

INVESTMENT OUTLOOK & COMMENTARY

First Quarter, 2007

Summary: Assuming oil doesn't spike and housing prices, at worst, only moderately decline; we expect a good year for stocks in 2007. Forces driving stocks higher include a combination of reasonable valuations, ample liquidity, and the influence of private equity. Within fixed income, while the yield curve may indeed be flatter for some years to come, we favor shorter maturity bonds but will be looking for trading opportunities in longer term bonds as they present themselves.

With the current phase of economic expansion in the U.S. entering its sixth year, we are seeing quite a divergence in prognostications on Wall Street. Slowing economic growth, weaker housing prices, and the fact that bull markets usually don't last this long without a significant (at least 10%) correction; have caused many to turn bearish entering 2007. It seems, as Harlan has noted, any one of a myriad of factors can send the markets in either direction—quite a change from early 2006 when we thought everything hinged on the Federal Reserve and whether or not they were going to stop raising interest rates (this proved to be quite the case). While we believe a correction is in the cards, we think it happens after 2007.

Private Equity Boom

For the past few years, we've pointed to earnings growth as the main reason stocks were relatively cheap and should post nice returns. While prices have gone up and many stock indexes are at new all-time highs, prices have not caught up to earnings, in our view. Partly to blame is overly conservative management among the nation's corporations. In the past, we've praised corporations' attempts to strengthen balance sheets by reducing debt and raising cash. Recently, however, managers have become too defensive. With corporate borrowing rates near 6% and return on equity at 16%, holding some debt adds value to shareholders; but most executives have gone the other way as the typical large corporation has reduced debt some 50% while holding 10-15% of its market value in cash.¹ The end result has been companies underachieving in regard to profit maximization for shareholders.² In other words, even though earnings growth has been good, overly conservative management prevented even higher earnings.

Enter private equity funds (pooled funds management by private equity firms seeking higher risk and return opportunities), the latest juggernaut on Wall Street and perhaps the market's cure to overly risk-averse corporate management and undervalued stock prices. Private equity firms raised some \$170 billion in 2006 and contributed to the record \$3,900 billion in corporate acquisitions made in 2006.³ With low interest rates, still-thin corporate spreads, and growing interest from institutional investors, more deals by private equity firms should be

done in 2007 and with bigger targets.

Mid and small cap stocks have initially benefited most from the private equity boom. As private equity grows, we expect the relatively-cheap large cap companies to be increasingly targeted; already, Home Depot, Dell and Deere have been the subjects of take-out rumors. The private equity threat should, at least, improve corporate governance and remind investors that U.S. stocks remain a good value.

Liquidity is also coming from overseas, as foreigners' high savings rates and the trillions of U.S. dollars sent abroad look for returns in relatively safer U.S. assets. Foreign ownership of all U.S. equities stands at 14% today compared to 5% ten years ago.⁴ Perhaps more revealing of the global savings glut is that foreigners now own over 40% of U.S. Treasury bonds compared to less than 20% just ten years ago.⁵

Like all things, opportunity should eventually turn to greed as demand from private equity and foreign investors will grow to excessive levels, using their vast capital to acquire companies of dubious value; but that should come much later. In the meantime, there are a lot of bargains out there; particularly in large, quality U.S. companies.

Oil and Housing Qualifiers

While ample liquidity should drive stocks higher, the biggest influence on stocks lately and into the near future may be the price of oil. It's probably not a coincidence that the S&P 500, which was negative for the year through July, turned around only as oil prices peaked this summer at \$77 and started a considerable slide. Although oil continues to be less of a factor in our ever-increasingly service-based economy, most still view oil prices as a significant tax to businesses and consumers alike. While most pundits (Peak-Oil theorists in particular) foresee continuously higher oil prices, we think moderate oil prices are possible in the near term as capacity has increased considerably. In addition, exploration and production activities are rising sharply, especially outside of OPEC.

In addition to oil prices, our bullish view on equities is also based on a soft landing for housing. While housing inventories have been rising sharply for sometime now, average home prices in the U.S. have just recently turned negative. With the Fed unlikely to raise rates further any time soon, we expect just a moderate correction in housing. A bigger fall in prices would likely precipitate a negative wealth affect that would have severe consequences on consumer spending and the economy as a whole.

Defensive on Bonds

Good monetary policy over the years has convinced investors worldwide that low inflation will prevail over the long term. That confidence in the world's central bankers, combined with governments shortening the overall maturity of their debt structures and the trillions of dollars in savings worldwide, has significantly lowered long term bond yields to the point

where short term bonds offer the same income as longer term bonds. In capital markets-speak, *term structure risk premium is zero and thus the flat yield curve*. While we believe in a rosy inflation picture over time, inflation could sneak-up on the economy from time to time, especially due to sharp weakness in the dollar. As we're not constructive on the direction of the dollar, we can't be sure inflation will not flare up sometime soon. Thus, we're relatively short on bond maturity, content to pick up higher current yields while being well-positioned should risk be re-priced back into longer term bonds.

Neil Rose, CFA Chief Investment Officer

1 To be fair, Sarbanes-Oxley legislation has significantly contributed to managers' unwillingness to take risk. Corporate heads, in addition to being under greater regulatory scrutiny, are now personally liable for their companies' financial reports.

2 With executive compensation coming under heavy scrutiny lately, performance and value-add are much stronger arguments against soaring executive compensation levels rather than simply comparing such pay to that of average employees.

3 *The Financial Times*, December 21, 2006.

4 Steven Wieting. *Economic & Market Analysis*, Citigroup publication, December 7, 2006.

5 Ibid.