

QUARTERLY  
COMMENTARY

A quarterly commentary on the markets and the economy from Rorer Asset Management, LLC

10 LARGEST HOLDINGS AS OF  
MARCH 31, 2007

Large Cap Equity:

Bank of America (BAC)  
AFLAC Inc. (AFL)  
General Electric Co. (GE)  
Linear Technology Corp. (LLTC)  
Marsh & McLennan (MMC)  
Halliburton Company (HAL)  
L-3 Communications Holdings Inc. (LLL)  
Citigroup Inc. (C)  
Valero Energy Corp. (VLO)  
Wyeth (WYE)

Mid Cap Equity:

Express Scripts, Inc. (ESRX)  
Parker Hannifin Corporation (PH)  
Varian Medical Systems Inc. (VAR)  
Thermo Fischer Scientific (TMO)  
Oshkosh Truck Corp. (OSK)  
UCBH Holdings Inc. (UCBH)  
First Marblehead Corp. (FMD)  
Kaydon Corp. (KDN)  
Office Depot Inc. (ODP)  
Thomas & Betts Corporation (TNB)

RORER  
ASSET MANAGEMENT, LLC

# THE RORER REVIEW

## The Slowskys

*"Reports Show Stronger Growth, Inflation."  
"Consumers, Factories Solid."*

These headlines appeared in the Investor's Business Daily on April 2, 2007. As we move through the second calendar quarter and into the second half of the year, the headlines will be a bit more dour.

We're always amused when we view the Comcast ads for high speed internet featuring the turtles who introduce themselves as "Bill and Carolyn Slowsky." The turtles dote on everything slow and find that high speed cable internet is just too fast for their liking. Appreciating their penchant for things slow, and notwithstanding the headlines above, we believe that Bill and Carolyn will revel in the sluggish economic conditions that will develop between now and the end of 2007.

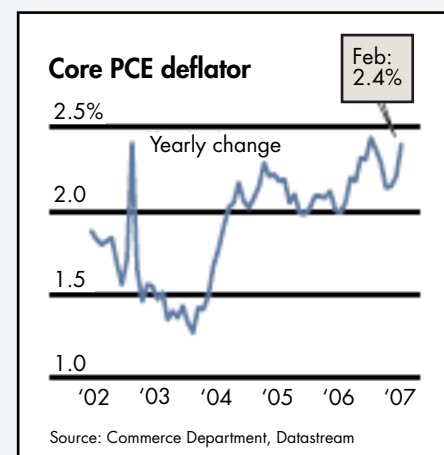
To kill the suspense, we'll cut right to the chase. Here is our thesis:

- Inflation is going through a mini flare-up but will recede in the second half of the year.
- The economy is exhibiting temporary strength, as articulated in the winter edition of the Rorer Review, *Ebb and Flow*, but it is in the process of peaking and will slow dramatically in the second half of the year.
- Interest rates are going down. In spite of current Fed talk to the contrary, the next move from that organization will be to lower short-term interest rates from the current 5.25%.
- Not to be left behind, long-term rates will join their younger siblings and march downward in the second half of the year. For the record, the 10-year U.S. Treasury Bond currently yields 4.65%.
- At the end of 2007, both stock and bond investors will take a look back and be able to say: "It was a good year!"

Let's start with inflation. It cur-

rently is running above the level the Fed would like to see. In Fed chairman Bernanke's speech to Congress on March 28, he characterized it as "uncomfortably high." No matter what measure of inflation one looks at, it has been running ahead of desired levels. The CPI, as of February, was running at +2.4% on a year-over-year basis. Another measure of core inflation is the Personal Consumption Expenditure Deflator. The Fed prefers this measure of inflation over the more widely cited CPI because it covers a much broader basket of goods and services for households, including healthcare goods and services paid for by third parties as well as other services not explicitly paid for by the consumer. Recently, it also has been advancing at a 2.4% clip (see chart), well above the Fed's 2% comfort zone.

Here's more bad news: there appears to be a seasonal influence on inflation



whereby it tends to surge in March and April. So, we expect bad inflation numbers over the next several months leading, perhaps, to growing unease on the inflation front during this period. Before we panic, let's take a look at some of the numbers behind the scenes. Last July and most recently in March, Chairman Bernanke noted that increases in residential rents had substantially contributed to higher core inflation. The inflation mea-

asures, CPI and PCE Deflator, use an indicator called “owner’s equivalent rent” as a pricing proxy for homeownership. Under normal conditions, this proxy serves its purpose. However, when the housing market exhibits large swings one way or the other, the rental proxy acts in the exact opposite manner. When housing was booming, fewer people were in need of rents, therefore rental prices, which are sticky on the downside, were largely unchanged or down just a bit. In the past several months, however, the housing market rout is causing an upswing in rental demand. Rents have been skyrocketing and greatly affecting the Core inflation measures. Owner’s equivalent rent accounts for a whopping 38% of the Core CPI index and 17% of the Core PCE Deflator. A recent study by the Federal Reserve showed that a record 69% of households now own their homes. Therefore, the large upswings in rental prices are really only affecting a very small percentage of consumers. By most other measures, inflation is extremely well contained thanks to the forces of global competition and technological innovation. Ultimately rents will stabilize again as more homeowners opt to rent out their unsold units, causing the rental supply to rise and the rental component of the Core inflation measures to fall. As the Fed contemplates an economy on the cusp of a serious slowdown, accompanied by a diminished inflation threat, we believe it will move to lower interest rates.

Why a slowdown?

Credit! It has been widely available, but the spigot has been turned down to a trickle. In the last several years, lenders made lots of “no documentation” loans to folks at teaser rates that are now moving substantially higher. For awhile, the money was almost free and anyone could get a loan. With the default rate on the rise, lenders are taking heed and starting to restrict credit. Congress is threatening to investigate “predatory” lending practices, giving lenders even more incentives to restrict additional lending. Tighter lending standards are here now, even before headlines and politics tighten the vise another turn. For proof of the

consequences, we need look no further than the housing market.

The housing market is in disarray. According to the National Association of Homebuilders, new house sales are falling rapidly and running at the slowest pace since June 2000. Inventories of unsold homes are high and rising rapidly. Home prices are down on a year-over-year basis and likely to deteriorate further. Homebuilders are being forced to lay off workers across the country. While sellers are lowering their asking prices, many potential buyers are unable to secure credit, creating a vicious circle of growing supply amidst diminished demand.

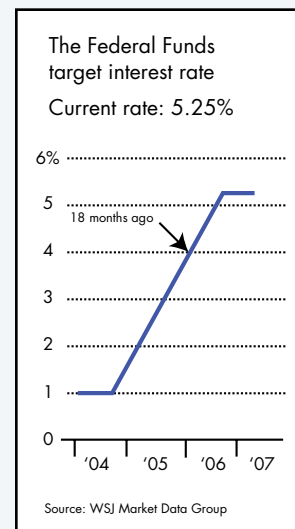
The tentacles of the housing market reach into every corner of the economy. In addition to appliance and home furnishing manufacturers, many retailers are closely aligned with this industry. Further, easy credit to homeowners has helped finance purchases in many other areas of the economy. This “mortgage equity withdrawal” over the last several years has declined from \$864 billion to \$386 billion. It will likely decline further. That is almost \$500 billion that helped promote economic growth in the past that is largely unavailable for future economic stimulation.

Signs of weakness are starting to show up all over, notwithstanding the upbeat headlines above. The Conference Board’s Index of Leading Economic Indicators has declined three months in a row and registered its largest year over year decline since before the 2001 recession. Auto sales are sluggish. Corporate profit growth is slowing. Capital expenditures are slowing, as evidenced by weaker than expected durable goods orders in January and February.

Much of this slowing may have occurred even before the credit crisis developed. It seems like an old story now, but recall that the Fed raised interest rates 17 times between 2004 and 2006. History shows that there is about an 18-month lag effect from when rates are raised until the move starts to affect the economy. 18 months ago, short rates (Federal Funds) were 4%, a full 125 basis points below their cur-

rent level. In other words, over the next year, the economy will continue to feel the impact of rising interest rates even if the Fed does nothing. The chart below depicts this phenomenon.

In our opinion, “doing nothing” is not an option for the Fed, though we



acknowledge that it will wait for more benign inflation readings before taking action. However, our hunch is that the bond market will, in fact, “do something” and react much more swiftly to the sluggish environment with the 10-year Treasury, currently at 4.65% working its way down toward 4.25% as the year progresses. This action will further invert the yield curve, perhaps putting more pressure on the Fed.

Well, Bill and Carolyn, how do you feel now? Are you happy yet? If not, consider this: even in the face of slowing economic growth, we don’t expect the economy to deteriorate to the point of entering a recession. Rather, we see a “pause” followed by renewed economic growth as lower interest rates start to reinvigorate the economy. Under these circumstances, we expect investors to look over the valley and recognize that high quality equities at moderate prices represent outstanding values and will provide excellent returns in the year ahead.

—April 2, 2007

The views expressed represent the opinions of Rorer and are not intended as a forecast or guarantee of future results. The Ten Largest Holdings are not investment recommendations and may no longer be held in account portfolios.