



INVESTMENT UPDATE

January 2007

Economic Conditions & Market Outlook

Happy New Year! Auld Lang Syne! Out with the old and in with the new! Noisemakers and resolutions! There's a lot of hoopla surrounding the move from one year to the next.

But in reality, aside from the close of the personal income tax year and a myriad of related year end deadlines, the actual transition from the last day of December to the first day of January has little direct financial significance. True, some corporations operate on a calendar tax year but many do not. And while financial data/economic measures are often quoted in traditional, convenient calendar year increments, the fact remains that the same market conditions and economic factors that were with us on December 31st will be waiting for us once the confetti settles and the champagne runs stale.

Given the stock market's performance in the latter portion of last year, this is not necessarily a bad thing. So before we entirely bid adieu to 2006, it is important to reacquaint ourselves with some of the good, the bad, and yes, the ugly that helped shape last year's economic landscape. Here are a few highlights.

The equity markets closed out the year in rather smart fashion; with the Dow Jones Industrial Average ending 16.3% higher, the Standard & Poor's 500 index topping out above 13.6%, and the NASDAQ closing up 9.5%. While these positive per annum performance numbers are noteworthy, even more so is the fact that all of the three indices' year-to-date results were firmly entrenched in the red as of mid-July.

What contributed to this dramatic turnaround during the last five months of 2006? As our *July 2006 Investment Update* noted, despite generally healthy economic conditions, the market malaise earlier in the year was being unduly influenced by inflationary concerns and the uncertainty of when the Federal Reserve's interest rate raising campaign would come to an end. With the first worry lessened and the second question finally answered after 17 consecutive rate hikes by the Fed, the stock market started to rally and continued to do so through year end.

Adding to this momentum was the fact that U.S. corporate profits continued to grow nicely, with the aggregate annualized profit increase for 2006 estimated to be somewhere north of 15%. Despite this, stock valuations remained rather reasonable versus historic standards and the combination of disposable corporate cash with attractive equity valuations contributed to a surge in stock buybacks that added shareholder value and helped push stock prices higher.

On the economic front, the upward march of oil prices abated, at least temporarily, and the economy as a whole appeared to adjust to petroleum's higher pricing paradigm without significant disruption. The Consumer Price Index fell throughout the last half of the 2006 and ended well below most consensus projections, additionally fueling the argument that inflationary concerns were effectively under control. Unemployment hit a 5-year low in October before moving slightly upward at year end. The Consumer Confidence Index ticked up during the last quarter, hitting an eight-month high in December. Retail sales figures were up 5.6% in November (although year end sales growth will likely disappoint) and the beleaguered housing industry received a glimmer of good news when new and existing home sales data for November proved to be better than expected.

Even the just released Purchasing Managers' Index showed some recovery in manufacturing activity during the month of December. While this number was certainly lower than where the figure stood at the beginning of the year, remember that the Fed objective was to apply enough brake to slow growth and inflation without tail-spinning off into a recession. Despite the concerns of a few observers, the data seems to suggest that, so far, Bernanke and crew have been successful in engineering that sought-after economic 'soft landing'.

But 2006 as a whole was certainly not a bed of roses, particularly for anything remotely connected to the housing industry. The ‘bubble’ in residential real estate continued to leak and most homebuilder stocks took it squarely on the chin. However, concerns of a cataclysmic bubble-bursting lessened as the year progressed and neither the consumer nor the economy suffered to the degree some Cassandras had initially feared.

Is the worst over? It’s hard to say. A huge rebound in real estate demand and pricing seems unlikely during the next twelve months. And there will undoubtedly be periodic stories of foreclosure, bankruptcy, and economic ruin related to the unprecedented run-up in residential property values, irresponsible lending practices by both lender and borrower, and big bets by builders or developers going bad. But the overall economy tends to be rather resilient, with the short term woes of one industry or sector, regardless of breadth, rarely being significant enough to drag down the entire ship.

The upcoming year should also see corporate profit growth slowing, with most economists forecasting an annual growth number under 10% during 2007. This is not a significant concern. After enjoying annual profit increases in the double digits since 2002, it is natural, and even necessary, to see a slow down in corporate profit expansion during the year ahead.

Likewise, the recent Wall Street Journal survey of economists predicts that overall economic growth, as measured by gross domestic product (GDP), should be in the range of 2.3% for the first half of 2007 - a full percentage point less than the 3.3% rate expected as 2006’s final figure. The survey then suggests a pickup in the second half of the year to the 2.7% range, although there is far from consensus on this number or timeframe.

Some forecasts also suggest a reduction in Federal Reserve interest rates sometime mid-year 2007 to keep the projected moderate economic growth on track if housing and manufacturing begin to stall further than expected. While this rate-reduction prognostication is far from universally agreed upon, the Fed’s propensity to overshoot its targeted impact when moving rates up or down certainly puts the potential for a mid-year pare back within the realm of possibility. Clearly the upcoming year will require a continued balancing act by the Fed to successfully maintain a ‘Goldilocks’ scenario; where the economy is neither too hot nor too cold but just right.

Most current stock market projections are betting the Fed can pull it off. Decent equity returns are being forecast by a consensus of analysts for 2007, although most suspect final returns will be less than those posted for the year just gone by. The precise percentage projected varies and is about as useful, i.e. useless, as any other specific numeric guess hazarded by financial soothsayers twelve months in advance. The important factor is that there is rather positive underlying sentiment as to the general direction the stock market is heading near-term, albeit with the potential addition of some overdue volatility along the way.

Several factors could turn this current market trajectory upside down. While more subdued corporate profit growth and less economic steam is already factored into the equation, any indication that the economy is moving toward a recessionary-level slowdown would derail the train. Likewise, though not expected, signs that inflation has not been kept under wraps would obviously be viewed negatively. In addition, as noted earlier, the positive projections for the upcoming year are predicated on the successful maintenance of a somewhat delicate balance; any surprise that unexpectedly tips that balance would not be welcomed by the markets. Geopolitical unrest, terrorist acts, gushing oil prices, and significant disruption of foreign markets and/or currency valuations are just a few of the surprises that would tip the scales.

On the fixed income side of the market, the general yield compression in bonds that existed throughout 2006 continues to linger longer than expected despite the Fed’s halt in raising short-term interest rates. The yield curve slope for most classes of bonds is slight, while remaining inverted for U.S. Treasuries, offering little incentive to buy anything other than short-term bonds. For example, the six-month U.S. Treasury yield currently sits around 4.85%, with average five-year and thirty-year U.S. Treasury yields in the range of 4.58% and 4.70% respectively. Things look a bit better for investment grade corporate bonds, which currently offer an approximate 55–65 basis point yield pick-up over U.S. Treasury rates at the five-year level and some additional rate spread enhancement as corporate maturities lengthen. This same proportionality currently applies to municipal bonds and there is no indication as to when yield spreads may begin returning to the historic norm.

Our Tactical Investment Stance

Roof Advisory Group's disciplined investment approach emphasizes adding value to client portfolios while controlling downside risk. Strategies include clearly defining investment policy ranges based on each client's specific investment objectives/risk tolerance, monitoring portfolio adherence to established benchmark parameters, and the ongoing evaluation of relative portfolio return.

Within this strategic context, the firm makes tactical shifts with changing market conditions to optimize client portfolio performance. While every client situation is unique, outlined below are a few of the tactics we are using in the current market:

- For the majority of clientele, we ***increased equity exposure in August*** back to a ***'one-step below maximum' equity allocation*** as defined by each client's individual investment policy. This increase followed a brief step-down to our 'midpoint' equity allocation in June as the equity market swooned. The firm had been at the 'one-step below maximum' equity allocation target throughout most of 2005 and remains there today. However, the upward range limit of our current 'one-step below maximum' target has been softened during the past month as a potential move to 'maximum' equity allocation has been under review.
- The firm continues its ***leaning toward large-cap stocks*** with solid management, consistent earnings, low P/E ratios (18 or below), higher dividend yields (2.5%+) and annual growth potential (10%+). Stocks outside these parameters are also used when unique pricing or appreciation opportunities exist. Throughout the year, ***several stock positions were pared*** that had either ***reached price appreciation potential, did not meet expectation, or were deemed to be at risk*** from near-term downward market pressure. The firm continues to ***selectively add new stock positions*** that meet firm valuation and growth expectations.
- ***Diversification remains a priority*** in both equity and fixed income portfolios. Equity exposure is regularly evaluated for diversification based on style and industry sector while fixed income assets are diversified by issuer, industry and, in the case of municipal bonds, geographic region. While the firm does not make deliberate industry sector bets, concentrations above the benchmark can result from our equity selection process. As a result, currently the industry sectors of ***Energy, Utilities & Telecom remain over-weighted*** versus S&P 500 benchmark averages; while the areas of ***Consumer Services, Healthcare & Media are under benchmark level***.
- ***International equity exposure*** is primarily maintained through investing in ***multinational firms that operate on a global basis*** with this fundamental exposure ***enhanced by utilizing asset managers that specialize in foreign investment opportunities***.
- Per usual, new account balances and large cash deposits are phased into targeted investment levels. The ***deployment of cash to build equity exposure has been accelerated*** in the appreciating market, while ***fixed income purchases remain paced*** based on opportunity and availability.
- Individual bonds are always used for larger fixed income portfolios to control quality, maturity, and yield. Overall bond quality is never sacrificed in the pursuit of higher yield and a client's tax bracket/account determines whether taxable or tax-free bonds are more advantageous. We continue to maintain a ***notably shortened average maturity*** in the bond portion of our client's portfolios due to market conditions, with most having aggregate ***bond durations of 2.5 years or less***. Similarly, we continue to ***selectively purchase short to intermediate tax-free municipal bonds*** in the taxable accounts of our high tax bracket clientele despite rather ***limited availability*** for many states.

E. Jeffrey Roof