

Investment Watch

2nd Quarter, 2007



St. Louis hosts "America's largest birthday party", and, of course, the 4th of July celebration ends with a bang! Brilliant pyrotechnic displays set to music will light up the night sky to the amazement of all. Just as many of us were amazed when we opened this quarter's report, and found that last quarter's "March Madness" ignited the stock markets and sent stocks soaring to **new heights**, while at the same time, the bond market was a **dud**.

Fireworks on the 4th is an American tradition, but most believe they were invented in China about 2000 years ago. This ancient east-west, international connection has some surprising similarities with the world we live in today.

Legend has it that gunpowder was accidentally discovered by a Chinese cook who mixed carbon and sulfur, common cooking ingredients in those days (which we hope are not being used today). It is speculated that the firecracker was also invented in China about 1000 years ago during the Song dynasty.

Firecrackers were used in celebrations to ward off ghosts and evil spirits who were frightened by the loud bangs. So the tradition continues. Both then and now, fireworks are lit to usher in the Chinese New Year free of evil spirits, as well as, here at home, to celebrate America's good fortune on the birth of our nation.

The Federal Open Market Committee (FOMC) uses interest rates like firecrackers to ward off the evil spirits of inflation while striving to maintain moderate, sustainable economic growth. FOMC ended their two day policy meeting just last Thursday, June 28th. The Federal Reserve kept its powder dry by holding their key target interest rate at 5 1/4%.

Because the Fed has such vast resources to analyze almost unlimited economic data, its finger is on the pulse of our economy. Hence, the Fed's words are examined and dissected by all the experts in gory detail. Rather than let the pundits explain, you can draw your own conclusions from the FOMC statement reprinted below.

Federal Open Market Committee Statement June 28, 2007

"The Federal Open Market Committee decided today to keep its target for the federal funds rate at 5-1/4%.

Economic growth appears to have been moderate during the first half of this year, despite the ongoing adjustment in the housing sector. The economy seems likely to continue to expand at a moderate pace over coming quarters.

Readings on core inflation have improved modestly in recent months. However, a sustained moderation in inflation pressures has yet to be convincingly demonstrated. Moreover, the high level of resource utilization has the potential to sustain those pressures.

In these circumstances, the Committee's predominant policy concern remains the risk that inflation will fail to moderate as expected. Future policy adjustments will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information."

Over the past three years the Fed had unsuccessfully tried to increase longer-term interest rates to no avail through its measured pace rate increases from 1% to 5 1/4% that ended just over a year ago. Then shockingly, like the burst of that first aerial shell, long-term interest rates exploded skyward. The yield on the 10-year treasury note soared over 1/2% during this quarter but then, thankfully, retreated slightly ending the quarter at just over 5%.

Because bond prices and yields move in opposite directions, bonds fizzled out having a dismal quarter. However, as the Fed's statement describes, although not convinced, they expect inflation to moderate which should keep a cap on future interest rate increases and allow bonds to again be the shock absorbers in your portfolio.

In the modern era, American influence of the Chinese fireworks industry began following President Nixon's normalization of relations with the Communist government in the early '70s. During the '70s and '80s Chinese state-owned factories distributed fireworks to the world through the government's Provincial Export Corporation. The Chinese government subsidized the production of fireworks to provide work for rural areas where there were no other industries.

Sound familiar? Today the Chinese are holding down the value of their currency, the yuan, which makes their exports artificially cheap, rocketing their economy to double digit growth. The Chinese government is willing to bankroll their explosive, low-cost export growth by holding down the yuan. Currently the world benefits from low cost Asian products but is wary of the longer-term effects.

In the late '80s, China dramatically opened its

doors to the world. At the same time, the US Consumer Products Safety Commission was concerned about the hazards of fireworks. In the later portion of that decade, an American delegation met for 10 days in Southern China directly with fireworks manufacturers to test and determine the appropriate warning labels that should be used. To this day the American Fireworks Standards Laboratory (AFSL) monitors fireworks production within China.

As you can see, US involvement in monitoring the quality of Chinese goods goes back decades. China's product safety record has recently been called into question again due to problems with pet food, toothpaste, tires and lead paint. The recent bad press, along with the explosive growth in Asian imports, will refocus world attention on monitoring and improving the quality of imported goods.

On Independence Day, rather than just embracing America's independent, idealistic values, we should reflect on how globally dependent the entire world has become.

Truly global societies and economies raise many issues, dilemmas and advantages that don't exist when living within one's own borders. The history of fireworks provides us with an example that globalization has been affecting our lives without our knowledge.

We can't expect global integration to come to pass smoothly, but rather, it will occur in fits and jerks. For every few steps forward, it seems we are pushed one step back.

For right now, let's be thankful for our low inflation and our economic stability that the globalization has afforded us here at home.

Integration of all the world's economies has begun. The fuse of the global firecracker is already lit. Let's hope it is powerful enough to fulfill the ancient Chinese promise to fend off ghosts and evil spirits and to help deliver world prosperity.



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