Market Review and Outlook—January 8, 2007

Happy New Year! What a good year it was for investors! The table below appears to describe a wonderful year with steady growth across the board. It wasn't smooth. There was a sharp stock market correction mid-year as rising oil prices and stumbling auto and housing sectors brought fears of a US recession. The stock correction was focused in the stock sectors that had done best during the recovery—smaller and foreign stocks. The slide slowly ended as the US consumer kept buying, the Fed stopped raising interest rates after June, the 2005 hurricane season did not return in 2006, and oil prices retreated. In the first half of 2006, the Fed continued raising the Fed Rate, however they left it alone in the second half as evidence grew that their job was done for awhile. After six months of studious inaction, the Fed seems to feel that at this time they don't expect that the economy will overheat, or tumble, in 2007.

The US dollar fell in 2006, partially due to the strong economic growth abroad. Europe actually looked like an economic player in 2006. Foreign stocks soared in 2007, led by emerging markets, but with very solid results from Europe, Latin/South America, and Asia. The higher Fed Rate (up 1% to 5.25% by the June 29th increase) led to higher money market rates, and in 2006 money markets modestly outperformed general bonds. Bonds posted only modest returns, which isn't too bad given that they spent some of the year underwater. The relationship between interest rates and maturities became inverted, with short term rates greater than long-term. This often indicates a pending economic recession. Most analysts feel that this is an exception, that foreign buyers are keeping longer-term rates low, while the Fed is keeping short-term rates a little high to head off an oil-price-led inflationary surge. Oil provided a roller coaster to investors and consumers in 2006, rising in the first half of the year, before falling sharply in the summer (due to a lack of hurricanes?), only to recover a bit in December.

The following table presents returns for many investment sectors for five periods. The one– and three-year periods include strong rebounding environments, while the five-year period also includes much of the dot-com-bomb. The contrarian in me worries about categories with 5-Yr results much greater than their 10-Yr results (International Stock, Real Estate, Natural Resources), and I see opportunities when the reverse is true (Large-Cap, Science/Tech, Growth). Contrarian investing usually works over time, however it can be downright frustrating in the short-term.

In 2006 the rising tide lifted all boats. As long as you had stocks, you did well. I doubt that 2007 will be so kind. *PSB*

Category	**3 Months**	**Past Year**	**3-Yr Avg**	**5-Yr Avg**	**10-Yr Avg**
Money Market—Taxable (Fidelity Cash Reserves)	+1.26%	+4.75%	+2.90%	+2.24%	+3.70%
Intermediate Term Bond	+1.26%	+4.04%	+3.27%	+4.54%	+5.54%
Intermediate Muni Bond	+0.64%	+3.43%	+2.47%	+3.94%	+4.37%
Large-Cap Core Stock	+6.32%	+13.52%	+8.9%	+4.85%	+6.88%
Mid-Cap Core	+7.41%	+12.28%	+12.38%	+9.57%	+10.03%
Small-Cap Core	+8.15%	+14.87%	+13.23%	+11.43%	+10.86%
International Stock	+10.51%	+24.87%	+19.08%	+13.95%	+8.10%
Real Estate	+10.19%	+34.32%	+25.41%	+23.34%	+14.59%
Natural Resources	+9.75%	+15.22%	+27.54%	+20.76%	+13.45%
Science/Technology	+6.55%	+8.91%	+6.76%	+1.49%	+7.01%
Multi-Cap Growth	+6.29%	+8.16%	+9.45%	+4.73%	+7.47%
Multi-Cap Value	+7.33%	+17.46%	+12.65%	+9.08%	+9.32%
Balanced	+4.88%	+10.66%	+7.77%	+5.65%	+6.86%

The data in this table comes from the Barron's Mutual Fund Quarterly Review.
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As I did last January, I wanted to review the accuracy of my expectations turned out over the past year, and then to share my expectations for the upcoming year. On January 11, 2006, the MARKET REVIEW suggested that 1) a real risk that real estate would fall existed, 2) large-cap stocks would outperform smaller-cap stocks by a little, 3) growth stocks would outperform value , 4) foreign stocks should outperform smaller US stocks, 5) general bonds would have mediocre results, 6) high-yield bonds would do fine in an improving economy, and 7) global bonds would have a good year.

The good news is that I was wrong on only two of the seven points (1 and 3). The bad news is that I was quite wrong on those two points (real estate was red-hot and value more than doubled the results of growth).

Sector	2006 Prediction	2006 Actual	2007 Prediction
Large-Cap US Stocks	Up 7 to 9%	Up 13.5%	Up 8 to 10%
Smaller US Stocks	Up 6 to 8%	Up 13%	Up 6 to 9%
Non-US Stocks	Up 7 to 9%	Up 25%	Up 6 to 9%
Growth vs Value	Growth leads by 2%	Value up 17%, Growth 8%	Growth leads by 3%
Real Estate	Flat at best	Up 34%	Flat at best
General bonds	Up 3 to 5%	Up 4%	Up 4 to 6%
High yield bonds	Up 3 to 5%	Up 10%	Up 5 to 8%
Non-US bonds	Up 4 to 6%	Up 7%	Up 5 to 7%

I also stated "At this point I wouldn't be surprised if all major stock categories do fine in 2006, despite beginning to stumble by the end of the year." Well, there is no stock or bond category in the Barron's Mutual Fund Quarterly Review which fell in 2006. It was indeed quite a good year!

Deserving a breather—When a sector enjoys year-after-year of strong results, it is often the case that investors have been chasing past returns, bidding up prices higher than they should. When I see that I often judge that the sector 'deserves a breather', and that the odds favor subpar results until prices in that sector return to normal. The converse is also true; when a sector suffers several disappointing results, there is a greater chance that investors are unjustifiably punishing it, driving its prices down to bargain levels. In this situation I see an opportunity. I am sometimes right, sometimes wrong, and sometimes merely early.

I expected foreign bonds to do well in 2005. I was early. They did not do well until 2006.

Real estate is proving to be my curse. I have considered it overpriced for several years, and yet despite my Henny Penny warnings of doom it continues to outperform. It is fortunate for my clients that during most of the years when I have recommended little if any real estate fund investments we have instead invested in stock markets which have enjoyed strong results. Otherwise I worry that a mutiny could have been brewing!

In 2007 I expect stocks to do well, but not nearly as well as they did in 2006. Long-term annual results from stocks should be in the high single digits, and I see no reason why this will not describe 2007 results. I expect stable results from bonds, with foreign and high yield bonds outperforming general bonds, but not by a large amount. I hope that, to save my ego, growth will outperform value and real estate funds will stumble in 2007, and that my past calls have merely been early.

There are several areas with tremendous results in the past three years—annual returns of 25% or more for Real Estate, Utilities, European Region, Emerging Markets, Latin America, Gold, Pacific Region. Tread carefully here. The dot-com-bomb proved that trees do not grow to the sky.

Keep an eye on your overall allocation of stocks versus bonds/cash. If the strong positive results of the past four years have tipped your portfolio to much into stocks, consider cutting back to protect your gains and get your portfolio back in balance.

-PSB