

# December 31, 2006 Market Commentary and Outlook

## 2006 Market Recap

In 2006, the U.S. economy came in like a lion and went out like a lamb, with U.S. gross domestic product growing at a 5.6% annualized growth pace in the first quarter, only to slow to 2.0% in the third quarter. Fourth quarter growth figures are not yet available, but estimates range from 0.5% to 2.7%.

Paradoxically, in 2006, U.S. stocks did the exact opposite. After a weak +2.7% total return in the first half, the S&P 500 Index of large cap stocks closed the year up +15.8% -- the market's best showing since 2003. The second half rebound in stock prices was driven by several factors:

- **Declining oil prices.** Per-barrel cost dropped from \$77 to \$56 between July and November, supporting consumer spending while cutting industrial production and transportation costs.
- **Record U.S. corporate profitability.** New technologies and an increasingly global labor market enabled after-tax corporate profit margins to climb to the highest levels in over 80 years.
- **Corporate mergers and acquisitions.** Corporate buyouts, by both competitors and independent private equity firms, rocketed to 1999 levels. The surge was fueled by moderate borrowing costs and a desire by corporations to shake off the burdensome regulations that arose in the wake of the Enron and WorldCom scandals.

International stocks blazed to a +26.3% return, ranking as the top asset class for a third year in a row. Foreign share prices were supported by a number of factors, including strengthening currencies, accelerating economies, and a growing investor class. Nordic countries led among developed regions, while China led among emerging markets. Jordan, Israel, and Turkey were among the year's weaker performers with sub-zero returns.

Bonds began the year on a sour note as investors worried that inflation was rising out of control. The Federal Reserve soothed investor concerns by raising its overnight interest rate to 5.25% in June. By late summer, declining oil prices further reduced inflationary pressures. Intermediate term bonds recovered to close the year with a +4.1% return, but they trailed Treasury bills for the second year in a row.

## Annual Returns of Major Asset Classes (1997-2006)

Ranked in order of performance (Best to Worst)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
BEST ↑	Large Cap 33.4%	Large Cap 28.6%	Int'l Stock 27.0%	Mid Cap 17.5%	Bonds 9.0%	Bonds 9.8%	Small Cap 47.3%	Int'l Stock 20.2%	Int'l Stock 13.5%	Int'l Stock 26.3%
	Mid Cap 32.2%	Int'l Stock 19.9%	Small Cap 21.2%	Bonds 10.1%	Cash 4.1%	Cash 1.7%	Int'l Stock 38.6%	Small Cap 18.3%	Mid Cap 12.6%	Small Cap 18.3%
	Small Cap 22.4%	Mid Cap 19.1%	Large Cap 21.0%	Cash 6.0%	Small Cap 2.5%	Mid Cap -14.5%	Mid Cap 35.6%	Mid Cap 16.5%	Large Cap 4.9%	Large Cap 15.8%
	Bonds 7.9%	Bonds 8.4%	Mid Cap 14.7%	Small Cap -3.0%	Mid Cap -0.6%	Int'l Stock -15.9%	Large Cap 28.7%	Large Cap 10.9%	Small Cap 4.6%	Mid Cap 10.3%
	Cash 5.2%	Cash 4.9%	Cash 4.7%	Large Cap -9.1%	Large Cap -11.9%	Small Cap -20.5%	Bonds 4.3%	Bonds 3.0%	Cash 3.0%	Cash 4.7%
WORST ↓	Int'l Stock 1.8%	Small Cap -2.6%	Bonds 0.4%	Int'l Stock -14.2%	Int'l Stock -21.4%	Large Cap -22.1%	Cash 1.1%	Cash 3.0%	Bonds 1.6%	Bonds 4.1%

Asset class performance is based on the following representative indices:

Large Cap: S&P 500 Index, a market-value-weighted index of the stock of 500 major, large-cap U.S. corporations.

Mid Cap: S&P Mid Cap 400 Index, an unmanaged market-value-weighted index comprised of 400 domestic stocks.

Small Cap: Russell 2000 Index, a market-value-weighted index of the stock of 2000 small-cap U.S. companies.

International Stock: MSCI EAFE, an unmanaged, market-value weighted index of European, Australia, and Far East stocks.

Bonds: Lehman Intermediate Government/Credit, an unmanaged list of investment grade government and corporate fixed income securities.

Cash: Ninety Day Treasury Bill, an unmanaged index of short-term Treasury securities.

Indices assume reinvestment of income and dividends. Indices are not directly investable. Index performance does not include provision for transaction costs, taxes, management fees, or other expenses. Past performance does not indicate future results.

## Outlook for 2007

Despite the buoyant stock market, analysts expect the U.S. economy to experience slow growth in 2007. Some estimate there may be as much as a 50% chance of recession in the coming year, due to the following factors:

- **Sluggish housing market.** Wilting home prices reduce the "wealth effect" of home appreciation, causing a drop-off in home equity borrowing and consumption.
- **Tapped-out consumers.** Retail sales lag expectations as households struggle to keep up with high energy prices and rising payments on adjustable rate mortgages.
- **Downshift in Manufacturing.** Due to weakness in autos, housing, and business investment, demand remains soft for manufactured goods.
- **Inverted yield curve.** Long-term U.S. treasury bonds have been yielding lower returns than their short-term equivalents for several months, an unusual occurrence that has historically been a harbinger of recession.

- **Earnings downturn.** Corporate earnings guidance for the 4<sup>th</sup> quarter of 2006 has turned negative, with downward revisions outnumbering upward revisions by a wide margin.

However, as we saw in 2006, economic growth and stock market results don't always go hand-in-hand. Surely, negative economic news may throw some cold water on the sizzling U.S. stock market. But will it put the fire out?

History tells us that market rallies have a way of becoming self-sustaining beyond any semblance of reason. The momentum of the current wave of corporate mergers and acquisitions, driven by low borrowing rates, could power the U.S. stock market for months or years to come.

In 2007, the U.S. stock market may be supported by an unlikely player: the faltering U.S. dollar. Since 2001, the dollar's exchange value has decreased by more than 6% per year, due to a persistently growing trade imbalance. Should the dollar continue to **gradually weaken**, it could lift stock prices in two ways:

- As U.S. dollars become cheaper, U.S. exports become more price-competitive, providing a boost to export-oriented companies.
- Foreign companies and governments, flush with depreciating U.S. dollars, may seek to put those dollars to use in ways that protect against currency devaluation. Attractive acquisitions might include U.S. companies that control tangible assets such as airlines, toll roads, ports, mines, oil fields, and real estate – assets whose value would be expected to persist even if the dollar depreciates further.

Thus, a gradually sinking dollar can drive U.S. stocks higher. We emphasize the term “gradual” because if the U.S. dollar were to undergo a period of **rapid decline**, the opposite might happen: nervous foreign investors could dump their U.S. investments indiscriminately, triggering stock and bond market corrections, and causing prices of imported goods to rise sharply.

We continue to see strong opportunities in overseas markets. However, we are concerned that pent-up geopolitical and trade pressures may be released in unpredictable ways. Should a global shock occur, U.S. and overseas stock and bond markets could lurch in opposite directions. We look to geographical diversification to help manage this risk.

Our outlook towards bonds is cautious: If the U.S. economy continues to slow, domestic bonds may appreciate in the first half of 2007. But, given current yields of roughly 5%, domestic bonds simply do not offer an appealing risk-reward profile when default risk, inflation risk, and price risk are factored in. We continue to find short-term investments (e.g. money market funds) and global bonds to be excellent diversifiers to intermediate-term bonds.

Investment Committee  
Northwest Capital Management, Inc.  
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