

## Market Commentary

### A Very Good Year

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2006 was a surprisingly good year for the stock market. Total returns exceeded the expectations of most analysts. The rally which started in the third quarter was propelled by stable interest rates, an expectation that the Fed's next move would be to reduce rather than increase rates, and declining oil prices. That combination of factors continued to move the market in the fourth quarter.

From the end of June when the benchmark ten year Treasury was over 5% to now when it is about 4.7% longer maturity interest rates declined. Short term interest rates, which are most directly impacted by Fed actions, did not decline much. They are now higher than longer rates (a so-called inverted yield curve). The decline in longer rates helped to lower mortgage and other borrowing rates thus offsetting some of the impact of the weak housing market. Because economic indicators show a slowing economy this has caused investors to bet that the Fed's next move will be to lower rates. However that expectation is not matched by the rhetoric coming out of the Fed itself with continued expressions of concern because inflation numbers exceed their target level of 2%.

The other major factor helping the stock market was the decline in energy prices with oil going from a high above \$75 per barrel to the high 50's and low 60's. Cheaper energy blunts inflationary pressures. Like lower interest rates, it puts more money in consumers' pockets and thus stimulates the economy and corporate profits.

All of this translated into good stock market performance over the last six months of the year. What does it mean for the New Year? The positives are that stock valuations are not at unreasonable levels. Compared to the height of the market bubble in early 2000, stocks are not terribly overvalued despite the excellent performance this year. That means that if corporate profits continue to advance stocks can move higher. This is not early 2000 revisited in our opinion. In addition the market seems to be discounting economic weakness, and if the economy proves to be more resilient that will help stocks. Finally, we don't expect the Fed to increase interest rates in the next six months absent a major unexpected spike in inflation. While an interest rate cut would likely stimulate the market, the absence of interest rate increases would be almost as good.

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There are some negatives. The first continues to be oil prices. The combination of some degree of calm in the Middle East (at least relative to this past summer), a warmer than expected winter which has caused energy inventories to increase, and the absence of major hurricanes which disrupted energy production in the Gulf of Mexico a year ago, has produced a drop in oil and natural gas prices. This can all change very quickly. Middle East tensions can easily increase (name the spot and there is lots of potential trouble) and the weather can change. The U.S. continues to be extremely insecure from an energy standpoint and rising energy prices are inflationary and will hurt the stock market.

The second major potential problem, which is not high on many people's radar screens but is a concern to us, is the tremendous growth of the largely unregulated hedge fund and private equity world. In 2006 several hedge funds imploded. While the impact on the economy was not great, the potential for much bigger problems which could reverberate throughout the economy is there. The reality is that no one really knows what hedge funds are doing and how many of them are pursuing very similar strategies and trades, which if they come unraveled could impact numerous very large financial institutions.

The world of private equity is another unknown. While investors love the premiums these funds pay to take over publicly traded companies, the net result is more and more very highly leveraged private companies with uncertain prospects for repaying their debt. If one or more of the large deals comes undone, it could mean major losses for lenders to these companies.

Perhaps our concern about hedge and private equity funds is not reasonable, and they will continue to be a positive force in restructuring laggard companies. That would be well and good. However it is something about which to be mindful.

We are pleased with the performance of our clients' accounts in 2006, but it is unrealistic to expect 2007 to be as good as 2006. It continues to be important to take a long term perspective with some years being very good and others not so positive. We are cautiously optimistic as we enter the New Year.

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