

Quarterly Market Review

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Financial Markets and Economic Analysis, Fourth Quarter 2006

Perspective

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When reviewing the various benchmark and manager returns for 2006, it is easy to forget the stomach churning path of the markets over the course of the year. The first quarter was fast paced, with gains across the board and growth stocks were at least holding their own if not outperforming the value segments of the market. Whispers ran that the pendulum was about to swing back to growth after four years of dominance by value. Then the second quarter gave us rapidly rising energy costs, the Fed continued to raise interest rates and the markets gave back significant portions of the gains of the first quarter. Whispers began to be heard around the investment community about the return of the stagflation ghost. Then the Fed came to the rescue in August and held rates steady, oil and gas prices peaked, then fell rapidly back (though not to 2005 levels), and corporate earnings remained steady. Index returns were jump started, especially in the value style indexes. Whispers began of a record year and strong holiday season. The final quarter of the year was exceptionally robust, despite a mostly flat final month, with returns in the 7 -9% range. Now the whispers are about setting new records for the Dow, and a fifth year of the current bull market.

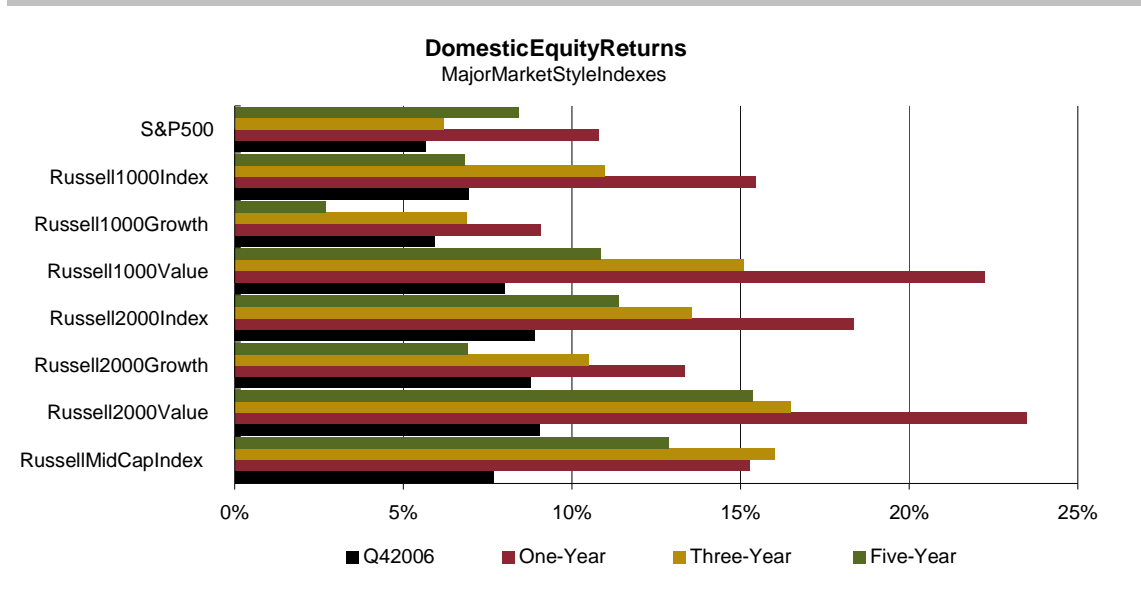
For all the positive news in the market returns for the year, the macroeconomic outlook, as we mentioned in last quarter's market review, is not all positive. Wage growth was at its highest in six years, which may keep the Fed on the sideline for much of the first half of the year. And while job growth for 2006 was relatively strong, it was concentrated in the services and construction sectors, while growth in manufacturing and other goods producing sectors was negative. The housing market showed some slight signs of recovery during the final quarter, but will remain a key issue during 2007, particularly if rates remain at current levels. Massive budget deficits remain in place, and a divided Washington may find it difficult to compromise on many economic issues.

Domestic Equity Markets Overview

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The final quarter of the year got off to a strong start with gains across the market cap and style spectrum in October. The rally continued through most of November, but weakened as the month came to a close. Returns were much more muted, though positive, during December as reports of weaker than expected retail sales trickled in. The Russell 1000 Index and Russell Midcap Index had nearly identical 6.95% returns while the Russell 2000 was up 8.90%. Likemuch of the year, the final quarter of 2006 was dominated by the value style indexes, though to a lesser extent than in previous quarters this year. The Russell 1000 Value was up more than 2% over the Growth Index, but the difference was only 0.30% for the Russell 2000 style indexes.

It was a different story over the course of the year, as value outperformed growth in three of the four quarters in 2006. The Russell 1000 Value Index was up more than 22% for the year, with the 1000 Growth Index up just over 9%. The same held true in the small caps as the Russell 2000 Value was up 23.5% and the 2000 Growth was up "just" 13.5%. Given the returns in the major indexes for the year, it is unsurprising that there were few areas where there were negative returns. In the Russell 1000, for example, Healthcare was the "worst" performing sector, up just 6.3% for the year. By contrast the Energy and Utilities sectors were up by more than 30% and the Financial sector was up nearly 20%. The leaders in the Russell 2000 Index were somewhat different however, with the Consumer Staples sector and the normally staid Materials sector up more than 30%. Healthcare was again the "worst" sector, returning just 9%.



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International Markets Summary

U.S. investors in the European markets benefited strongly from a fall in the dollar during the year. Although the regional returns across the globe were not as strong as those domestically, the fluctuation in currencies added 10 - 14% to total returns. The MSCI EAFE index was up 13.81% in local currency terms but 23.47% in dollar terms, equaling the best returns in the domestic market. The currency boost was even more dramatic when focusing solely on the Eurozone countries, as a 18.96% local return was a 32.99% return in dollar terms. Japan was one of the weakest markets in 2006. After a relatively flat first three quarters, a 4.94% return in the fourth quarter put the Japanese index up just 5.09% for the year (both in dollar terms).

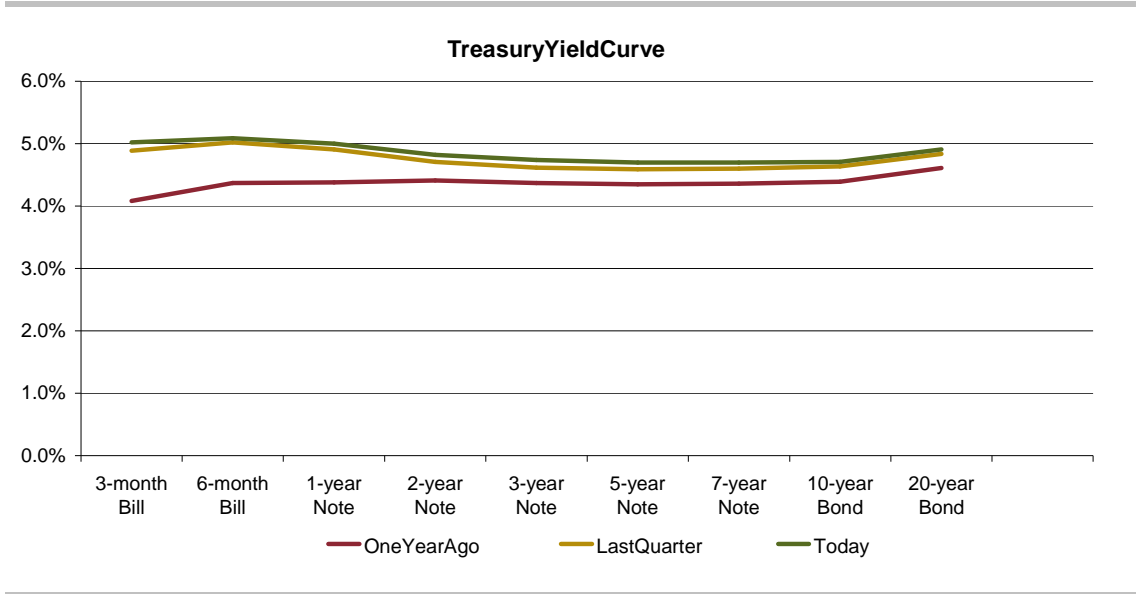
In the emerging markets the dollar's decline was much more subdued for the year, with the average boost to returns for U.S. investors in the 5 - 6% range. For the year the MSCI Emerging Markets Index was up 32.59% for the year. As many market analysts had forecast, the emerging markets continued to be led by China, up 82% in dollar terms. Latin America also saw its share of hot markets, with Venezuela showing a 79.52% return for the year in dollar terms, despite a 50% drop in currency value relative to the dollar.

Fixed Income Summary

As the Federal Reserve continued to stay on the sidelines during the fourth quarter, the Treasury yield curve remained largely unchanged. This left returns for the quarter as slightly less than the current yield in most categories. Treasury bonds returned between 50 and 75 basis points depending on maturity and corporate bonds returned 1.36% according to Lehman Brothers. Although returns for the year were sedate relative to the equity market, fixed income investors should be relatively pleased with the total year's return. For the year, the intermediate range bonds, typically four to seven years in maturity, had the best returns across all of major categories. Breaking down the Lehman Brothers Aggregate Index, the short maturities returned 4.34%, the intermediate maturities 4.71% and the long maturities (10 or more years), returned just 2.71%. There was little difference in returns in the Index based on credit quality. The lowest rated bonds returned just 28 basis points more than the AAA issues. The high yield market rewarded those investors staking on the additional credit risk, as the Lehman Brothers Corporate High Yield Index was up 4.20% for the quarter and 11.85% for the year.

The municipal bond market was more normal during both the fourth quarter and for the year as a whole. Investors were rewarded for taking on the pricing risk of longer term bonds with higher returns. An

while there was little difference for the year between the AAA and AA issues, investors were nicely rewarded for taking on credit risk, with a 3% higher return on BBB issues. Prices were down for most of the market during the quarter, but current yields were just high enough to keep the indexes in the black. The short and intermediate Lehman Brothers indexes were up 60 to 90 basis points for the quarter, with only the very long end (15 years and longer) up more than 1%. The third quarter of the year provided virtually all of the returns for the municipal market for the year.



Outlook

2007 appears at first glance to be a year of transition for the domestic equity and fixed income markets. While the most recent notes from the Federal Reserve meetings indicates that inflation is still a key concern, the futures market has been forecasting an 85% chance of a rate cut in the first half of the year. This could give the equity market a base of support, as well as set up the bond markets for at least a reasonable return. The big question mark for the domestic markets in 2007 is likely to be in the political rather than the economic arena. While the markets have historically favored divided control in Washington, many of the priorities of the new congressional leadership (raising the minimum wage, modifying the Medicare drug program, and changes in tax policy) if enacted, could have a significant impact on the markets.

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