortgage market. Most of the headlines are a result of concentrated purchases of these securities. We have timed our purchases of corporate securities as spreads widen and yields rise, taking advantage of headline risk.

*For now, the Federal Reserve will remain on hold finding no significant expansion or contraction in the United States economy. The rest of the globe has been catching up to some of the interest rate movements initiated in the U.S. As global rate increases cease and the global economy finds a new comfort zone, the Federal Reserve will have a better opportunity to further evaluate the need for an increase or decrease in rates domestically. Until then, it is steady as she goes.*



## AT THE FIRM

At the May Board of Directors meeting of Davidson Trust Company, the following promotions were recommended and approved:

William S. Covert, CPA has been promoted to Chief Financial Officer

Anne Bartolomeo DeSipio has been promoted to Vice President

Steven R. Klammer, Esquire was promoted to President

Mary Lisa Powers has been promoted to Vice President

Bernadette Simmons has been promoted to Investment Officer

*"I am very proud of our team and appreciate their efforts in building the firm's professionalism and performance."*

-JIM DAVIDSON

### Investment Management Team

James M. Davidson  
*Founding Partner*

Ernest E. Cecilia, CFA  
*Partner*

Joseph J. Costigan, CFA  
*Partner*

Malcolm C. Wilson, CFA  
*Partner*

James J. Wright, CFA  
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J.L. Keefer-Hugill  
*Vice President*

N. Ray Sague, CFA  
*Vice President*

Stephen R. Burns  
*Investment Associate*

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Steven R. Klammer, Esq.  
*Partner*

Cole P. Vastine, ChFC  
*Partner*

Glen Reyburn  
*Senior Vice President*

Mary Lisa Powers  
*Vice President*

Monica C. Ahern  
*Trust Officer*

Margaret M. Shirey  
*Trust Officer*

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Anne Bartolomeo DeSipio  
*Vice President*

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William S. Covert, CPA  
*Partner*

Vjecko Dimter  
*Technology Officer*

Mary Talbutt-Glassberg  
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Jacqueline Pasquarello  
*Vice President*

Bernadette J. Simmons  
*Investment Officer*

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Maryann DeSanto

Rosemary DuFrayne

Joanna Eill

Deborah A. Groark

Marie Jacob

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We know you are concerned about the confidentiality and security of your nonpublic personal and other client information you provide to us. Davidson Capital Management does not sell or otherwise distribute nonpublic personal information to other organizations or individuals.

Once your information is on our systems, it is protected from outside access and our employees are not permitted to disclose any information they have access to as a result of their work with outside individuals or organizations. In addition, we maintain physical, electronic and procedural safeguards to protect your nonpublic personal information from unauthorized use.

Should you be concerned about the accuracy of any information we have in our database concerning you, you may request a copy of your records by contacting our office. We will send you a copy of your records for your review and update, if needed.

If you have any questions or comments regarding our privacy policy, please email us at [info@davidsoncapmgt.com](mailto:info@davidsoncapmgt.com)

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