

4th Quarter 2006

THE MARKET

The stock market rallied strongly in the fourth quarter. The DOW was up 16.3% in 2006 followed by the S&P 500 up 15.8% and the NASDAQ up 9.5%. The EAFE index of international stocks was up 26.3% and the AMEX was up 16.9%. The industry sectors that led the up market were Telecommunications up 36.8%, Energy up 24.2%, Utilities up 21.0% and Financials up 19.2%. In alternative asset classes, real estate led the way with the NAREIT index up 35.1%, Emerging Markets up 29.2% and Energy 24.2%. The bond market ended up just slightly with short maturities outperforming intermediate and long maturities as interest rates rose slightly in the fourth quarter.

THE ECONOMY & INTEREST RATES

“The most remarkable aspect of the economic recovery is the magnitude and persistence of liquidity,” says James W. Paulsen, Ph.D., Chief Investment Strategist of Wells Capital Management. He goes on to say “...although the current recovery will soon be seven years old, the Federal Reserve has been tightening monetary policy for almost two and a half years, and short-term interest rates have been increased 17 times by a total of 4.25 %, there is still very little evidence liquidity has diminished. Liquidity is increasingly recognized as ‘the defining force in the economy.’”

“Corporations are flush with cash to the point of initializing large stock buyback programs, announcing widespread dividend hikes, pursuing record-setting merger and acquisition, and taking themselves private. Households are also cash flush. The annual growth in household deposits is more than 9% in the last year. Household liquidity growth has been accelerating as the expansion matures. It has been rising since late 2003 when its annual growth rate was below 2%. Currently, at 9%, household liquidity growth is comparable to the high inflation of the 1970s. Excessive liquidity is also evident around the globe. Foreign central bank vaults are chalk full of U.S. dollars.”

Looking ahead, Mr. Paulsen believes that the world economic recovery still has a way to go. There is still too much liquidity chasing both goods and assets. Interest rates are low compared to core inflation rates, wage inflation, personal income growth and profit growth. He points out that the household sector is still enjoying low unemployment, healthy job and income creation, and rising net worth. People still show considerable propensity to go to the mall. “There is simply too much economic momentum in the world,” he says.

Van Hoisington of Hoisington Investment Management (a bond manager) and Bill Gross of PIMCO (a bond manager) believe the economy is slowing down because of higher interest rates. They think that consumer spending will slow because of a borrowing slow down; that adjustable rate mortgages and low quality mortgages will come home to

roost; government expenditures will slow; GDP growth will slow to 1.5% in 2007 along with inflation running at 1.5% equaling nominal GDP of 3%. This, Hoisington says, is the lowest since 1958. PIMCO looks for a Fed-Funds rate of 4.25% by December of 2007 with 5 and 10 year yields hovering at levels perhaps 25 basis points higher. Bill Gross says that if the Fed lowers rates sometime within the next six months then the U.S. bond bull market will gain new vigor. Hoisington agrees.

Mr. Paulsen, on the other hand, believes that the Fed will be back raising interest rates by next summer and bond yields will have a ways to climb simply to catch up to the current Fed funds interest rate. “Ultimately, we still think the interest rate structure within the U.S (both short-term and long-term yields) will rise above 6 % before this recovery cycle peaks,” he says. He thinks the stock market may surge during the first half of 2007 because of liquidity and valuation of the stock market. He also expects the dollar to continue to decline relative to emerging currencies.

Mr. Paulsen draws some comparisons for 2007 to 1987 when the stock market crashed. He points out that in 1986 the economy was sluggish, inflation was dormant, bond yields had been declining and most people expected the same for 1987. The dollar was weakening causing improvement in the trade deficit during 1987. Domestic spending was strong, boosted by low long-term yields. The stock market soared by 40% by August of 1987 amidst surging economic growth and ballooning commodity prices. He says, “...if trade improves and at the same time autos and housing bottom, while consumption is boosted by lower mortgage yields, lower gas prices and continued job creation could 2007, like 1987, produce a surprisingly strong economy and stock market through the summer, followed by intense inflation fears, culminating in much higher yields and a rougher stock market by the Fall?”

You will hear in the media about P/E expansion, growth stocks out performing value stocks and energy leveling out. The economy is showing signs of being stronger than most realize which should be good for stocks and bad for bonds.

CONCLUSION

Well there you have it. Contradictory views from very intelligent and experienced professionals. Based on their views we believe that a wait and see attitude is the prudent course for now. Our master asset allocation today is Small Cap Growth 5%, Small Cap Value 5%, International Equity 15%, Large Cap Growth 10.0%, Large Cap Value 10.0%, Intermediate Bonds 13%, Money Market 27%, Direct Real Estate 5.0% and Energy Equity 10%. This allocation will vary by the type of client, the risk tolerance and time horizon of each client of Monroe Vos. There is no allocation that fits all clients.