January, 2007

2006 Review and 2007 Outlook

Review: Stocks finished the year strongly with a 6.8% gain in the final quarter. Bonds had a return of 1.0% in the quarter. As shown below, the S&P 500 increased a robust 15.9% for the year, while the Merrill Lynch Intermediate Bond Index gained only 4.1%. This is the fourth consecutive year that stocks have outperformed bonds.

Annual	***2006***	***2005***	***2004***	***2003***	***2002***	***2001***
S&P 500 Index	***15.9%***	4.9%	10.9%	28.7%	-22.1%	-11.9%
Merrill Lynch Int. Bond Index	***4.1%***	1.6%	2.9%	4.2%	9.7%	9.0%

The Economy: In 2006, economic growth continued, but the rate of increase slowed as the year progressed. GDP growth measured 5.6% for the first quarter. By the fourth quarter, GDP grew at an estimated 2.5%. The housing market weakened dramatically as the year progressed and energy prices remained high. As a result, consumption growth slowed from 4.8% to 3.0% during the course of the year, but remained healthy, due to a number of offsetting factors: continued good job growth, growing exports, and robust commercial construction. A clearly negative factor was the core inflation rate, which ended the year at an estimated 2.3%. The Federal Reserve target range for core inflation is 1-2%.

Looking ahead to 2007, we expect the economic numbers to be generally favorable. Corporate profits are strong. Capital spending is growing. The job market is healthy. International growth is robust. The most significant negative is the ongoing decline in housing. In summary, GDP is expected to grow at 2.5%, down from 3.3% in 2006. At this point in the cycle, it is natural for the economy to ebb and flow because there is no one strong driving force. We do, however, expect the overall trend of moderate growth to continue.

There are three significant risks to the health of our economy. Inflation is somewhat elevated due to a tight labor market, but productivity increases are holding it in check. Housing could weaken further, to the point that it damages consumer confidence. Also, geopolitical events could depress the markets, as happened in July of 2006. Such events are hard to predict.

Stock Market: As 2006 began, we projected an increase of 6-10% for corporate earnings. When the fourth quarter tally is in, the expectation is for a 14% gain. The sectors that provided positive earnings surprises were commodities, such as energy and basic materials, and financials.

Energy earnings were driven by the spike in prices associated with Middle East tensions. Basic materials benefited from continued strong demand in emerging economies. Financial stocks were helped by record earnings in investment banking, due to heavy merger and acquisition activity, and insurance companies that enjoyed a benign hurricane season. Consumer discretionary, weighed down by weak housing, was the only major sector with declining earnings estimates during the year.

This year, earnings for the S&P 500 are expected to grow at a more moderate 7-10%, reflecting slower economic growth. International growth looks to be strong, helping the earnings of multinational companies.

Bond market: The yield curve remains inverted—longer-term bond rates are lower than short-term rates. This normally means that the bond market believes the economy is slowing and that the Federal Reserve is poised to lower short-term rates. However, the recent indications of strength in the economy and comments from Fed officials that they are still concerned about inflation lead us to believe that short rates will stay at current levels, at least through mid-year. Long-term interest rates are too low, given this scenario. We expect long rates to rise moderately through the first half of the year.

Strategy: Stocks will again provide better returns than bonds, as corporate earnings continue to grow. The leaders will be the traditional steady growth sectors- healthcare and consumer staples, and the capital spending-related sectors- industrials and technology. Many of these companies have significant international businesses and will benefit from strong international growth.