

# Q4 2006 Quarterly Commentary

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Capping off a solid year in the investment markets, the 4<sup>th</sup> quarter of 2006 ended with positive news. The U.S and World economies continue to grow while inflation appears to be contained. The price of a barrel of crude oil (the world's most important commodity) fell into the \$53 range, far below the high of \$78 hit in the summer of 2006. The US stock market as represented by the S&P 500 ended the 4<sup>th</sup> quarter with a solid gain of 6.6% to finish 2006 up 15.6%. Large Cap Value stocks had another great year, ending up 23.3% for the year, compared to 9.1% for the Large Cap Growth Universe. Small company stocks rose 23.4% with developed market international companies nearly matching with an increase of 23.3% for the year. The star asset class for 2006 was commercial real estate as represented by the Wilshire REIT index, up 8.9% for the fourth quarter and 36.1% for the year. With the U.S. economy stronger than many had anticipated in 2006, bond yields trended slightly higher, despite a 4<sup>th</sup> quarter rally. The Lehman Brothers Aggregate Bond Index ended up 1.2% for the quarter while totaling 3.9% for the year. For 2006, the total return on bonds was slightly less than the interest earned, indicating bond prices declined slightly with rising rates.

With the close of 2006 we continued a string of 4 straight positive years for the economy and overall financial markets. Our economic indicators show a high probability of continued U.S. economic growth in 2007, even possibly reacceleration of the economy due to the stimulative effects of lower energy and commodity prices and continued strong business profitability. U.S. manufacturing growth rebounded in December, and services are still healthy and growing, as shown by the ISM Non Manufacturing (services) Index well above 50, which indicates continued expansion. U.S. labor markets remain healthy with unemployment insurance claims down, and wage growth positive. U.S. corporations have significant cash balances, financial capacity which is driving both increasing capital expenditures and more mergers and acquisitions. 2007 real gross domestic product growth between 2.5% and 3.5% would not surprise us. With this type of economic backdrop, overall U.S. stock market growth around 10% for 2007 would be consistent with today's equity valuations and expected profit

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growth. We are at target allocation for U.S. stocks given these positive trends and moderate equity market valuation.

Naturally, the world is not suddenly looking all rosy. Fears of a housing driven slowdown remain, although perhaps overblown as U.S. consumer and business capital spending offsets the weakness in housing. Since July, we have had an inverted yield curve (short-term interest rates higher than long-term rates). In our post-World War II history, inverted yield curves have been followed by recessions. Thus, the inverted curve has led some economists to predict a recession in 2007. We, on the other hand, think the inverted curve results both from some market participants' concerns of near-term weakness as well as much of the market anticipating low long-term inflation due to globalized labor and production keeping tight limits on prices.

The Federal Reserve remains wary of inflation, however, and we do not expect interest rate cuts any time soon. With the current inverted yield curve, this may lead to temporarily higher longer bond yields as the bond market comes to this realization, a phenomenon currently playing out as the 10 year Treasury yield has risen from near 4.4% to 4.75% in the last 45 days. 2007 is not starting out well for fixed income, but we are choosing to remain at our target allocations in bonds. If inflation remains under control from globalization effects, bonds will provide good real returns. If the economic pessimists are right, and at some point they will be, bonds will rally at strong signs of a recession. If the dollar drops significantly, leading to higher import prices, higher demand for U.S. based labor, rising commodity prices, and the higher inflation rates that would come with these, only then would our investment in bonds lead to near-term negative returns. We don't anticipate this situation, but are watching developments carefully.

We are still bullish on global economic growth and continue our overweight of international developed and emerging stock markets. Emerging economies represent 15% of the world market capitalization but slightly over 50% of world GDP. Some estimates place 40% of global GDP growth on China



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alone. Over time, we anticipate emerging market stock values will more closely align with their underlying economic contribution. Both Europe and Japan are growing their economies faster than they have in years, providing opportunity for those invested in those stock markets as well as for U.S. companies selling to their consumers.

Our underweight of REIT equities in 2006 was early, however history has shown that significant periods of strong appreciation (REITS have had a seven year run of out-performance, gaining nearly 166%, or an average of 23.7% annually) are followed by periods of underperformance. With REIT dividend yields down significantly due to large stock price appreciation, we remain slightly underweight at this time.