

## **CMA Update: US Economic Activity and CMA Stock Holdings**

The Federal Reserve has just released its Beige Book Report, which describes the economic condition of the entire country and across major industries. It is an important resource in our common stock portfolio management. Fed representatives call actual companies to pole them for how their businesses are doing within each of the 12 Fed districts. This feedback on industries is “very fresh” ....and is “fact” not opinion. We regularly use this Fed data to actively manage our stocks in portfolio....increase holdings of companies that are in the stronger areas of the economy, and reduce or eliminate company holdings in troubled or weakening areas of the US economy.

This current report has been edited by us to eliminate any extraneous data or economic conditions info that is not relevant to our stock selections and overall strategy. Further, we have inserted our own comments that are underlined, which refer to our investing relative to specific economic conditions.

As you will see in reading through this abbreviated report, there are pockets of strength in the economy and weakness. We are investing where there is strength, and mainly with international companies that do a lot of business outside the US, where growth is higher. You will see “tickers” listed after each important Fed comment indicating the companies we are in, that are in those industries. Below are listed the top 25 common stock holdings across our portfolios, showing the ticker symbol and a number that indicates the percent of the company’s business that comes from outside the US.

General Electric GE 50%, 3M Company MMM 61%, JPMorgan Chase JPM 16%, Duke Realty DRE 0%, HRPT Properties HRP 0%, Starbucks SBUX 17%, Intel INTC 85%, Disney DIS 23%, Bank of America BAC 8%, Citizens Communication CZN 0%, Alaska Air ALK 0%, Sunstone Hotels SHO 0%, Avon AVP 72%, Strategic Hotels BEE 15%, Wachovia Bank WB 0%, Harley Davidson HOG 17%, Dell Computers DELL 35%, Marriott MAR 35%, Allstate Ins ALL 0%, Microsoft MSFT 35%, American Express AXP 32%, EMC Corp EMC 43%, Broadcom BRCM 70%, and Texas Instruments TXN 87%

### **General Overview...**

Reports from the twelve Federal Reserve Districts suggest that economic growth has slowed since the beginning of the year. Two-thirds of the Districts cited softening or weakening in the pace of business activity, while the others referred to subdued, slow, or modest growth. Retail activity in most Districts was reported to be weak or softening, although tourism generally continued to expand. Manufacturing was said to be sluggish or to have slowed in about half the Districts, while several others indicated manufacturing results were mixed or trends were steady.

Residential real estate markets generally remained weak; reports on commercial real estate markets were somewhat mixed, but also suggest slowing, on balance, in many Districts. Most Districts reporting on banking cite tight or tightening credit standards and stable or weaker loan demand. Districts reporting on the agriculture and energy sectors said activity is generally strong.

Upward pressure on prices from rising materials and energy prices was noted in almost all the District reports. By contrast, wage and salary pressures were generally said to be modest, as the hiring pace slowed in various sectors and labor markets loosened somewhat in many Districts.

### **Consumer Spending and Tourism**

Reports on retail spending were generally downbeat, although Boston, St. Louis, and Dallas described sales as mixed and Kansas City reported that consumer spending was "largely unchanged" since the previous survey period. We have only one retail stock in major holdings SBUX. The majority of Districts characterized sales as below plan, downbeat, weak, or having softened. Among product categories, apparel sales were soft in New York, Philadelphia, and Richmond, but strong in Boston. Several Districts noted declines in sales of big-ticket and/or home-related items. Our only domestic apparel company holdings is a small position in Saks

Districts commenting on vehicle sales described them as slow or sluggish, with little exception. We hold no stocks in auto or transport, just the debt of GM and Ford at 11-12% yields.

The majority of reports on tourism spending (travel, hotels and products) were positive, on balance, although most Districts mentioned some areas of softening. The San Francisco District commented that while tourism in Hawaii had fallen from previous levels, activity in California remained stable, partly because of growing foreign travel resulting from the lower exchange value of the U.S. dollar. Minneapolis reported an increase in tourism activity generally relating to winter sports. Tourism and travel in Kansas City, Atlanta, New York, and Chicago were also mostly positive. We hold the upscale and luxury hotel companies: MAR, BEE, SHO and DIS.

### **Non Financial Services**

All Districts reporting on transportation services noted weaker activity in the first quarter of 2008 compared with the previous quarter. Trucking and shipping respondents from the Richmond and Dallas Districts reported declining import volumes, which was more than offset by growth in exports, stimulated by the depreciation of the dollar. We hold export companies: GE, MMM, INTC, AVP, HOG, DELL, MSFT, EMC. However, airlines in those Districts reported higher passenger volumes since the start of the year. We hold ALK that has growing passenger volume on West Coast and Hawaii.

## **Manufacturing**

Reports on the manufacturing sector were mixed but, on the whole, subdued. New York, Philadelphia, Richmond, Kansas City, and Dallas indicated that production or shipments were sluggish or falling. Atlanta, Minneapolis, and San Francisco characterized activity as varying across industries. Boston, Cleveland, and Chicago indicated stable levels or trends. Only St. Louis noted a strengthening relative to prior reports. All our manufacturing and tech hardware companies have high foreign business...none are all domestic. GE, MMM, TXN. DELL, INTC, HOG.

## **Real Estate and Construction**

Residential real estate markets were generally weak over the last couple of months. Sales were low in every District with very few local exceptions. Sales declines were particularly large in the Boston, Minneapolis, Richmond, and St. Louis Districts; at least some respondents in each of these Districts reported drops in home sales of more than 20 percent year-over-year. Contacts in the Chicago, Kansas City, and Philadelphia Districts cited tight credit conditions as a reason for low sales; each of those Districts either reported or expected stabilization of demand for homes in the low and mid-price ranges. We hold no construction company stocks or their debt. A cutback in commercial construction will reduce new supply in 2008 and beyond to benefit property REITs DRE and HRP that own/lease office and industrial income property.

The markets for office and retail space showed signs of a slowdown in several Districts. Office vacancies were reported up, and leasing volumes down, in Manhattan, Baltimore, Washington, D.C., Memphis, portions of Maine and Rhode Island, and Las Vegas. Districts indicated that office vacancies held steady in Boston and the Carolinas, and were down in Philadelphia and in the Minneapolis and St. Louis Districts; however, contacts in the Boston and Philadelphia Districts and see some emerging slack. Office rents were mixed, however, coming in about flat in greater Boston and Manhattan, either flat or down in the Richmond District, and up in Philadelphia. HRP and DRE hold long term leases at fixed rates, and look protected on leasing income for a few years before a lot of renewals occur. At that time, the reduction in new office and industrial bldg supply should provide a stronger lease renewal market.

Retail vacancy was reported up in the Minneapolis District and retail space demand was described as slow in the Chicago District. Demand for industrial space was described as either "firm" or "flat" in the Districts commenting on that sector. Our only retail store holdings are Saks and LOW...small positions.

## **Banking and Finance**

Reports on loan demand for commercial, industrial, and residential mortgage loans varied across Districts. Overall loan demand was flat in San Francisco and weakened in the Kansas City, St. Louis, Dallas, New York, and Richmond Districts. Consumer lending was flat or declining in the St. Louis, Chicago, and

Cleveland Districts. Commercial and industrial loan demand was mixed in San Francisco and remained stable or declined in the Kansas City, St. Louis, Dallas, New York, and Richmond Districts. By contrast, the Chicago and Cleveland Districts reported increased business lending. Even as loan demand for new residential mortgages remained sluggish or declined, lower interest rates prompted increases in refinancing of existing mortgages in a number of Districts, including San Francisco, St. Louis, New York, Richmond, Atlanta, Cleveland, and Chicago. Our top 25 company holdings are high grade borrowers, if/when they might need new debt...most have all borrowings locked in at low fixed rates already, or are cash rich and seldom borrow...INTC, MSFT, DELL, MMM, SBUX, DIS, AVP, HOG, MAR, ALL.

### **Agriculture and Natural Resources**

All Districts reporting on energy cited robust levels of activity and steady or higher prices; in addition, Kansas City and Cleveland mentioned increases in hiring. However, Dallas noted that drilling had flattened domestically and declined in the Gulf of Mexico, leaving activity outside of North America to drive future growth, while Kansas City, Cleveland, and Minneapolis expected exploration and capital spending to increase going forward. We hold PWE, ED, PGN energy companies as minor holdings for their high dividend yields.

### **Conclusion**

The Fed is indicating new softness in a lot of areas of the economy around the company, mainly associated with some pullbacks in consumer spending. Also, Jan and Feb are typically slow months on consumer spending being right after Christmas shopping season and before Easter shopping begins.

In-bound US tourism is strong and growing. US exports of manufactured products and ag commodities are booming. Growth outside the US is pretty strong, with the recent IMF survey looking for 4.1% GDP global growth in 2008. The US dollar has weakened against many currencies stimulating exports and tourism. 16 of our top 25 holdings have significant international business.

The stock market is trading more on the anxiety and fears off the housing industry slowdown, credit crunch in certain areas, and defaulting residential mortgages...not the fundamentals of what is happening in a more positive vane, across the remaining 90% of the US economy.