



HarborViews

MARCH 2007

Thoughts on the Economy

We were impressed with the resilience of the U.S. economy in 2005 with \$65 oil and hurricane Katrina taken in stride.

The current performance is no less impressive with 2007 starting by generating over 150,000 new jobs per month even as residential reconstruction slows dramatically and the big three automakers announce layoffs exceeding 100,000 jobs. Studies show employers with over 500 employees continue to reduce employment while firms with fewer than 500 employees create new jobs. This labor force flexibility is an attribute that gives the U.S. economy comparative advantage versus our peers.

We think the economy can provide real growth of 2.5-3.0% this year and show corporate earnings growth of 6-8%. Inflation should slow to a core rate of 2.0% by late in the year and the dollar should continue its gradual decline. Oil prices will likely remain high with a trading range of \$60-70. These conditions allow the Federal Reserve to begin easing policy in the latter half of the year with one or two .25% interest rate reductions possible.

Export demand should remain strong with growth in the high single digits as foreign demand will continue at elevated levels. World economies are experiencing the strongest synchronized growth in recent memory. This allows for U.S. growth to slow slightly in what is typically called a mid-cycle slowdown without dragging the global economy toward recession.

The performance of the U.S. economy continues to be impressive but we would be remiss to not address the counterpoint. With all the headwinds we face and the advanced

age of the current expansion, it would probably require only one more large 'straw' in the form of an exogenous financial or negative geopolitical event to tip the scales toward recession.

Our view of the Financial Markets

The U.S. equity markets were nearly unchanged in the first quarter while most international markets moved higher. We expect stocks to tread water this spring as investors come to grips with the transition from four years of double digit earnings growth to single digit increases. Equity buyers are also watching energy prices moving higher, edging back into the \$60-70 trading range. Also of concern is the changing complexion of the political environment which could place in question the current favorable tax treatment of dividends and capital gains. Washington may not extend the 2001 and 2003 marginal tax cuts and has been making protectionist noises as well.

In the end we believe fundamentals will carry the day and by year-end earnings growth of 7-9% and a bias toward easing by the Federal Reserve will lift equity prices. We believe one or two .25% funds rate cuts are possible in the second half and expect stock prices to rise on the back of multiple expansion. A total return of 8-12% would not surprise us.

Internationally we expect similar total returns with a 1-2% tailwind from further depreciation of the dollar. Harbor's exposure to European and Asian developed markets is expanding with two new ETFs issued by Vanguard.

The fixed income markets outperformed stocks in the first quarter and Harbor clients enjoyed strong results as GMAC continues to call our high coupon long dated maturities

and the firming Euro currency benefits our Ford Motor Credit Euro bond holdings. We believe the Fed will be successful in containing inflation which will hold bond yields in check. We continue to invest in Treasury inflation protected securities which will provide a hedge against higher inflation in case our trust in Fed policy proves unjustified. Generating above average fixed income returns in this environment will require continued pursuit of 'special situation' bonds where we believe the financial markets are mispricing risk.

Safe Harbor during Global Warming

Nod to the ubiquitous disclaimer:

While we are not infrequently, and always quite accurately, accused of being of strong opinion...we want to let the reader know we've been wrong before...will be again and please don't hold it against us. The forward looking parts of the letter are the best educated efforts of fallible humans here at Harbor.

Most of our clientele come to us from existing clients or professionals who know our work. If you know of a family who is seeking counsel and might appreciate personalized and attentive financial advice from an independent firm we would welcome the opportunity to serve. We are warm and friendly folks.

HARBOR ADVISORY

Corporation

500 Market Street, Suite 11, P.O Box 4520

Portsmouth, NH 03802-4520

Tel: 603-431-5740 | Fax: 603-431-2927

www.harboradvisorycorp.com

Jack De Gan (Editor), Weld Butler

Joan Gordon, Jan Yeaman, Cheryl Crowley