NOESIS CAPITAL MANAGEMENT

A REGISTERED INVESTMENT ADVISOR

July 15, 2007

Dear Client:

As we move forward into the second half of 2007, the outlook for the domestic economy is becoming somewhat clearer, notwithstanding the existence of several uncertainties.

The housing market and the American auto manufacturers represent under 10% of total real GDP, and continue to show considerable weakness. The remaining 90% of the economy is showing more strength than was generally expected in the recent past, reflecting strong consumer spending and the impact of a boom in exports.

Exports of goods and services increased 9.8% to \$377.0 billion in the first quarter of 2007 versus \$343.4 billion in the first quarter of 2006, while imports grew only 4.2% to \$557.7 billion. The largest export gains were to China and Japan, 15.5% and 8.5%, respectively. This strong export growth is not only attributable to global economic strength, but also to weakness in the U.S. dollar which reduces the prices of U.S. products in foreign currencies.

The slump in housing is unusual since no housing decline of this magnitude has ever occurred outside of a general economic recession. This decline was self-induced in a sense as it resulted largely from overbuilding, speculation and sharply higher prices, as compared with traditional causes such as escalated mortgage rates, tight credit and rising unemployment. Another new factor is the meltdown in subprime lending, which is turning out to have broader implications than initially indicated.

Surprising to many, the economy is proving to be much more vigorous than many expected reflecting considerable strength in the other 90% of the economy, benefiting from international as well as domestic factors. A group of 60 economists surveyed by *The Wall Street Journal* in mid-June expect real GDP growth at an annualized rate of 2.6% in the second half of this year and 2.9% in 2008. We would consider this very encouraging taking into account the weakness in housing and autos.

At its June 28th meeting, the Federal Reserve softened its inflation stance slightly, but repeated its concern that core inflation may fail to moderate as expected. An obvious consideration would be that softness in home building leads to softer prices for construction materials and home related goods and services. We believe this could make moderate core inflation look better than it really is. The Fed is not cutting rates to help the housing market because it would be stimulative for the other 90% of the economy. Furthermore, a major inflation risk could surface if housing recovers while the rest of the economy is strong, with unemployment already below 4.5% and the factory utilization rate near 82%.

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A rise in a key index of manufacturing activity for June increased expectations for continuing U.S. economic growth in the months ahead. The Institute for Supply Management (ISM) reported its index of manufacturing activity in the U.S. rose over one point to 56.0 last month, the highest level since April 2006 (a level above 50.0 indicates manufacturing activity is generally expanding). There has also been a rise in European manufacturing activity in June, according to the Eurozone's Purchasing Managers' Index. Overall, European factories increased employment at the fastest rate in nearly seven years. In another positive sign for the global economy, cross-border airfreight traffic in May rose 5% from a year earlier, as reported by the National Air Transport Association, an acceleration from a 2.8% gain in April.

As we have mentioned in previous quarterly letters, there continues to be a persistent rise in liquidity on a worldwide basis and this is having a stimulative effect. Corporations, financial institutions and private investment firms, among others, are all "awash in cash." Bond yields are not rising as they normally would in a strong economy because some of the excess liquidity is going into the bond market. Similarly, the equity markets are attracting excess cash and stock repurchases and mergers and acquisitions are barreling along at a whirlwind pace.

Worldwide, merger deals added up to $1.65 trillion in the second quarter, up 90% from the same period in 2006. This followed deal volume close to $1.0 trillion in the first quarter and the full year 2006 record of $3.6 trillion could easily be exceeded.

Liquidity normally contracts during periods of economic expansion as corporations use more funds to finance their growth and as the Fed restricts the money supply. Why is it different this time and how long can it last? The first question is easier to answer than the second. As we discussed last quarter, 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. Based on current stock market valuations, use of long or intermediate term debt to finance stock repurchases provides an excellent return. We had also discussed global currency pegging as a factor contributing to global liquidity growth. Small and developing countries traditionally pegged their currencies to the U.S. dollar; however, as the growth of many of these countries accelerated in recent years their central banks had to increase their money supplies aggressively to maintain these pegs, and even more so 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 as a result of record corporate profits combined with concerns about the sustainability of the current economic expansion. As we mentioned in our April 12, 2007 letter, *The Wall Street Journal* stated that 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. Such a shock may well be out there someplace and, while difficult to identify, its possible existence justifies maintaining some degree of caution. Another factor to be borne in mind is that the present high level of liquidity is unlikely to prevent short term volatility or the possibility of market corrections.

NEW PURCHASE IN SECOND QUARTER OF 2007

Honda Motor Co. Ltd. (HMC)

We added to our position in HMC, taking advantage of a recent pull back. The company is facing some near term challenges, in particular the upcoming *Accord* model change in September 2007 and production capacity difficulties with its *Civic* model. With 50% of U.S. earnings, the *Accord* is Honda's most important model in the U.S. market. Due to the transition period, management expects a slowdown in the U.S. sales growth throughout 2007. However, assuming good consumer acceptance of the updated *Accord* model, 2008 sales could benefit significantly. Regarding its *Civic* model, HMC is bringing its plants to full utilization as well as extending its production capacity in order to meet the strong demand. We believe that these near term concerns are close to being fully priced in and we can take advantage of HMC's unchanged positive long term outlook.

FIXED-INCOME UPDATE

After a year long inversion, the yield curve corrected course during the second quarter. The 3-month Treasury Bill and the 10-year Treasury Note ended the quarter at 4.68% and 5.03%, respectively. The second quarter also brought an end to the disparity between the bond market and the Federal Reserve with the bond market re-pricing the immediate chances of a recession and therefore the need for the Fed to lower the federal funds rate. The move was exacerbated by mortgage portfolios extending in duration, and the need to sell Treasury securities to maintain durations from before the re-pricing. The re-pricing did not appear to be from inflation expectations increasing, as the recent core inflation data has been consistent with the Fed's forecast of a gradual decline. However, as noted at their recent meeting, the Fed is still concerned about future inflation because resource utilization has become tighter, not looser, as core inflation has ebbed. Therefore, we should still be concerned that interest rates could move higher over the coming months. As such, we are still interested in buying floating rate bonds because their coupons will reset upwards if interest rates move higher.

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We recently purchased Gramercy Capital Corporation (GKK), a mortgage REIT, that pays roughly 8.5% of its stock price in dividends and expects to grow its dividend by at least 7% per year. GKK finances commercial properties, including office, hotel, industrial and multi-family buildings. GKK is able to grow its dividend by investing at higher rates than those that they are borrowing at. GKK has one of the widest investing spreads in the sector due to the high quality of its real estate collateral, the type of funding source they use to finance their assets and the fact that most of their loans are from direct origination.

We hope that everyone has an enjoyable summer. We are always available to discuss your portfolio and/or address any questions.

Sincerely,

Richard M. Brown

Richard M. Brown, CFA
Chief Investment Strategist

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

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