



Gathering Strength

THE BROAD MARKET S&P 500 INDEX held its gains from April and advanced 1.3% in May, reducing losses so far this year to -3.8%. Smaller stocks gained more and the small-cap Russell 2000 advanced 4.6% bringing its year-to-date loss to just -1.8%. The strongest domestic group was mid-caps, up 5.3% and resulted in a positive year-to-date return of 3.4% for the S&P Midcap 400, the best of any index.

Growth funds were far stronger than value funds last month and technology funds are rapidly rising up the ranks. Certain value-oriented sectors of the U.S. equity market have been hit hard by ongoing problems in the credit markets and the slowdown in household consumption. Financials remain battered.

Last month, U.S. markets continued to outperform foreign markets as measured by the Europe Asia and Far East (EAFE) index, up 0.3% in May. Latin American funds were strongest, up nearly 10% while diversified emerging markets funds, Europe and Japan funds all gained over 2% for the month. China, India and much of Asia sold off.

We've been in a five-year market trend that favored international funds over domestic funds, but this year domestic funds took the lead.

Internationals no longer dominate the top ranks, among the top foreign funds are Harbor International and Fidelity Worldwide. Many diversified domestic funds are now rising up the ranks as are small-caps and growth funds.

The weak U.S. dollar provided a boost to international funds for the past six years, and we benefited because Upgrading led us to internationals. Now, after losing nearly half of its value against major foreign currencies, the U.S. dollar decline has lost its downside momentum. We don't know if the recent shift toward domestic funds is cause or effect of the rebound, or a reflection of other fundamental factors. We do, however, have confidence in knowing that we have the flexibility to adapt as circumstances unfold.

As the U.S. dollar trended lower, it made domestic companies more competitive overseas. Larger internationally-oriented companies profited from a falling greenback. While a weak dollar is assumed to favor big stocks over small, there are many other influences and no direct correlation to relative performance. Again, Upgrading kept us in the leading sector regardless of why. For instance, the dollar fell from 2002 yet large-caps did not start to outperform small-caps until 2006.

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Nevertheless, since March of this year, when the dollar's seems to have bottomed, the relative advantage of big stocks may be in question.

The Federal Reserve is not likely to raise rates until it is confident that the credit crisis is a thing of the past, but it has signaled a concern for the weak dollar causing inflation. Fed Chairman Bernanke has indicated that interest rates cuts are likely over. Higher interest rates would make it more attractive to hold dollars.

Oil Surge

Domestically, natural resource funds led by wide margins last month and are the only sector with outsized gains this year as well as the last few years. The price of oil has doubled since May 2007 because worldwide oil production is static at best, while global demand is growing.

In most markets, surging prices would promote increased supply and decreased demand, and result in easing prices. But the natural resources markets are more fixed. It takes years to find new resources and there are no ready substitutes. Some governments keep the price of fuel artificially low and have recently begun to allow prices to rise. It's estimated that global demand would drop significantly if all fuel was market priced. This, along with high prices pinching off demand could help ease the current shortfall in global supplies, but longer-term we don't see energy demand going anywhere but up.

Thank you for your business and continued trust,

P. Michael Valley II

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