

**AND THAT'S THE "YEAR" THAT WAS...
For the Year Ended December 31, 2006***Market Matters...*

Market/Index	2005 Close	2006 Close	1 st Qtr Return	2 nd Qtr Return	3 rd Qtr Return	4 th 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

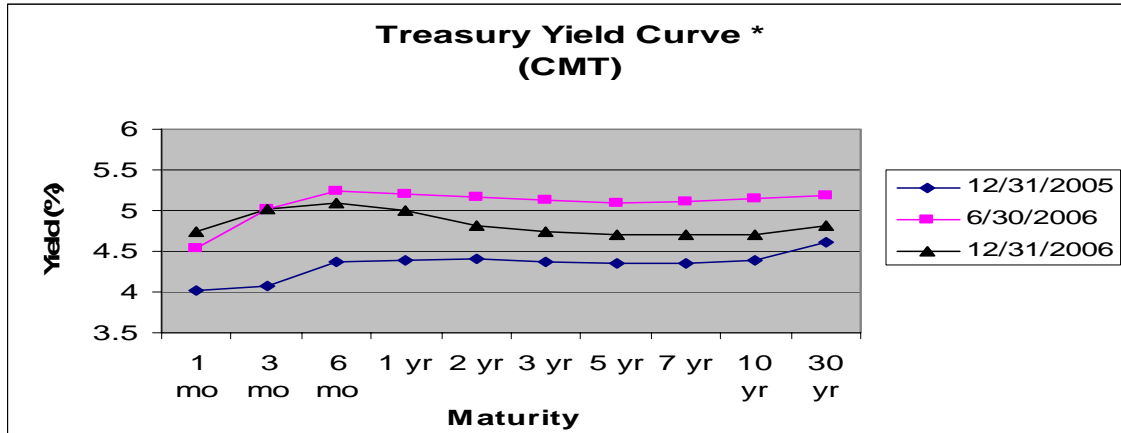
Pop open the champagne; slap a few high fives with fellow investors; and count those profits all the way to the bank. After all, 2006 was a stellar year (pretty much) across the board. While the S&P 500 and Nasdaq both celebrated their fourth straight years of positive performances, the Dow Jones moved 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 (+32%), oil and gas (+20%), and financials (+16%) leading the charge. The majority of the gains came during the second half of the year after incoming Fed Chief Bernanke finally learned how to address the media without spooking the markets. (Apparently Greenspan was a great communicator?) Gentle Ben more than made up for his early misstatements by shifting Fed policy in the 3rd quarter. Oil prices peaked in July at \$78/barrel before falling to far more reasonable levels (if you can call \$60 reasonable?) as last year's hurricane season luckily became a nonevent. Investors benefited from the reduced inflationary concerns.

While domestic equities rewarded investors for their continued confidence, many of the international/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 (following 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 \$64k question).

Let's make a deal was a recurring theme in 2006 as acquisition activity surged to record territory, highlighted by the \$72 billion **AT&T/Bell South** transaction. Apparently, private equity firms like what they see in equity valuations. Wall Street benefited from the deal biz with the Goldman Sachs CEO pocketing a cool \$53 million bonus. *Gridlock* became the word du jour as Democrats steamrolled into power; investors are now speculating about how a lame duck Republican Prez can work with a perceived "tax and spend" Congress. Corporate profits skyrocketed 19% in the 3rd 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. Perhaps...but the books are now closed on a stellar 2006 and investors can worry about those issues after the celebration ends.

Economically Speaking...



* Reflects changes in interest rates over various time frames.

The sky is falling; the sky is falling!!! Or so claimed those economic naysayers (and a few folks at the Fed named Poole, Moskow, Guynn, and Bies). 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. And, thus, the perfect storm of economic negativity: a weak economy further 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.

In fact, a seemingly overheated economy (as measured by **GDP**) surged by 5.3% in the 1st quarter of 2006, 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 3rd quarter; a good chunk of the slowdown (about 1.2%) could be attributed to the weakness in **housing**. Speaking of which, while the sector data remained a concern and related stocks were hurt during the year, the most recent home sales releases revealed that the ongoing sluggishness finally may be turning the corner. In November, new home sales (+3.4%) experienced its third increase in four months and 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 being proclaimed “healthy” again.

The **labor** market continued plugging along nicely in 2006 as the unemployment rate remained at an historically low level (4.5%) with new jobs solidly added to the economy each month. Apparently consumers were content with their job situations as confidence levels ended the year at the highest rate since early 2nd 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 taking a wait and see attitude to determine whether a new alarming trend was established or the release was merely a one month aberration.

Inflation remained relatively subdued throughout the year though a concerning November wholesale report (PPI) revealed a substantial gain 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. While the Fed continued to keep inflation at the top of its radar screen, Bernanke and friends felt comfortable enough to leave interest rates unchanged (5.25%) at the past few meetings, a significant shift in monetary policy. So, while naysayers will always exist, at least the sky did not officially fall in 2006. Happy New Year...

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