



Between a Rock and a Hard Place

January 1, 2007

As we begin the New Year, the markets are entering the fifth year of an upward trend, albeit one that has generated muted returns when compared to those of the previous decade. However, it should be noted that this continued expansion represents the exception rather than the rule. More important than the duration of the bull market is the lack of any significant adjustment to stock prices. The market has now entered the longest period in history without experiencing a pullback of 10% or greater.

Being a firm believer in “what goes around, comes around” this record may be short-lived, but more of that later. For the moment we should enjoy the returns that were generated in 2006. For the year the venerable Dow Jones Industrials rose 16.3%, while the broader based S&P 500 Index increased 13.6%. Bringing up the rear was the NASDAQ generating a still respectable performance rising 9.6%.

Though the domestic markets performed well, the real money was made in the international markets. The EAFE index generated a return of 23.18% in dollar terms, while the Emerging Markets helped by countries such as Brazil, Russia, India, and China (BRIC’s) produced returns north of 25%. The only real disappointment on a relative basis was the fixed income market where bonds continued to lag behind equities once again.

The primary motivation behind the rising equity markets could be attributed to declining energy prices, a signaling by the Federal Reserve that the long period of interest rate hikes would at least for the time being halt, and a tremendous amount of liquidity or cash sloshing around the global economy as represented by the private equity firms. These factors provided the catalyst for stocks to stage a rally in August that continued into the end of the year.

It could be argued that a squeeze by the short-sellers and a burst of buying by professional money managers (*70% under performed their benchmarks for the year*) fearing they would completely miss the rally pushed the indexes higher than was warranted. If indeed that is the case, at some point in the future, the markets will take back some of what it freely gave in the fourth quarter; which of course leads us to what may be ahead for the capital markets in the coming year.

The majority of analysts and market strategists are predicting solid returns for the markets in 2007 with all the usual caveats. If one lesson was learned by Wall Street after the last bull market, it was to insert any and all disclaimers that could impact your forecast. So, while the analysts are calling for higher stock prices they do mention that if housing, energy prices, corporate earnings, or geo-political events don’t quite work out the way they planned, their predictions may be impacted and they would kindly request that you ignore anything they may have rashly written or expounded upon at the year end.



I would agree with the reasoning behind the continued strength in equity prices for 2007, but have to admit to being a bit uneasy by everyone predicting the same general outcome.

The following represents the case for continued strength in the equity markets both domestically and internationally.

- The economy will play out the much-anticipated Goldilocks scenario.
 - Inflation will moderate as energy prices continue to trend down and wage pressures remain contained.
 - Economic growth will slow moderately while avoiding a recession.
 - Corporate profits will continue to expand just at a slightly lower rate of growth. Analysts are forecasting a slowing growth rate for corporate profits in the first quarter with a reacceleration in the fourth quarter averaging out to 9.5% year over year growth.
- As corporate earnings continue to grow, investors will display a willingness to pay up for stocks thereby providing for multiple expansions for the first time in several years. Traditionally in the latter stages of a bull market, earnings will slow as prices continue to rise causing price to earning ratios to expand.
- Liquidity, as represented by hedge strategies, buy-out and private equity firms, and the introduction and expansion of ETF, will continue to provide a source of capital for the markets. With all of the cash available and a desire to put the money to work, any significant correction in the market will be met by buying. This should enable a bid to be placed under the market.
- After a significant correction, the decline in housing has pretty much run its course with the up tick in December's numbers indicating the bottom. With a stabilization of the housing market, the consumer should be able to continue his propensity for spending and provide a firm foundation for economic growth.
- The mid-term elections will create a state of gridlock going into the presidential election cycle with neither side being able to accomplish any meaningful reform or enact any significant policy change. A resumption of the status quo should be evident for the next two years.
- The only exception to this state of inertia may be addressing the unpopular AMT tax and paying for the reform with a reduction in the estate tax thresholds. While this could potentially impact many of our clients, it will have little impact on the markets and the economy.

All of these factors indicate a relatively benign environment for the equity markets.

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What could possibly go wrong?

- For starters, the Goldilocks scenario of a soft landing that avoids a recession while maintaining strong corporate earnings and the absence of any inflationary pressures is a pretty neat trick if you can pull it off. Historically, when the Federal Reserve completes an interest rate tightening cycle, something adverse occurs in the financial markets. Things could be different this time, but at the least we should keep our eyes open.
- The NASDAQ didn't go straight down after peaking in March of 2000 and the housing market may follow a similar pattern. The up tick in December's housing numbers may be an up tick followed by the next leg down. If you ask an economist what keeps him up at night it is a collapse in the housing market. Again, I am not saying that housing prices are going to decline 20%, but I also don't believe the worst is necessarily over.
- With the exception of a few lone voices in the wilderness, everyone is calling for higher equity prices in 2007. Usually when everyone bets in one direction, the market decides to go in another. Everyone *may* be right this time...
- Inflation is stable, but it may not be dead. If oil kicks up due to geo-political factors or it turns out that global warming was just a fad or perhaps companies have to start paying people more, the Fed could be forced to raise rates to combat inflation. I think this is more of a long shot but don't forget the new kids in Congress are calling for an increase in the minimum wage.
- We have full confidence that the consumer will continue to spend considerably more than they make. (Credit card balances increased 47% last reporting.) But what happens if their homes don't increase in value and the big ATM machine runs out of money, gas prices stay at current levels, and the Fed raises interest rates pushing up short-term borrowing costs?
- Insider selling is at all time highs. Corporate executives could be prudently dumping options before the investigations begin or they may believe their company's shares are fully valued or god forbid over valued.
- If you think of a five year old that has just been given some money for his or her birthday you will begin to understand the mentality of the folks running a buy-out firm. Having been give billions of dollars by investors, their desire to buy something, anything over rides any sense of fundamental value or reason. For them, the deal is more important than whether it should be done in the first place. Short-term, all of this liquidity will provide a solid support to underlying stock prices, long-term this may represent a financial bubble.

The day you hear about a company in the Dow being taken private for a ridiculous amount of money by a group of investors you never heard of is the day my advice to you will be to place your stop orders because it will all end in tears.

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As you can see, we are clearly between a rock and a hard place. Things could go either way or you could stand still and just get bruised. Borrowing a bit from each camp would lead us to the following conclusions:

- The markets may run a bit further, but will subsequently enter a corrective phase adjusting equity valuations to more reasonable levels.
- As stated previously, the level of liquidity on a global scale will provide an underlying support level from which stocks should bounce.
- International markets continue to display stronger fundamentals, but the amount of cash flowing to these areas may dampen returns while increasing volatility.
- Large caps may finally get their day in the sun and out perform small caps. We would even venture to recommend health care, though we were disappointed by last year's performance.
- The bond market will remain lackluster with cash and high quality short-term fixed income the most attractive options. It's important to remember that cash is at times an appropriate investment if your only other option is losing money in the short-term.
- As fixed income yields will remain relatively low, high dividend paying stocks should make an interesting alternative providing income and growth potential.
- If the markets pull back, increasing the percentage of growth stocks in the portfolios may finally make sense.
- Finally, all good things must come to an end and if the markets manage to finish anywhere near the consensus view; this should be the last year in the uptrend. Just remember nothing goes straight up, but patient investors can always profit when markets fall.

We hope that the coming year will be profitable and safe for you and your family. Thank you for allowing us to assist you in your financial affairs and we look forward to speaking with you personally.

Sincerely,

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