



2006 In Perspective

After the splendid results of the stock market in 2003, 2004 and 2005, most investors were anticipating a weak stock market environment for 2006. After all, the trees can't grow as high as the sky, and we seemed due for some disappointing times. The economy had been growing at a good clip, and it seemed that it was time for a pause.

The first six months followed this script. The first quarter produced good returns for stocks, but these profits were given back in the second quarter. Then, on came a good third quarter, a surprise to many, to be followed by an even stronger fourth quarter (so stated at the time of writing this article in mid-December).

What gives? Why should the stock market be strong in the face of an apparent synchronized slowing in the activity of the global economies?

It's the Fed

An economy is like a ship at sea. When there are headwinds, the going is slower. Our economy has had several, the most important of which are higher interest rates, which have been engineered by the Federal Reserve's policies on short term interest rates, and the high price of energy.

However, our engine has been fueled by increasing productivity of labor and capital (thank you, technology!), rapidly growing corporate profits as the result of lower costs on balance, and rising positive cash flow. Our corporate balance sheets are in very robust shape.

The Storm Abates

The Fed hasn't raised rates since last June (after a string of 17 consecutive increases), and long-term rates have diminished quite a bit. So much for the headwind of interest rates. Energy prices have been abating, but are still high, but the relative impact of energy prices has diminished in importance. But, what about the housing slump? Without doubt, our housing industry is having a tough time of it.

Looking at a chart of housing starts indicates that the rate of growth had been too much too fast. A correction is in order. Some are worried that we might have a residential construction slowdown that lasts more than 5 years. No one knows. But with all the weakness in the housing sector, why hasn't that spilled into the general economy with such force so as to cause a recession?

Answer: Corporate America's investment in plant and equipment. "Business Week" magazine refers to our domestic corporations as America's "unsung heroes of the economy's resilience" for 2006 (BW, Dec. 1, 2006).

Goldilocks Is Alive and Well

This concept was lifted from a theme espoused by Ned Davis, one of the most insightful and informed macro analysts whose work we incorporate into Howe & Rusling's investment strategy. The concept is simple: When Goldilocks visited the house of the Three Bears, she experienced extremes in the environment represented by the momma and papa bears, but the baby bear's fixings were just right for her.

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AT A GLANCE

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Moderation Is the Key

Think of the U.S. economy in somewhat the same light. The stock market thrives in a period of moderate growth, with moderate inflation and moderate interest rates. The stock market is a discounting mechanism, attempting to predict the future, definitely NOT reflecting just what is happening today.

Here's what we believe will unfold in 2007. We will continue to experience a global slowdown in economic growth, in which the U.S. economy will participate, as is the case now. But we will still witness some real economic growth, not a recession. Admittedly it's a fine line that might be stepped across, but the overwhelming evidence we have indicates that our economy will have plenty of horsepower to keep growing.

Employment growth is likely to slow. This seems to be one of the keys for future Fed policy on interest rates. Coupled with our expectation that inflation will moderate in 2007, the slowing economy will "allow" the Fed to reverse its fairly restrictive policy on interest rates, and effect some rate cuts. Lower interest rates provide a powerful backdrop for the stock market to experience higher price-to-earnings multiples, i.e., higher stock prices.

Climbing a Wall of Worry

It is said that "The stock market climbs a wall of worry." We think that is precisely what is in place right now. There is no end of matters to worry about, but the macro picture adds up to an economy currently in process of slowing its rate of growth, but with growth continuing. Corporate balance sheets are strong, most costs are well contained, inflation pressures are lessening once again, and the forces at work could induce the Fed to reduce interest rates before summer.

Reality Check: Bears in the Woods

Having said all this, we have to keep in mind another part of the "Goldilocks" story. A veteran colleague of mine reminded me that three BEARS play an important part. Wall Street investors have had ample experience with this strain of animal. We don't believe that these bears will come out of the woods for a long time, and manifest their presence in the stock market.

There is always the possibility of mitigating circumstances (terrorist attacks, financial crisis somewhere, you name it) that can confound the best-laid strategies. But short of a nasty surprise, it feels like we're in a sweet spot for our economy, and the implications for future stock market returns are decidedly upbeat.

Standard & Poor's 500 Index Through 12/29/06



Source: Bloomberg, 2006

4th Quarter 2006 Bond Market Overview

“Steady as she goes”

This past quarter's theme could be described as “uneventful.” There has been very little change in bond yields from our last writing and performance has continued to remain positive for the year. The “steady” market for bonds is attributable to no change in monetary policy by the FOMC (Federal Open Market Committee); the policy setting arm of the Federal Reserve Bank, and a slight easing of inflation.

Bond sector performance so far this quarter has been good:

Start Date: 9/29/2006 End Date: 12/15/2006

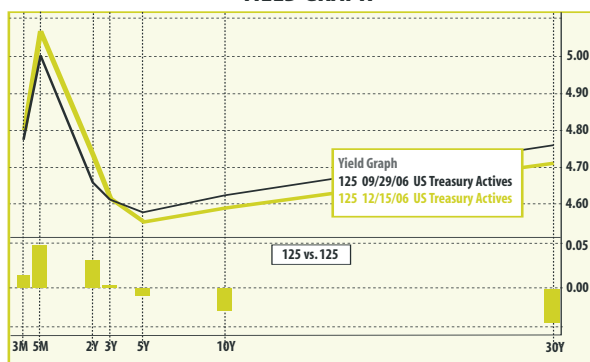
Index	Return for Period	Annualized Return
Intermediate U.S. Government Credit	1.21%	5.85%
U.S Treasury: Intermediate	0.98%	4.71%
U.S. Agency: Intermediate	1.20%	5.81%
Intermediate: Corporate	1.51%	7.37%
Invest Grade: Industrial - Intermediate	1.43%	6.97%
Invest Grade: Financial Institutions - Intermediate	1.57%	7.68%
Municipal Bond: 1-10 Yr Blend (1-12)	0.83%	4.00%

Source: Bloomberg, 2006

The overall performance for the past quarter of the Lehman Brothers Intermediate Govt/Credit index is 1.21% with the Corporate and Agency sectors outperforming the Treasury sector. This continues to imply that investors are not concerned about taking credit risk in return for higher yields. This is consistent with the good returns in general for the U.S. equity markets that we have seen this quarter. If inflation expectations continue to be low we would expect that bond performance will remain positive in the short term.

The Treasury yield curve remains inverted (short term rates higher than longer term rates) which is representative of the bond market's belief that inflation expectations are under control. However, short-term yields continue to follow the lead of the Federal Reserve Bank's Fed Funds rate which has remained at 5.25% since the last 0.25% increase on June 29th of this year. We are now in the 5th month of inversion of the yield curve. How long can the Treasury yield curve remain inverted?

YIELD GRAPH



Source: Bloomberg, 2006

As we have written in previous newsletter articles, inverted yield curves are not the norm. There have been four inversions of the Treasury yield curve prior to this one since January 1973. The first two lasted considerably longer and were much more “pronounced” than the last two.

Start	End	Months
March - 73	Oct - 74	19
Sep - 78	Apr - 82	44
Feb - 89	Sep - 89	7
Apr - 00	Dec - 00	8
Jul - 06	?	

We believe that the first two occurrences and the economic conditions that led to those inversions were completely different from the last two. The oil embargo of the mid 70's created a “supply shock” that had a rippling effect on our economy. That period of time saw high unemployment with high inflation. We are not experiencing those economic conditions today. So, while we don't know how long this inversion will last, we can safely say that it will not last four years. Although every economic cycle is different, the last two inversions would be more representative of what we could expect this time. We'll have to wait and see whether we have a clearer picture at the end of the first quarter of 2007.

We believe the first half of 2007 will be a pivotal period for the bond market. Future monetary policy will depend on the economic data to be released in the next few months. Of particular concern to the bond market is the negative effect the recession in housing is having and will continue to have on the rest of the economy. We have already seen economic growth slow in the 3rd quarter to approximately 2.2% annualized from the 5.6% and 2.6% growth in the 1st and 2nd quarters of 2006.

How long
can the
Treasury yield
curve remain
inverted?

Over the last two years, H&R has overweighted its investment in bonds issued by some of the GSEs because we felt that there was an opportunity for better returns than U.S Treasury bonds and some Corporate bonds. We are pleased that the performance of these securities has indeed exceeded the performance of intermediate term Treasury bonds, as well as intermediate term Corporate bonds during the last two years.

Last quarter we wrote about the bond market anticipating the Federal Reserve Bank “easing” monetary policy in the near future. We also mentioned that since 1980 the average time from last rate hike to the first rate cut was approximately 5 months. Well, we are in the 6th month since the last rate hike and it does not appear that the economy has weakened enough for the Federal Reserve Bank to act. In fact, while the official statements made continue to refer to a “moderating” economy due to the housing sector, their economic forecast is for an improving economy in 2007. The bond market and the Federal Reserve have “conflicting” points of view at present; they cannot both be correct. At the moment, we would remain cautiously optimistic that the economy will continue to expand at a moderate pace and that the Federal Reserve will be neutral on monetary policy.

Government Sponsored Enterprises - What are they?

Many of you may have fixed income securities in your portfolios whose names you may not recognize. Sure, everyone knows the names of some of the corporate bonds they own; General Electric, American Express, Proctor & Gamble to name a few. But do you know what the Federal Home Loan Bank (FHLB) or the Federal Farm Credit Bank (FFCB) is and what they do?

The Government Sponsored Enterprises (GSEs) are a group of financial services companies (some publicly and some privately owned) created by the United States Congress. They were formed and chartered to reduce interest rates and borrowing costs for specific sectors of the economy, farmers and homeowners. The mortgage borrowing segment is by far the largest of the borrowing segments that the GSEs operate in. Their debt obligations are not guaranteed by the U.S. Treasury. However, they all carry the highest of credit ratings by the respective rating agencies (Moody’s and Standard & Poor’s) Aaa/AAA. Some of the more commonly known GSEs and the year they were chartered are:

Housing

- Federal Home Loan Banks (1932)
- Federal Home Loan Mortgage Corporation (Freddie Mac) (1970)
- Federal National Mortgage Association (Fannie Mae) (1938)
- Government National Mortgage Association (Ginnie Mae) (1968)

Farming

- Federal Farm Credit Banks (1916)
- Federal Agricultural Mortgage Corporation (Farmer Mac) (1988)

Over the last two years, H&R has overweighted its investment in bonds issued by some of the GSEs because we felt that there was an opportunity for better returns than U.S Treasury bonds and some Corporate bonds. Furthermore, the tax advantages on income generated by FHLB and FFCB bonds was also an attractive feature in taxable accounts for clients living in states and localities with high marginal tax rates. We are pleased that the performance of these securities has indeed exceeded the performance of intermediate term Treasury bonds, as well as intermediate term Corporate bonds during the last two years.

Our fixed income team at Howe & Rusling has prepared a brief document describing the characteristics and functioning of each of the major GSE’s. Please call us if you would like a copy.

The GSEs are integral components of our financial markets. They provide efficiencies in making capital available to consumers that otherwise would have to pay more or in some instances, may not even qualify for loans at their local banks.

If you are interested in learning more about our affiliate, Cook Mayer Taylor, and their small-cap portfolio management, please contact your portfolio manager or Craig Cairns, President of Howe & Rusling.