NOESIS CAPITAL MANAGEMENT
A REGISTERED INVESTMENT ADVISOR

April 12, 2007

Dear Client:

The prospect of slower growth in the domestic economy, weakness in the housing market, and subprime mortgage problems have been headline items in recent weeks, causing considerable volatility in the equity markets. While these are all valid issues, there are some highly relevant factors that should be borne in mind to provide a more realistic perspective.

Ben Bernanke, chairman of the Federal Reserve, in his most recent comments, downplayed the risk of recession and repeated his expectations of moderate economic growth. Moreover, he expects the effect of the subprime mortgage problems on the overall economy to be "relatively small." He also indicated that the Fed will show a great deal of flexibility if economic growth weakens considerably due to problems in the housing and mortgage markets or other causes.

The weak housing market combined with recent indications that there has been a decline in business investment have caused some economists to cut their expectations of real GDP growth for 2007 to about 2.0%, compared with forecasts a few months ago in excess of 2.5%. There is a belief, however, that any further weakening would motivate the Fed to counteract this with an appropriate easing policy.

The housing market and the American auto manufacturers, which combined account for under 10% of total real GDP, remain weak. However, the remaining 90% of the domestic economy is continuing to expand, although at a more moderate pace than previously indicated.

Global economic strength increasingly is taking on great importance for the United States as well as for other countries. Growth has accelerated in Europe and Japan. The growth rate of China exceeds 10% and India is near 8%. Mexico, Brazil and many other emerging countries also are enjoying rapid development. With 90% of the U.S. economy expanding and benefiting from strong export demand, combined with unprecedented growth in the rest of the world, there are valid reasons to be optimistic.

In last quarter's letter, we referred to the world being "awash in cash" and the positive effect this has had on equity markets and merger activity, as well as boosting the prices of lower grade domestic and foreign bonds. This rise in liquidity stems from a number of causes, none of which appear imminently likely to disappear or significantly diminish.

1801 Clint Moore Rd., Suite 100, Boca Raton, Florida 33487
561-999-9888 • Fax 561-994-2893 • E-Mail: info@noesis-capital.com
www.noesis-capital.com

One use of available liquidity is illustrated by the relationship between current interest rates and stock market valuations, which makes it very profitable for many companies to

borrow large amounts of money to use for stock repurchases. An important but little mentioned factor is the capitalization rate, or earnings yield of the equity market. This is the inverse of the price earnings ratio. For example, a company earning $1.00 per share with its stock selling at $15 has a price-earnings ratio of 15. In reverse, it earns $1 per share with a market price of $15 per share, for an earnings yield or capitalization rate of 6.7%.

As an illustration of the effect this can have, Home Depot issued $5.0 billion in long term debt late last year with a weighted average maturity of 9.3 years at an average coupon of 5.69%, primarily for stock repurchases. With a 38% tax rate, the after-tax net cost to Home Depot is 3.53%. With a price-earnings ratio of about 13.5 times earnings the earnings yield is 7.4%, making this a very attractive strategy. Companies in the S&P 500 Index bought back over $431 billion of stock in 2006, about triple the amount repurchased in 2003.

Fed easing, erring on the side of preventing deflation with a fear of depression, has also contributed to the rise in liquidity. Despite almost 2½ years of Fed tightening and a rise in the federal funds rate to 5.25%, real short term rates are only average by historical norms and long term yields are still near a 40-year low. As illustrated above, use of long or intermediate term debt to finance stock repurchases provides an excellent return.

Global currency pegging is another contributing factor to the rise in global liquidity. Small and developing countries have traditionally been allowed to peg their currencies to the U.S. dollar officially or unofficially and, due to their size, this usually was not a problem. As the growth of many of these countries accelerated in recent years, however, they had to increase their money supplies aggressively to maintain these pegs—particularly with a weakening dollar. With many of these economies reaching major size (i.e. China), the practice of pegging currencies to the U.S. dollar is having a significant effect on global liquidity.

Large cash reserves in oil producing countries also add to worldwide liquidity, as well as the fact that many companies have been accumulating cash due to concerns about the sustainability of the current economic expansion. According to *The Wall Street Journal*, even the most pessimistic economists and central bankers see little sign that the liquidity boom will end anytime soon barring a major shock to the system.

On a long term basis, much of the abundant cash may ultimately be invested in equities or other asset classes in order to become more productive. While this is a realistic possibility, it is in our opinion unlikely to prevent short term volatility or the possibility of market corrections, but it could be, however, a source of underlying support.

NEW PURCHASES IN FIRST QUARTER OF 2007

In our last quarterly letter, we mentioned that our research analysts were monitoring a number of domestic and foreign companies. Several attractive opportunities arose, as we will review.

Caterpillar Inc. (CAT)

Caterpillar is the world's largest provider of machinery, including construction, mining, and forestry equipment. More than 50% of its sales are derived overseas. With this global breadth and its leading position in earthmoving equipment, the company is well positioned to benefit from the expansion of infrastructure, particularly in emerging countries.

Amdocs Ltd. (DOX)

Israel-based Amdocs is a leading provider of software and services for communication providers worldwide. Its complete offering of highly mission-critical software plays an integral part in the consolidation and resulting service expansion (voice, data and video) of the communication industry. These solution packages help to handle the communication providers' increasingly complex operation tasks and ensure a consistent quality in customer support.

Suntech Power Holding Co. Ltd. (STP)

Suntech, a Chinese solar energy company, designs and manufactures solar panels which produce energy used in residential, commercial and industrial applications. Alternative sources of energy like solar power are experiencing an increasing demand as a result of rising oil prices and environmental awareness. Solar panels thereby became very popular due to the abundance of sunlight and their flexibility in installation. In addition, solar panels have increasingly become economically attractive for end users due to improving cost-efficiency and government incentives in countries like Japan, Germany and the U.S. Suntech enjoys a cost advantage because of its technology expertise and operations in China. Due to its strong academic connections, the company works closely with research labs and institutes to develop new solar technologies.

Expeditors International of Washington, Inc. (EXPD)

Expeditors is a global logistics company offering a variety of third-party logistics services. Beyond the consolidation of shipments and the forwarding of cargo to airlines and ocean carriers, the company completes its offering with value-added services like customs handling, insurance distribution and packaging. Outsourcing and growing international trade are resulting in increasingly complex global supply chains of companies and thereby leading to a surge in demand of these logistics services. With Expeditors' dominant position, particularly in the Asia-North America trade lane, it can benefit from the above average growth of shipments.

FIXED-INCOME UPDATE

Both short and long term interest rates, measured by the 3-month Treasury Bill and 10-year Treasury Note, respectively, changed little during the quarter, keeping the yield curve inverted by 38 basis points. The federal funds rate was left at 5.25% following the Fed's most recent meeting. The Fed noted that "the adjustment in the housing sector is ongoing" which was less positive than its previous note that "some tentative signs of stabilization in the housing market." Although the Fed's growth and inflation forecast still shows core inflation moderating this year and next, there still is uncertainty surrounding the inflation forecast. We believe this to be a factor in the Fed's decision to maintain the federal funds rate at current levels longer than previously expected and may even lead to an increase at some point. Core inflation trends do not yet suggest a move away from the inflation risk bias. However, the forward federal funds market is pricing in two rate cuts, one in the fall and one by next spring, reflecting a continuing disparity between the Fed and the bond market.

To take advantage of this difference, we have been buying inflation linked income securities issued by various investment grade corporations. These are floating rate income securities that pay monthly based on the consumer price index plus a market determined spread. Because the market believes future inflation to be very low, the spread has been very high, up to 425 basis points above the consumer price index, which should average roughly 3% per year (425 basis points plus 3% = 7.25% annual yield). This security is very similar to a Treasury Inflation Protected Security (TIPS), but the government security does not pay a credit spread and the adjustments for inflation are paid at maturity. Since the returns are larger for a corporate inflation protected security for a given rate of inflation, and the interest payments are more frequent, we believe they are more attractive than the government equivalent.

We are always available to discuss your portfolio and welcome the opportunity to address any questions.

Sincerely,

Richard M. Brown, CFA
Chief Investment Strategist

Our most recent Form ADV, Part II is available upon request

1801 Clint Moore Rd., Suite 100, Boca Raton, Florida 33487
561-999-9888 • Fax 561-994-2893 • E-Mail: info@noesis-capital.com
www.noesis-capital.com