



June 12, 2007

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Is it the 1980s all over again? Then, it looked as if Japan was going to take over the United States. They were buying up property left and right, including gems like Pebble Beach and Rockefeller Center. Alas, their own real estate and stock markets collapsed, and they were forced to liquidate, and at losses. Now it's China's turn. First it was a small personal computer manufacturer that they purchased from IBM (Lenovo). That was nothing. Now, however, they have invested \$3 billion in a US private equity firm (Blackstone) that has filed for an initial public offering. Apparently, they have had their fill of low-yielding US Treasury bills and bonds and have decided to assume more risk. Should we be worried? Not really. China is still new at this capitalism game, and they will face many pitfalls on their economic journey, just as we have. Like Japan in the 1980s, China is staring down two giant economic bubbles – real estate and the stock market. They are trying desperately to keep a lid on both of these excesses, but it is difficult to keep investors from wanting to catch a ride on the boom. History is fraught with these bubbles from the tulip bulb craze in Holland in 1634 to our own stock market bubble in 1929.

It is difficult to obtain accurate data on the Chinese economy. We know they desperately want to put on a good face for the 2008 Olympics which has no doubt resulted in over building of commercial real estate in Beijing. There is also no doubt that their stock exchange is over heated. The best information we can get is that their stocks are selling at an average of forty-five times earnings compared to our stock's average of seventeen times earnings. On June 4th the Shanghai Composite Index dropped 8.3% amid fears of the government's steps to cool the stock market. The Shanghai index doubled in 2005 and doubled again last year. Our stock market reacted but we don't expect a collapse no matter what happens in China. The Chinese market is very closed, so overseas investors have little exposure to this very speculative market. These are some unpleasant realities that will be addressed soon.

How would this impact us and the rest of the world? There would be some initial pain but not of a lasting nature. We are still the strongest and most stable economy in the world and believe it or

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not the most politically stable. We are prepared better than any other country to withstand any outside shocks.

However, we are feeling some shocks brought by China's recent actions. Their moves to diversify away from our Treasury issues has caused our interest rates to rise; when demand for bonds drops, interest rates must necessarily rise. We now have a positive sloped yield curve with three month treasuries at 4.75%, ten year treasuries at 5.12% and thirty year treasury bonds at 5.25%. Those that have been concerned about the negative yield curve for the past year leading to a recession can now breathe a sigh of relief. China's actions, plus interest rates rising around the world, will force our rates up. In addition, Fed head Ben Bernanke recently stated that he sees no need to cut interest rates at this time. Inflation is still his chief concern as labor costs are rising and productivity is slowing. The consumer price index for May will be released Friday and is expected to be up 0.5%. New Zealand recently raised their overnight interest rate to 8% (yes 8%). The current rate of inflation in New Zealand is 2.5%, and they have a two year target of 2%. Let's hope the Fed isn't using that as one of their indicators.

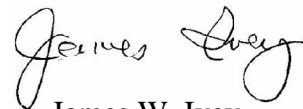
Investment in pools of adjustable rate mortgages is attractive at this time. With fixed rates on mortgages rising, there will be less inclination to re-finance and hence slower pre-payments which leads to higher over-all returns. Stricter lending guidelines will also lead to slower pre-payments.

Random thought for June: And speaking of Hollywood, "When they discover the center of the universe, a lot of people will be disappointed to discover they are not in it."

Bernard Bailey



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