FIRST HALF 2007 REVIEW: THE FOUR INFLATIONS

Inflation is going to be a bigger problem than people think. For the first time since the 1970's, the world is experiencing meaningful inflation in energy, metals, food, and labor. We'll review this and other pertinent topics in our regular Semi-Annual Review.

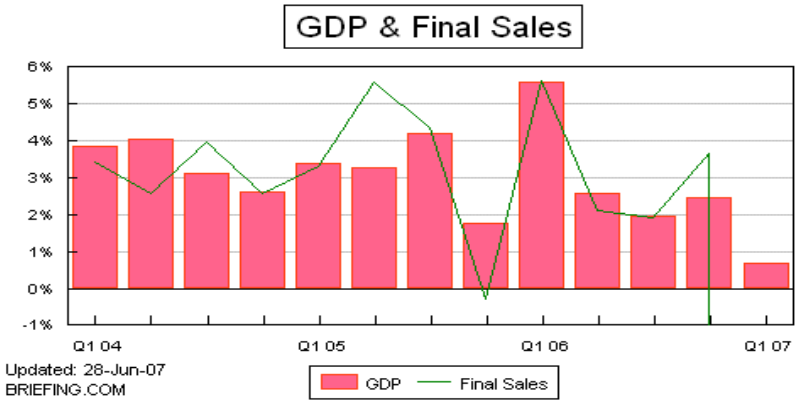
With respect to market returns, the second quarter produced solid gains for equity investors, while bond markets were off:

	Last 3 Months	2007 Year to Date	Last 12 Months	Last 3 Years
S&P 500	6.28%	6.97%	20.59%	39.25%
Value Line Composite	4.68%	7.83%	16.66%	30.98%
Citigroup 5 Year T-Note	-.58%	1.18%	5.15%	6.77%
Lehman Five Year Muni	-.33%	.60%	3.84%	8.76%
Citigroup 3 Month T-Bill	1.24%	2.49%	5.07%	11.44%
CPI	1.26%	3.05%	2.49%	9.62%

While equity outperformance has been notable, the more striking feature is the outperformance of Treasury Bills versus fixed rate bonds. This is a direct result of the "Greenspan Put", where the U.S. Fed from 2001 to 2003 drove rates down to abnormally low levels (1%) to combat weak markets globally, resulting in another Bubble: the massive over-valuation of bonds. This "yield dearth" produced a second Bubble: risk premiums collapsed in corporate bonds and elsewhere as investors stretched for yield anywhere they could find it, driving junk bonds and real estate to stratospheric levels. These Twin Bubbles are in the process of working themselves out, as sub-par returns will eventually return these assets to fair value. We are not there yet. Continue to favor stocks over bonds.

Macroeconomic Outlook

U.S. GDP growth slowed meaningfully in the first half of 2007:



Business spending rose 2.7%, providing firm support, while personal spending rose 4.2%. Housing however, was a big detraction, slipping 16%, and imports continue to offset growing U.S. exports. Growth in inventories subtracted a full percent. We believe GDP will recover as the year progresses, and that this "mid-cycle slowdown" will prove to be an opportune time for investors to recalibrate their portfolios for stronger growth down the road.

We do not foresee a recession, but we have been warning investors for some time now to expect the housing slump to be longer and deeper than most expected, with potential negative consequences for the economy and markets. The U.S. Federal Reserve has now acknowledged the same, as their Open Market Committee minutes of May 9 attest: "participants noted that…the incoming data on new home sales and inventories suggested that the ongoing adjustment in the housing market would probably persist for longer than previously anticipated…the correction of the housing sector was likely to continue to **WEIGH HEAVILY** (our emphasis) on economic activity through most of this year—somewhat longer than previously expected'". In the meantime, the home builders continue to write down inventory, lay off workers, and warn of continuing weak sales.

So the main event for housing and the U.S. economy is now moving to center stage: a tidal wave of mortgage defaults and a collapse in the value of the bonds securitized by "sub-prime" loans. The great speculative excess in housing was financed by these loans, which were sold by Wall Street to gullible fund managers around the world. The loans were vetted by Moodys and S&P, who assigned AAA ratings to many of the senior tranches (for the layman, a loan's cash flows are divided up into separate categories, or "tranches", based on their likelihood of repayment). These loans are now chock full of delinquent payments and outright defaults, as low initial teaser rates reset higher: what once was a 3% rate is now 6% and rising. And there are hundreds of billions of dollars yet to reset this year and next.

Hedge funds and other supposedly sophisticated investors rushed to buy these assets, and then borrowed more money to invest using the same assets as collateral. But they all forgot to ask the most basic question in investing, something I learned in my first month as a rookie bond trader with Wachovia over 20 years ago: "what's the real price if I need to sell?". As Bear Stearns learned the hard way, just because their hedge fund managers "mark to market" the prices of these exotic bonds, that doesn't mean that's what they are worth to another buyer. The Bear had to pony up over $1 billion to cover the gap when they tried to sell and discovered their bond valuations were fictitious. Over in London, Cheyne Capital realized only 50% of the value of their sub-prime assets when they were forced to sell to cover their declining collateral position. Folks, the great unwinding of all these specious valuations has now begun, and it is going to be a long, ugly, and drawn out affair before it ends for certain unwary buyers. It ain't for nothing that we refer to these sub-prime exotica as "toxic waste"!

But there is some good news. If you're a vulture real estate investor with a hankering to own coastal condos or suburban single-fams, it's likely that you'll have bounteous opportunities to buy "distressed properties" at deep discounts, as the unwary who got themselves into this mess walk away from homeownership that they never should have qualified for in the first place.

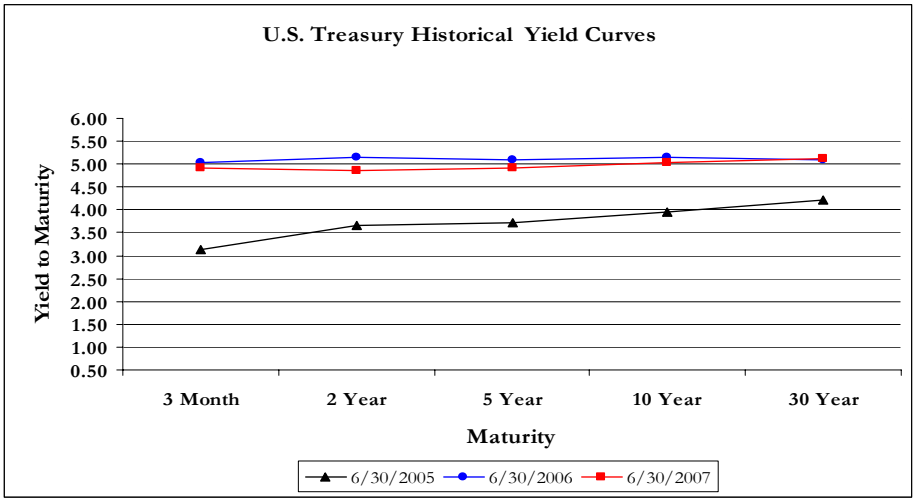
So the next time you hear the phrase "global markets rising on a sea of liquidity" by one of the talking heads on CNBC, you will understand that the sea (or perhaps one of its attendant harbors or coves) can be drained mighty quickly if you happen to own sub-prime loans. We don't know how all this is going to turn out, but our hunch is that investors are going to experience some very fearful times in the months ahead as more

of the shakeout occurs. (As we finished writing this, Moodys and S&P downgraded hundreds of bonds backed by these risky loans, admitting "they goofed". It won't be as easy for the buyers to get out. The draining has begun). Yet we don't see a systemic collapse. As many have said, these bonds are spread out "a mile wide and an inch deep", so a haircut here and there by a German Land Bank, a Japanese insurance company, or a plain-old gunslinging U.S. hedge fund should not have a sustained knock-on effect. The best thing investors can do now is to be armed and ready to buy when the Big V (volatility) kicks in.

Bonds

Another way the sea can be drained is by central banks around the world raising interest rates. And that has happened repeatedly this quarter: the European Central Bank (ECB), the Bank of England, the Bank of Canada, the Bank of China; all have made money and credit more costly by raising their overnight/short term borrowing rates. It is important to realize, though, that overseas rates are, for the most part, still abnormally low: the Bank of Japan at .5% and the ECB at 4.0% are the world's two largest trading blocs outside the U.S., and they are striving to "get back to normal". All of the rate rises have occurred because robust growth is producing unwelcome inflation, which is mostly good news for stocks but not so for bondholders.

The U.S. Fed, however, has not joined the rate-raising party, leaving the fed funds rate at 5.25%, where it has been stuck for over a year. As a result, not much has changed for the U.S. yield curve:



But the yield curve is set to re-steepen, led by long maturities rising in yield. This will be a direct result of rising inflation expectations. The Fed itself has admitted this is their primary concern in the most recent FOMC Statement: "….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." We don't believe the Fed will have the luxury of cutting rates as inflation continues to surprise to the upside. And our call for a gradual strenghthening in the U.S. economy over time means that the Fed will be raising short rates eventually.

The other significant move that is set to occur is a widening of credit spreads, i.e. the additional yield obtained by investing in "risky assets" like corporate bonds. This has been a true and epic Bubble as far as we are concerned, and, while it has persisted for

several years, the unwinding of ridiculously tight spreads appears to have finally begun. A news release from Reuters illustrates the point: "The perceived risk of U.S. junk bonds rose on Tuesday (July 10) by the most since February after rating downgrades on subprime mortgage-related bonds turned investors risk averse, according to Merrill Lynch data...the extra yields that investors demand for the risk of holding junk widened by 19 basis points on average…the biggest move since February. Average junk bonds yield spreads ended at 312 basis points more than Treasuries, the widest since Dec. 5, 2006, when they were 314 basis points...Spreads had hit a record low of 241 basis points in early June." In sum, as Don Coxe, chief global strategist for BMO Nesbitt Burns recently put it: "The coming point of inflection will not be equity centered. The defining excesses of this era have permeated and polluted corporate and home mortgage debt. Therefore, the killing fields will be populated with fixed income instruments". Investors should be migrating to high-quality issues, especially government-backed debt, and keeping their maturities short, with a healthy dose of floating vs. fixed rate exposure.

Stocks

Stocks had a tremendous run during the second quarter, producing most of the gains year to date. The S&P 500 returned 6.28%, while the average stock (Value Line Composite) returned 4.68%. Year to date, equities are up 6.97% (S&P 500) and 7.83% (VL).

Sector returns year to date are varied:

Basic Materials	18.80%
Energy	17.43%
Telecom	13.59%
Industrials	12.79%
Technology	9.02%
Utilities	7.31%
S&P 500	***6.97%***
Health Care	5.13%
Consumer Staples	4.71%
Consumer Discretionary	4.07%
Financials	-2.13%

We believe the starting point for equity portfolio construction in an increasingly globalized world is to select securities based on industries and sectors, not by country or currency. This is in direct contradiction to the legions of consultants out there who are paid to slice and dice the markets, and make pronouncements such as "tactical asset allocation changes are needed as we perceive value in European small caps and Asia-Pacific blue chips". This is beside the point. Over 70% of the world's equity market cap is made up of multinationals. Procter & Gamble is going to do a better job of managing currencies than a third party consultant. The world is flat. The right question to ask is not whether to own a British vs. a U.S. bank, it is whether to own a bank vs. an oil company, etc.

And as the table above illustrates, that is a crucial question driving returns. We refer to this as "The Canoe Theory". As a youngster spending many summers canoeing the Lumber River of NC's Sandhills region, I learned early on the value of letting the river do the work by traveling downstream with the current. Paddling upstream was strenuous! And so it is with investing. One can travel in the finest canoe, but poor progress will be made paddling upstream compared to the same craft (stock) flowing downstream with the current. We think investors in bank stocks have realized this over the past year. Investors in REIT's and homebuilder stocks are discovering this, as these industries have cratered in 2007.

Equity investors also need to understand that a major global economic shift has been underway: the world is moving away from being overly dependent on U.S. consumption

and growth and a robust, broad-based global expansion outside of the U.S. is in progress. What we believe will unfold as the year progresses is that the U.S. will prove to be the weak link in an otherwise solid global economy. Investors, therefore, should be heavily exposed to those industries and companies whose profits are derived from foreign sources, and be significantly underweight "domestic only" type holdings.

Earnings, in the end, drive stock prices, and the first quarter saw stronger than expected earnings reports: S&P 500 Q1 earnings checked in at a 7.9% year over year gain, versus a concensus estimate of less than 5%. Once again, analysts are guiding down for the second quarter to around 4.5%. Whatever the result, the U.S. is in the midst of a mid-cycle slowdown, so we should expect to see soggier profits. We don't know where the trough is but we suspect it will be seen this year, on the way to a re-acceleration in growth as we enter 2008. Investors should emphasize industries and groups that will benefit from globalization and which possess strong earnings and macroeconomic fundamentals, especially in areas where scarcity/market dominance enables pricing power.

The Four Inflations

We are now at a major inflection point for inflation, as the four major "cost-push" areas are rising in tandem: energy, metals, food, and labor. It has been twenty years or more since we last endured this kind of environment, so investors should take careful note of how their holdings will behave if this long-forgotten world returns in force.

Investors are well aware of the price increases that have taken place in the energy sector, as oil and gasoline continue their upward march. Investors should expect more of the same, as worldwide demand exceeds supply. The latest International Energy Agency medium term forecast report stated that "Oil and gas price pressures look set to remain in the coming years…Slower-than-expected [gross-domestic-product] growth may provide a breathing space, but it is abundantly clear that if the path of demand doesn't change on its own, it may well be driven to change by higher prices." In the U.S., the National Petroleum Council, at the request of the Dept. of Energy, completed a draft report on global oil markets, which concluded that demand will outstrip supply, and that "high energy prices are likely for decades to come". We turned bullish on oil in 2003, and, despite intervening periods of weakness, have remained steadfast. Nothing has caused us to change our view, and these recent reports may finally cause the skeptics to convert.

Metals, similarly, have been on a tear, with benchmark copper rising from $.70 a pound to over $4 from 2002 to 2006. Every metal has participated, from lead to zinc to nickel to aluminum to steel. Wall Street has missed this entirely, remaining skeptical that price increases could stick due to the "inherent cyclicality" of the industry. They forgot to check the migration of over 2 billion people overseas moving from mud huts to indoor housing. Dont'cha think that might change the demand characteristics just a wee bit??

And now those same folks are discovering the joys of protein, as they move away from starch diets. At the same time, the industrialized world has embraced the joys of biofuels (made from foodstuffs), which means less supply for you and I. And so food price inflation is coming.

According to the USDA, grain consumption has outpaced production in seven out of the past eight years. This year grain inventories are expected to fall to a 32 year low of just two months usage. And the "carryover" from this years U.S. planting season to the next is at an all-time low. In short, worldwide demand is overwhelming supply.

Food producers are beginning to implement what is sure to be a series of price increases, as their input costs soar. Consumers are not going to continue believing government statistics which tell them the CPI is "muted", and inflation expectations will

rise. In the first half of this year, the Lehman Brothers ingredients cost index—which covers cocoa, coffee, oats, tea, soybeans, and milk among other commodities--rose 14.9%. That follows a 16.5% increase in the last half of 2006. Powdered milk has doubled in the past year, while barley is up 53%, wheat is up 50%, and corn is up 68%. Peter Brabeck, the head of the world's largest food group, Nestle, spoke out on July 7, warning that food prices are set for a period of "significant and long-lasting" inflation because of demand from China and India and the use of crops for biofuels". Investors ignore these informed comments at their peril.

And all this comes after 15 years of no Midwest drought. A disaster is looming when difficult weather conditions return to the nation's farmbelt. Moreover, while our food budget is only 6% of total income, it is 30% in China and 40% in India, so you can bet there is big trouble coming from these areas. Firstly, the "disinflation/deflation" that was exported from China and India to the rest of the world is OVER. The world's largest consumer of pork has seen prices rise 30% this year, and Chinese companies are starting to increase prices for exports in response to this pressure at home. And, more ominously, there have already been riots in Mexico over tortilla price increases. We fear this could be the beginning of a long period of social unrest, with more than a few governments toppled in its wake.

The most recent of the four inflations to stir is labor costs. Many have believed that outsourcing and overseas manufacturing would produce an endless disinflationary wave of cheap, unskilled labor. No more. In short, the West's "birth dearth" is finally coming home to roost. There are simply not enough workers to replace aging Boomers globally, as all-time low unemployment rates across the OECD attest. Employers globally are being forced to bid up wages to attract workers, especially skilled ones (when they can be found). In the U.S., skilled immigrants are in vast demand: the annual 165,000 available H-1B visa slots were filled in less than 90 days. IBM and Microsoft have both cited a shortage of skilled workers as their primary obstacle to growth.

Fed Chairman Bernanke has mentioned wage inflation repeatedly in his public remarks. A recent lead story in the Wall Street Journal was entitled *"Shortage of Skilled Labor Pinches Eastern Europe"*. As more emigration to the richer Western countries occurs, "a dwindling pool of workers is driving up wages in key industries and forcing companies to go to greater lengths to recruit and retain people." This is the story being repeated across the OECD countries, and it augers very well for what we today call the emerging markets, where most of tomorrow's workers currently reside.

The Bigger Picture and Outlook

From a broader perspective, our view is that the great unwritten story of the current (and future) markets is the rise of Sovereign Wealth Funds (SWF's). We have advised in our previous letters that China was setting up an investment office to pursue higher returns than those available in U.S. Treasury bonds, and that this would be strongly supportive of stocks versus bonds. China wasted no time as they announced in May that they would invest $3 billion in restricted equity of the Blackstone Group, a major U.S. hedge fund manager. Not to be outdone, Russia has announced the same intention to invest its burgeoning cash from natural resource sales into "shares of international companies". Japan, long one of the most traditional global investors, is considering establishing a special state investment fund to manage part of its $900 billion in foreign exchange reserves to "improve returns". Even long established SWF's, like Norway's giant $300 billion State Pension Fund, are changing tack to adopt more risk, as they announced this quarter an increase in their target exposure to global equities from 40% to 60%.

The total investible funds of these SWF's are estimated to be currently $2.5 trillion, and this pile is growing rapidly. This development is exceedingly supportive of stocks globally. Investors need to understand that in a "low return world", very little of this

money will be seeking the safety of bonds. Interest rates, therefore, must rise to attract this capital, until such time as it offers a reasonable alternative to "risky assets" like stocks. We suggest that 5% in U.S. Treasuries, 4.00% in Euro Notes, and 1% in Japanese JGB's ain't gonna do the trick (another nail in the coffin of the great bond bull market). (We think that the debt of emerging market economies will be one of the winners in the coming bond re-allocation game, as their higher yields and improving fundamentals merit a re-look.)

The signs of this re-allocation are clear, as the world is moving out of the dollar in a big way. The chart below is of the "DX Index", which tracks the value of the dollar vs. a basket of major currencies:

Kuwait, a stalwart U.S. ally, announced in May that it would end its "dollar peg" and switch to a basket of currencies. The Central Bank of the United Arab Emirates announced that they would increase their holdings of Euros from 3% to 10%. Similarly, Egypt is cutting their dollar reserves from 90% to 60%. In a nutshell, the world is growing weary of receiving excess dollars through foreign trade, and then watching those dollars go down in value. (Case in point: a European investor who traded Euros for dollars to buy the S&P 500 in October 2002, its recent low, and holding to May 2007 would have seen a currency-adjusted return of 55%, versus a U.S. dollar-based investor, who enjoyed a rise of 97%---a deficit of more than 40%!). We began writing about this threat in 2003, and we are now witnessing the "mainstreaming" of this shift. The proper stance for U.S. dollar based investors is to insure a healthy ownership of foreign stocks, and precious metals and related stocks as gold is the "Anti-Dollar".

On the political front, Congress continues to make protectionist threats against China, and momentum appears to be growing to support increased tariffs and/or trade sanctions. Likewise, the European Union described China's ballooning trade surplus as "unsustainable" after a 75% rise, year over year, in May. Concrete protectionist measures, as opposed to sentiment, ranks very high on the list of what could derail markets globally, and investors should monitor these activities closely.

In the meantime, changing political winds in the U.S. are currently pointing to much less capital friendly changes in the tax code. The low long term capital gains rate of 15% appears to be at risk, as do rising estate tax exemptions. We have emphatically advised investors to use the low long term capital gains tax in place for the last few years to sell low cost basis stock and/or concentrated holdings to diversify their holdings, and this window appears to be closing. Don't miss the exit if you're looking to get off. In any event, taxes are likely to become a headwind for investors after 2008.

Geopolitical events as always present challenges to investors, as Venezuela's Hugo Chavez demonstrated ably this quarter with the outright confiscation of energy assets from Exxon Mobil and Conoco Phillips. We have advised investors for some time to look north to Canada for robust natural resource assets which exist, importantly, in a politically stable and secure country with a strenghthening currency. We are doubly drawn to Canada by Congressional threats of "windfall profits taxes" on energy companies here in the U.S. Instead, Congress should be pursuing a sensible offshore discovery program, which could go a long way to helping us achieve a more independent energy profile, but the political will does not appear to exist to pursue this intelligent solution.

So while the risks in investing remain ever-present, careful investors can gain exposure to strategic assets which offer deep intrinsic value in a world set to revisit the inflationary ghosts of yesterday. An increasingly global market means the selection set of securities is robust, and the rapid consolidation of the world's stock and derivatives exchanges are making it easier and safer for U.S. based investors to "go global". In short, there has never been a better time to build and enjoy the benefits of a global portfolio.

Robert E. "Emery" Pike, CFA
July 12, 2007

(This letter is being sent to clients, colleagues, and friends, of Stratford Advisors, Inc. If you do not wish to receive it, you may email us at service@stratfordadvisors.com, call 336.777.3670, or return by mail with a note to 2150 Country Club Rd., Ste. 205, Winston-Salem, NC 27104.)