

The U.S. "Negativity Bubble"

Summary: There's a saying in sports regarding trading players: "Sometimes the best trade, is the trade you don't make", since the players can have a better year than expected. I have the advantage of the perspective of writing this review on 4/16/07, a day that saw our average account leap 1.5% and our year to date return approach +4% net of expenses. Since 2003 Growth stocks have had about as much upward movement as an anvil. The easy move would have been to swap growth and chase some value stocks or exotic equities from emerging market countries. The problem would then be: What happens when the US markets get hot? The Chinese stock market sells for 40 times 2007 earnings while the US sells for 15 times earnings. Its so odd that US investors have more confidence in Chinese stocks at very rich prices while US stocks languish at cheap prices. When was the last time we saw 40x earnings? The year was 2000! D'OH!

The wrong trade would have been the trade to swap the anvil-like Growth stocks for the trendy Value and international stocks. In 2007, Growth is in the process of trading its anvil qualities for the upward slope of a David Ortiz home run. All this being said, we have hedged our bets with purchases of several international holdings during the mini-swoon in March, including the ultra-hot Trina Solar. Fortunately, it appears we no longer have to be patient as the emergence of US Growth stocks is upon us. My projection for returns in excess of +15% for 2007 could be conservative.

Credit Suisse First Boston has stated that current conditions favor Growth by the largest margin since 1977. One of the biggest mistakes investors make is chasing performance, you need to let the markets come to you, much like a merry go round. Cycles tend to repeat themselves, this may mean you lag performance-wise for a bit, but averages out in the long run.

U.S. Growth Stocks Are Set To Outperform Value

Bank Credit Analyst - April 19, 2007

A weakening U.S. dollar points to a turnaround in growth vs. value leadership. Last week we argued that the U.S. dollar should depreciate further in the weeks ahead on the back of declining returns on investment in the U.S. relative to the global economy and expectations for diverging monetary policies. Today, we present two U.S. equity implications of a soft dollar. First, the S&P growth index is mostly comprised of sectors that have sizable international sales exposure. Importantly, a soft currency makes their products cheaper to foreign customers, a positive development for revenue growth. Meanwhile, the opposite is true for companies in the value benchmark, as their client base is primarily in the U.S. The upshot is that analysts will continue raising relative earnings estimates in favor of growth companies in the coming months. Bottom line: diverging global economic expectations and a weak U.S. dollar bode well for growth over value.

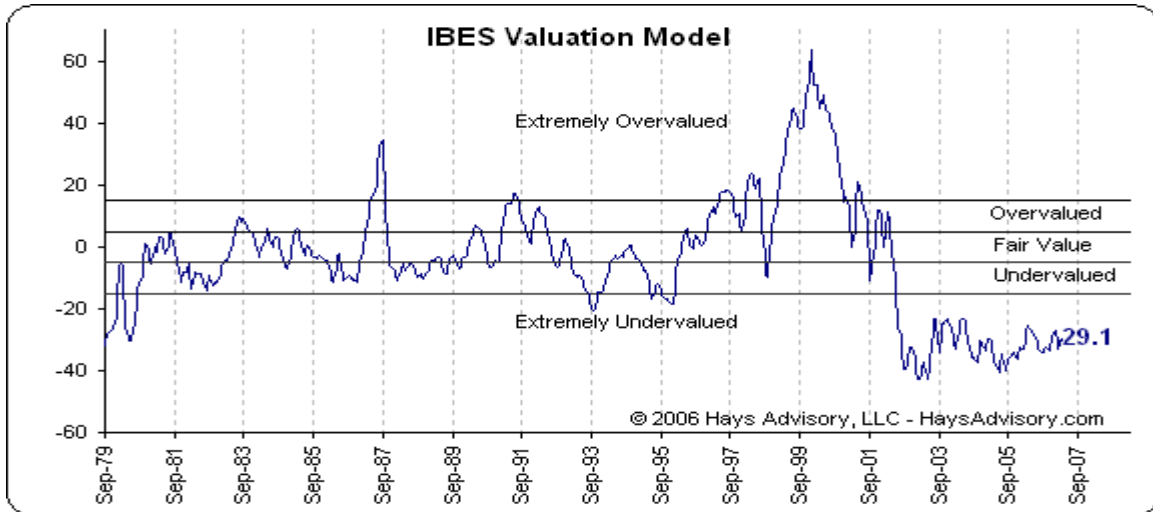
Cheapest Stocks in Two Decades Signal Bull Market

By Michael Tsang, Daniel Hauck and Nick Baker

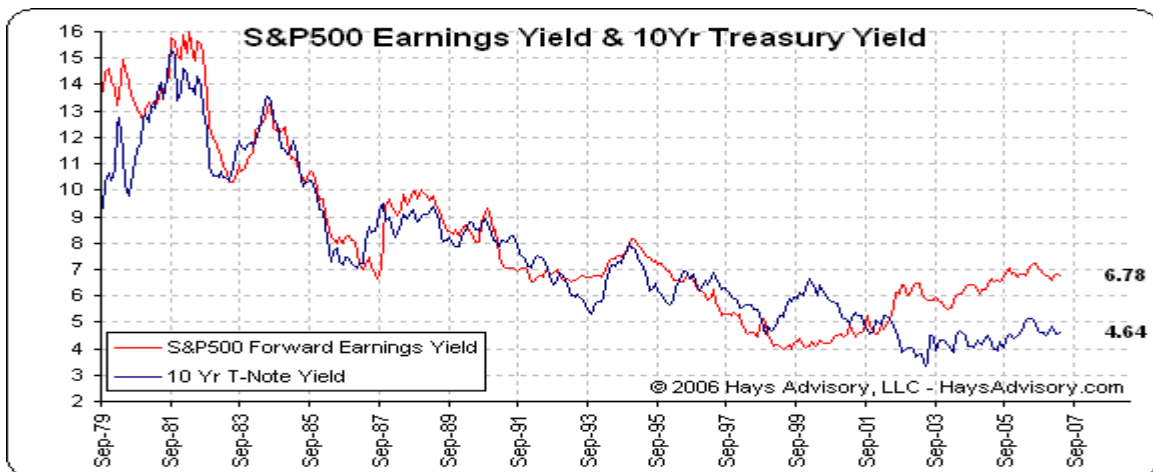
April 2 (Bloomberg) -- The U.S. economy is slowing. Mortgage defaults are rising. And stocks are the cheapest in 20 years, a "buy" signal for some of the world's biggest money managers. BlackRock Inc., Fisher Investments Inc. and Schroders Plc, which manage about \$1.4 trillion, say stocks are inexpensive relative to bonds. Profit of companies in

the Standard & Poor's 500 Index, the benchmark for American equity, is growing faster than shares, and represents a yield of 6.53 percent compared with 4.65 percent for 10-year U.S. Treasury notes. The gap -- the widest since 1986, according to data compiled by Bloomberg -- is encouraging investors because earnings forecasts indicate the U.S. will keep growing, while bond yields show confidence that inflation will stay in check. "I'm on the wildly optimistic side of things," said Kenneth Fisher, who oversees about \$38 billion as chairman of Fisher Investments in Woodside, California. "The economy is stronger than people think it is....."

Despite the rally in '06, stocks remain extraordinarily cheap, especially Growth Stocks. As the chart below reveals, stocks remain 29% undervalued relative to bonds, a disparity that is extraordinarily wide and means that risk is modest while upside potential is significant.



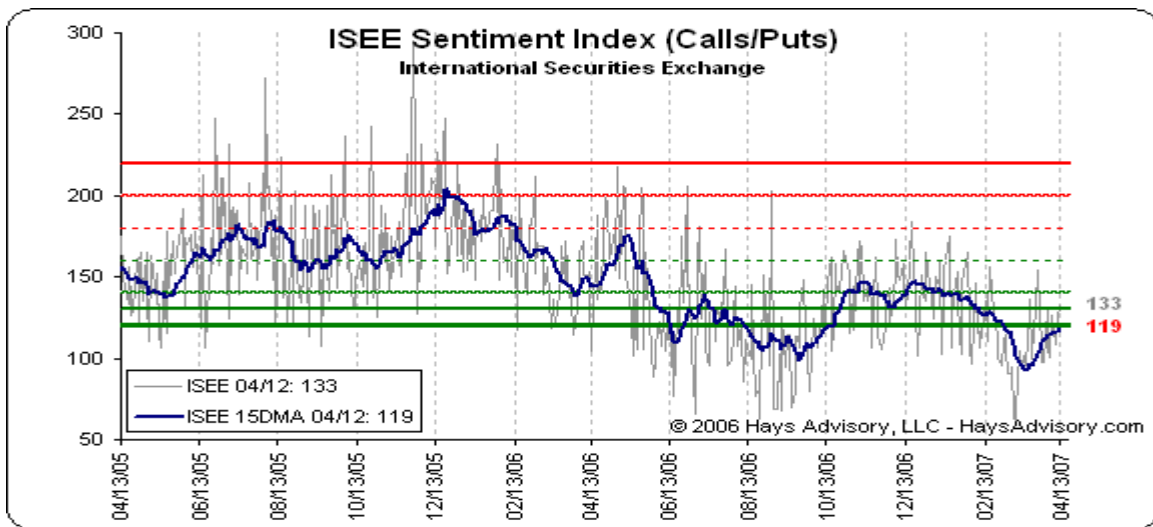
As the chart below shows, stocks tend to track very closely to interest rates, but have delinked themselves since 2002. Money tends to flow to where its treated best, and the “earnings yield” on the SP 500 is 6.78% which is sharply above the 4.64% bond yield. This means stocks remain the more attractive asset with higher return potential.



Historically, the period after the mid term elections is typically very strong for U.S. equities. Despite recent gains the S&P 500 sells for a very reasonable 15 times earnings (P/E), which compares favorably with its average of 23 times earnings. The P/E of the Standard and Poors average has contracted for three consecutive years, but has only contracted 4 times in a row twice

since 1905. Each point of P/E is the equivalent of a 6.6% gain in the SP 500. This means that if earnings growth for 2007 is a modest 7% and the PE moves from 15 to 17, the increase in PE would had 13.3% on top of the 7% earnings gain which amounts to a 20.3% return on U.S. stocks, this is the basis for our being very positive going forward for U.S. Stocks.

The Negativity Bubble: There is a strong belief in the investment community and the general public that the U.S. Stock Market is in a long-term trading range, or a secular bear market. I do not believe this is true. This belief is substantiated by the continual negative slant of the financial news media and the proliferation of Hedge funds, many of which have a negative or market neutral investment bias. I find it astonishing that despite the strength in the US markets that investor polling continues to be at measure of market *bottoms*, not market tops. This “Negativity Bubble” is the only way that a strategist on CNBC can suggest returns of 7% for the year and be considered “very bullish” by the hosts and bearish pundits. The long-term average gain is 8.3%.



This chart shows the investing and trading action of option traders, these traders reflect the significant negative sentiment that exists today. When the indicator is in the green area as it is now, indicates that we are much more likely at a market bottom than a top, which is very positive going forward. Notice when it entered the red zone in December, it coincided with a market peak.

There continues to be substantial evidence that the general public has not returned to the U.S. stock market and that’s confounding when you consider the major indices have recently been registering new highs. Although the general public tends to be a late arrival at any investment party, the popularity of foreign stock exchanges and my own anecdotal surveys indicate that the public is unaware that the SP 500 has risen 96% off the market lows of 2002 while real estate has at best traded sideways for close to two years. Unfortunately this kind of thinking only widens the “wealth gap” in the U.S. Diversification amongst all asset classes is always essential.

If you consider that in 2006 the supply of U.S. stocks actually shrunk by the largest amount in 22 years due to mergers and acquisitions; add to that, the significant negative trading strategies that have become popular since 2000, any significant and consistent individual investor participation in US stocks could have dramatic upside results. A shift in popular opinion to US stocks followed by cash inflows, would likely mean Hedge funds would be forced to scramble to buy

back shares they've shorted, combine that with the reduced amount of US stock supply, is a lethal combination with big upside potential.

A recent UBS investor sentiment survey hit a three-year high and was characterized as "very bullish," yet only 37% of respondents expected a gain in the DJIA this year. Moreover, of those 37% that expected a gain, only 11% thought the DJIA would rise over 10%.

Eventually the tide of opinion will turn, but it will only turn when the markets are substantially higher, much higher.

One important issue that bears watching is the wildly overheated Chinese stock market, which has risen 242% in the past two years and 31% year to date. The Chinese Central Bank has been raising interest rates and reserve requirements of their banks to soak up the cash available in their financial system. There is a realistic chance the Chinese stock market is a disaster waiting to happen, even despite their earnings and revenue growth.

Vietnam for example is considering requiring investors to commit capital to their stock market for a minimum of one year and require 30-days written notice for withdrawals. Funds are obviously flowing to this hot market from overseas.

What will bear watching is the flow of capital from overheated Emerging stock markets to established markets like the U.S, where we are emerging from three long years of Federal Reserve restraint. Regardless, the values in U.S. growth stocks are significant with the risk/reward excellent.

To sum things up, the environment for stocks remains good and consistent with previous periods that have provided superior returns. For more details, please the RMHI Holdings report.

Warmest Regards,
Brad Pappas