NOW'S A
GOOD TIME
TO GET SOME
GOOD ADVICE

Rare Air - Five Positive Years?

Nice Year

2006, the fourth year of the current bull market, was characterized by significant moves: up then down (a scary -14.6% for the NASDAQ 100) and then up again, as investors grappled with rising interest rates, another intensification of geopolitical instability, high oil and commodity prices and a softening in housing sector demand. In the market's favor, liquidity remained buoyant, profits were stronger than expected, employment figures were constructive, global growth held strong and inflation remained in check. For the year, the Thomson U.S. Average Balanced Fund returned 10.3% while the Thomson U.S. Average Diversified Stock Fund returned 12.4%.[1]

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Current Economy

United States Economy

Warmer weather and lower oil prices helped the U.S. GDP (Gross Domestic Product) grow 3.5% in the fourth quarter. With colder weather and higher oil prices in the first quarter, The Blue Chip Economic Forecasters Survey expects first quarter real GDP to grow at a 2.4% annual rate and then pick up gradually throughout the year. Continued strong employment gains will more than offset the weakness in housing and problems in the sub prime lending market. The Survey predicts 2.7% GDP growth in 2007, versus 3.4% in 2006 and 3.2% in 2005. Core CPI is expected to advance 2.3% in 2007 and 2.2% in 2008.[2] If these forecasts prove correct then there is little or no reason for the Fed to lower interest rates any time soon. Federal Reserve Chairman Bernanke suggests he is comfortable with current interest-rate levels and stands ready to raise rates if inflation doesn't moderate as the Fed expects: "So far, the incoming data have supported the view that the current stance of policy is likely to foster sustainable economic growth and a gradual ebbing of core inflation."

World Economy

China continued to lead the world economy in 2006 with spectacular growth of 10.7%, the highest rate in more than 10 years. To put this in perspective, at this rate, if it were to continue, the Chinese economy would **double** in size in the next **seven** years! Going into 2007, we see no serious economic dislocations that require immediate and dramatic policy reaction by the Chinese government. We expect gradual economic growth deceleration in the early half of the year, which will lead to a further downshift in inflation and remove the need for further government tightening. With China as the economic engine, the International Monetary Fund expressed confidence that global growth would remain "solid" at close to 5% this year. "Economic recovery in Europe has broadened, Japan is broadly on track (helped by Chinese growth) and emerging market growth remains vigorous." [3] There is nothing on the economic horizon that would trigger a slowdown next year except an actual disruption in the supply of oil and/or extreme geopolitical turmoil.

Investment Outlook - United States Equities

Bull markets normally last two to three years. 2006 was a rare fourth year for the bull that began in 2002. The last extra long cycle was 1982-1987, which ended in the short violent bear market, known fondly as "The Crash of 87". The prior long bull market was 1957-1962, which also ended in an abrupt market decline. Before these one must go to the early 1930's, back to 1932-1937. While five positive years does happen, history shows it is a rare event; cautious participation in the current market is recommended.

We expect ever-increasing volatility in 2007 as investors assess the increasing prospect of a profit slowdown and the absence of near-term stimulus from the Federal Reserve. We see another Up, Down, Up sequence, with an above average mid-year decline that sets the stage for a new Bull Market advance that should last into 2009. As this current Up phase is certainly maturing (It has been 154 trading days without an S&P correction of 2%, the third longest streak since 1928.)[4], it is time for increasing defensiveness in asset allocation and sector themes.

Asset Allocation

U.S. Stock and Bonds

We expect the Fed to do nothing for many months to come, the economy to continue at a moderate pace, and interest rates to remain flat or even rise over the next four to six months. In this environment we favor cash and short-term bonds in the fixed income portfolio. Near term, we may lighten up on U.S. equities as this current intermediate rally tops out, waiting for the next entry point sometime in the second or third quarter. We favor big-cap issues over small and mid-cap stocks. We believe that at the next bottom, growth stocks will finally take the lead from value stocks that have outperformed for nearly seven years. We also favor health care, high technology, industrial, telecommunications and selective consumer stocks. From a defensive viewpoint we have recently added to consumer staples (such as the Consumer Staples ETF (Exchange Traded Fund)) and healthcare (such as the Pharmaceutical Holders -PPH). High Technology stocks look particularly intriguing for a major commitment at the next bottom. Ever since the "bubble" in 2000, the technology group has been a laggard. Earnings for the S&P 500 technology group increased only 1.2% in 2006. In contrast, Thomson expects earnings growth of 20% or more in 2007.[5] Technology could be the market leader in 2007.

International

We continue to over weight international equities. We are sticking with core international mutual funds, Exchange Traded Funds (ETFs) and big-cap international equities. It is too early to be aggressive buyers in emerging markets. We favor the Far East, China and especially Japan. The average Japanese stock fund was **down** 2.4% in 2006[6] while earnings rose almost 14%. A combination of increased revenues and streamlined operations suggest Japanese profits will rise about 13% in 2007 with GDP growth of 3%. Japanese exports remain strong thanks to continued robust demand from China and other surrounding emerging markets. With the stock market at 15X forward earnings and a modest market capitalization to GDP ratio of 80% (half of the prior peak level),[7] we believe the market is still in the early stages of a secular bull market.

Natural Resources and Energy

We continue to over weight this area. We expect strong global growth will continue to put upward pressure on prices for commodities. Natural gas stocks look attractive at this time.

Real Estate

The recent bidding war for Equity Office Properties could prove to be a top for this asset class. The Blackstone Group won the bidding against Vornado Realty Trust, valuing Equity Office Properties at $39 billion. When the bidding started in October the Trust was valued around $28 billion. Because of high valuations, we recommend under weighting real estate.

Summary

For the U.S. stock market, we forecast another Up, Down, Up sequence in 2007, similar to 2006, with a mid-year decline that sets the stage for a new Bull Market. As this current Up phase is probably maturing, we may become more defensive by raising cash, moving to big cap stocks and/or employing hedging strategies: inverse (move opposite the market) mutual funds, ETFs, or puts on the S&P 500 Index. At the next cycle low we will emphasize buying U.S. big cap stocks, technology, natural resources and international equities.

Dave

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1 Thomson.com
2 AspenPublishers.com
3 Imf.org
4 Ndr.com
5 Thomson.com
6 Lipper.com
7 WSJ.com

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