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Long view: Mkt and economic retrospective on 2006

Ron Brounes - 10 January 2007

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Market/Index	2005 Close	2006 Close	1st Qtr Return	2nd Qtr Return	3rd Qtr Return	4th Qtr Return	2006 Return
Dow Jones Industrial	10,717.50	12,463.15	3.66%	0.37%	4.74%	6.71%	**16.29%**
NASDAQ	2,205.32	2,415.29	6.10%	-7.17%	3.97%	6.95%	**9.52%**
S&P 500	1,248.29	1,418.30	3.73%	-1.90%	5.17%	6.17%	**13.62%**
Russell 2000	673.22	787.66	13.65%	-5.29%	0.13%	8.55%	**17.00%**
Fed Funds	4.25%	5.25%	50 bps	50 bps	0 bps	0 bps	**100 bps**
10 yr Treasury (Yield)	4.39%	4.71%	47 bps	29 bps	-51 bps	8 bps	**32 bps**

Pop open the champagne; slap a few high fives with fellow investors; and count those profits all the way to the bank. After all, 2006 was a stellar year pretty much across the board. While the S&P 500 and Nasdaq both celebrated their fourth straight years of positive performances, the Dow Jones moved past, and held, the crucial 12,000 mark late in the year and set 22 new record highs in the process.

In fact, all 18 market sectors tracked by the Dow experienced gains with telecommunications (up 32%), oil and gas (up 20%), and financials (up16%) leading the charge.

The majority of the gains came during the second half of the year after new **Federal Reserve** Chief Bernanke finally learned how to address the media without spooking the markets. Gentle Ben more than made up for his early misstatements by shifting Fed policy in the third quarter.

Oil prices peaked in July at $78 a barrel before falling to more reasonable levels -- if you can call $60 reasonable -- as last year's hurricane season became a non-event. Investors benefited from the reduced inflationary pressures.

Fed calls a halt

While domestic equities rewarded investors for their continued confidence, many of the International and global markets produced even better results. A steadily declining dollar prompted investors to look to China and other emerging Asian markets for more favorable returns (though Japan's markets were disappointing after an exceptional 2005). Likewise, Latin American stocks in Venezuela (despite the government's disdain for capitalism) and Brazil surged to record levels, while Europe also experienced a year of strong corporate profits.

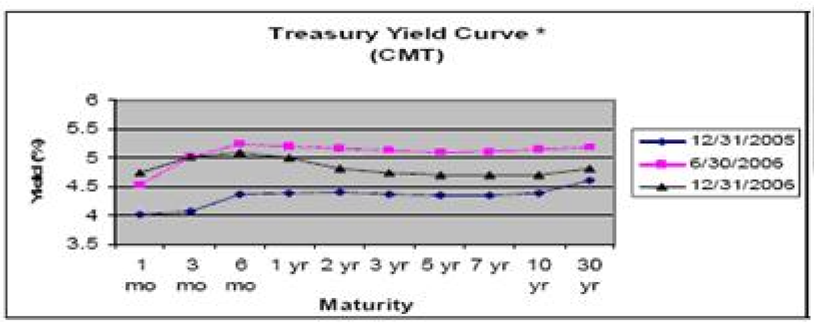
Though domestic rates remained low and the yield curve was flat or inverted throughout much of the year, fixed-income investors earned slightly positive returns as investors sought any extra yield they could grab from corporate bonds and mortgage-related securities.

The Fed ceased its rate hikes at mid-year -- after 17 increases -- and corporate-debt issuance took off with $1.07 trillion in new supply hitting the street last year, primarily used to finance the record acquisition activity. The slope of the curve seemed to indicate that yields would soon head lower and the next Fed move may be downward (just when that happens, however, remains the $64,000 question).

"Let's make a deal" was a recurring theme in 2006 as acquisition activity surged into record territory, highlighted by the $72 billion **AT&T**-**Bell South** transaction. Apparently, private-equity firms liked what they saw in equity valuations. Wall Street benefited from the deal biz with **Goldman Sachs** ' CEO pocketing a cool $53-million bonus.

"Gridlock" became the political word *du jour* as Democrats steamrolled into power. Investors are now speculating about how a lame-duck Republican president can work with a perceived "tax and spend" Congress.

Corporate profits skyrocketed 19% in the third quarter though the boardroom was not without its share of hardship. **HP** suffered through an untimely directors' scandal; **BP** struggled with lost production from poor maintenance at a key oilfield; **Wal-Mart** announced its first decline in monthly sales in over a decade, prompting retail analysts to project a weaker than anticipated holiday season.



** Reflects changes in interest rates over various time frames.*

"The sky is falling, the sky is falling." Or so claimed some economic nay-sayers, and a few folks at the Fed. The scuttlebutt early in the year had inflation soaring through the proverbial roof as oil prices moved into record territory. More pessimistic talk had the plummeting housing sector pulling down the rest of the economy into recession. Excessive gloom and doom had worried consumers taking a hiatus from buying sprees and sitting out this holiday season. A perfect storm of economic negativity, in other words: a weak economy hindered by rising prices with average folks struggling to get by. Fortunately, after some excessive worry, none of these worst-case projections came close to fruition in 2006.

Economic roundup

In fact, a seemingly overheated economy saw U.S. gross domestic product (GDP) surge by 5.3% in the first quarter, its best showing in over two years. A nice soft landing ensued in the months to follow as GDP reflected growth of 2% by the third quarter; a good chunk of the slowdown -- about 1.2% -- could be attributed to the weakness in housing.

Though the housing sector data remained a concern and related stocks were hurt during the year, the most recent home sales releases revealed that the housing market may finally be turning a corner. In November, new-home sales increased for the third time in four months; existing-home sales jumped by a surprising 0.6% as well. Still, the majority of the news was far from positive and the sector has a long way to go before it gets a prognosis of "healthy."

The labor market continued plugging along nicely in 2006 as unemployment rate remained at an historically low 4.5% and new jobs were added to the economy each month a decent pace. Apparently consumers were content with their job situations as confidence levels ended the year at the highest rate since early in the second quarter.

While the jury is still out on the success of the holiday season, some late-December sales and an abundance of gift card purchases (that will be redeemed in the months to come) should help prove that retail activity was far stronger than many analysts had feared.

The manufacturing sector suffered a setback late in the year. After 41 straight months of expansion, the most recent ISM index revealed that activity had contracted. For now, economists are adopting a wait-and-see attitude to determine whether an alarming trend was established or whether the release was just a one-off aberration.

Inflation remained relatively subdued throughout the year though a worrisome November wholesale report (PPI) revealed a substantial uptick in gasoline prices. Further, a change in Congressional power brought talk of an increase in the minimum wage, which may lead to some potential price pressures.

Though the Fed kept inflation at the top of its radar screen, Bernanke and friends felt comfortable enough to leave interest rates at 5.25%, which is itself a significant shift in monetary policy. So, although there will always be nay-sayers, the sky did not officially fall last year. -FWR