WealthHealth
Personal Wealth Management

2007 Market Outlook

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In 2006, the stock market proved its resilience. In the face of Federal Reserve interest rate hikes, fears of inflation and recession, high oil prices, a continuing war in Iraq, and a cooling housing market, record levels were attained by the Dow Jones industrial average and the Russell 2000 index of small stocks. What was thought in the beginning of 2006 to be common wisdom was proven to be commonly incorrect. Below is a chart of all of the major indices performance figures:

Index	2006 Return	3-Year Annualized	5-Year Annualized	10-Year Annualized
Standard & Poor's 500	15.79%	10.44%	6.19%	8.42%
Russell 1000	15.46%	10.98%	6.82%	8.65%
Russell 3000	15.72%	11.19%	7.17%	8.64%
Russell 2000	18.37%	13.56%	11.39%	9.44%
MSCI EAFE	26.34%	19.93%	14.98%	7.71%
MSCI Emerging Markets	29.18%	27.26%	23.52%	6.73%
Lehman Aggregate Bond	4.33%	3.70%	5.06%	6.24%

The latter part of 2006, particularly the 4th quarter, saw investors putting to rest all of the worries about the economy that earlier in the year caused the S&P 500 index to slump 7.7% between May 5 and June 13 (the worst slide since the bear market earlier this decade). As of the close of 2006, the economy proved stronger than expected with oil prices stabilizing and the Fed all but saying that it was done raising short term rates - at least for now.

What does this mean as we look ahead into 2007? Most investors believe the economy is – not too hot, not too cold – a perfect environment for stocks often characterized as a “Goldilocks” economy. This idea is further supported by the belief that Fed Chairman Ben Bernanke has stopped raising rates and may even reduce interest rates in the first half of this year, thereby stifling inflation without causing a recession. However, bond investors are still concerned about a possible recession, as they have pushed the 10-year Treasury rate to 4.708%, higher than 4.39% which began 2006, but still shy of the 5.25% mark hit in late June when concerns about the economy saw stocks plummet.

Based on these diverse attitudes, we expect to see some volatility in the first half of this year as investors solidify their opinions. Even if the economy slows, stocks are still attractively priced when compared to profits earned. Looking back to early 2000, stocks in the S&P traded at multiples (price to earnings ratio) close to 28, nearly double their historical average. Today, in contrast, stocks are more reasonably priced, currently trading at multiples less than 15 times earnings, its lowest since the end of 1994. At the same time, operating profits per share have been on the steady increase and cash on the balance sheets of companies has more than doubled. This is referred to as P-E contraction, which typically translates into more upside opportunity for stocks. If P-E’s expand, that usually means higher prices. When you combine that added return with potential gains in earnings and dividends, there is tremendous potential upside for stocks, especially in the large cap asset style.

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An additional boost for stocks can be had by the continued demand through merger and acquisition (M&A) deals. If as mentioned above, investors continue to believe that stocks are undervalued, coupled with the abundance of cash on corporate balance sheets and in private equity funds, the potential for share buyback activities and leveraged buy-outs is high. As a result of this activity, potential shares available in the marketplace could shrink, assuming the flow of new public offerings remains moderate and foreign investors' and hedge funds' demand remain strong.

Finally, aside from current market fundamentals, one can look to the non-economic trends such as the political climate. If history is any indication, the last time the stock market fell during the third year of a president's term was 1939. If fact, since World War II the S&P 500 has averaged 22% in a president's third year in office. The reason: doing what's necessary for the economy to ensure that it keeps positive momentum for the political party in power.

However, we must not ignore the fact that the yield curve remains inverted, causing some investors to fear a recession. Although such an inversion has preceded and been a good indicator of a possible recession, this time may be different. There is strong foreign demand for long-term US Treasuries and a low world-wide inflation rate thereby keeping US bond yields lower than normal. As a result, mortgage rates and market interest remains low, aiding consumers and businesses in their ability to borrow, spend, and invest, all of which is positive for corporate profits and hence the stock market.

Overall, we think the fundamentals are good when considering inflation, interest rates, earnings, valuations, and the Fed's policy on interest rates. As long as the economy escapes a recession, we believe our portfolios are properly allocated to reap the rewards in what looks to us to be a favorable 2007. As always, risks exist such as a slowdown in capital spending by businesses, resulting in a slowdown in hiring, and thus consumer spending. The housing market may not have bottomed, potentially weakening the economy, consumer spending, and the stock market. We have invested our client portfolios in the "best of class" managers within all asset styles. As the economic forecasts begin to play themselves out, our managers are positioned to actively shift their holdings to find value and opportunity in companies they expect will increase in value.

As your advisor, we too will make strategic shifts when we see opportunities. We have witnessed this positive impact this past year by adding the Merger Fund and Commodities exposures to our portfolios and staying committed to our large cap managers in the face of small caps' outperformance year over year. Merger activity has never been stronger, adding real value to our portfolios while also being uncorrelated to the volatility of the overall stock market. Although commodities gave back some of its positive performance from when it reached its new highs earlier in 2006, it continues to be a valuable asset style within our client portfolios for the long term, as global growth and demand remains strong. We have already seen the rotation begin from small cap to large cap and we believe that this will continue in 2007 as large cap companies are typically rewarded when growth slows and the interest rate environment is uncertain. Larger companies have a lot of cash on their balance sheets and are better positioned to withstand some of the uncertainties expressed above.

We continue to experience exciting yet sometimes uncertain times. While the end results of 2006 were good news, how we got there bears reflection on what was common wisdom. It proved to be commonly incorrect as it often does, which is why we focus on investment fundamentals of a well diversified portfolio. As opposed to market timing and predictions on markets, we believe that such a strategy provides a more certain, less volatile path to investment success.

As always, we are grateful to our clients who entrust their assets to us with unwavering confidence. We thank you for allowing us to serve your financial needs now and throughout the coming years.

Warmest wishes to all for much health and prosperity in 2007!