

INVESTMENT BACKGROUND

January 2007

Positives

Negatives

ECONOMIC

- Economic and earnings growth slowing, but still positive
- Liquidity—global glut of money seeking a home
- Inflation still subdued
- Interest rates remain at low levels
- Companies are cash rich—can be used for dividend increases, share repurchases, M&A, capital spending
- Demographics—older, richer population
- Commodity prices remain high—gold, precious metals
- 65% of oil from overseas
- Debt bubble—government/consumer debt over \$30 trillion
- Asian low wage competition
- Dollar instability—will central banks diversify?
- Housing prices
- Negative U.S. savings rate vs. high savings rate abroad—Europe saves around 10% of income, China 40%
- Global and U.S. economic growth decelerating
- Legacy costs—pensions, social security, healthcare
- Reduced consumer spending? Retail sales slowing.

GOVERNMENT FISCAL POLICY

- Political gridlock
- Low tax on capital gains and dividends
- Ongoing federal budget deficits
- Total federal debt
- Protectionist/populist economic policy moves by Congress

MONETARY POLICY

- Adequate liquidity available in banking system
- Pause in Federal Reserve action on interest rates—next move likely to be a cut in rates
- Tighter lending policies
- High short-term rates
- Inverted yield curve

(over)

Positives

Negatives

VALUATION

- Earnings yield of stocks vs. 10-yr bonds
- Avg. level of P/E's fairly priced
- Low yields—investors income starved
- Low risk premiums on all asset classes
- Profit margins unsustainably high
- Credit spreads too tight—risks being ignored

TECHNICAL

- Presidential cycles—3rd/4th years usually good for stock market
- Low cash in mutual funds
- Poor breadth
- Sentiment—investors are getting optimistic

GENERAL

- Stocks reasonably valued versus investment alternatives
- Terrorism—cost of fight, human toll, political disharmony
- Markets are cyclical—“seven fat years, seven lean”—long bull market period 1982-2000 vs. slowdown 2000-?
- Proliferation of quick twitch investors—hedge funds, program trading, and derivatives

CATALYSTS FOR CHANGE

What could make us more bullish:

- Oil price falls to mid \$40s per barrel
- Inflation remains subdued
- Corporations boost pace of hiring, capital spending, stock buybacks, and merger activity
- Federal Reserve cuts Fed Funds rate
- Pull out from Iraq and Afghanistan
- Business friendly legislation from Washington

Key downside risks:

- Dollar collapse—foreign liquidation of U.S. debt, foreign investors stop lending to U.S.
- Excessive U.S. monetary tightening
- Recession
- International crisis—North Korea, Iran, a major terrorism event
- Higher long-term interest rates, mortgage rates spike
- Housing prices continue to fall
- Oil prices stay over \$60/barrel and rise
- Financial accident/crisis—hedge funds, Yen carry trade, derivatives, subprime lending/higher consumer default rates

BOTTOM LINE

The current bull market began in October 2002 and is now one of the longest in history. 2006 got off to a bumpy start, but closed strong ending the year with a price increase of 13.6%, as measured by the Standard & Poor's 500. The economy is slowing, but the consensus is that there will be a soft landing. Goldilocks lives! To us, positives and negatives seem evenly balanced, and the big question is what will stimulate future growth—exciting new products, government policy initiatives, upturn in consumer spending, etc. The potential for economic disruption is growing. Our goal is to expose our clients to a wide variety of relatively stable earnings streams, combined with good liquidity and minimum debt. For now, we stress financial moderation, balanced asset allocation with exposure to a number of different asset classes, and broad diversification.