THE MARKET OBSERVER

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By now you may have already read more than a few year-end reports recapping the returns realized in the financial markets last year. The stellar returns realized in 2006 and continued momentum so far this year, while cause for much rejoicing, also seem to be the cause of much consternation. The 1/1/07 issue of Barron's echoes a fear sighted in numerous commentaries that,

> *"this is a market that has gone longer without a 9% pull back than any in history...only a couple of bull markets have lasted through a fifth year, so we're testing the odds here."*

Perhaps the experience from March 2000 through October 2002 is still lingering in the minds of many investors. As we pointed out in our last update, at its current level of approximately 1450, the S&P 500 is still 5% below its 2000 high of 1527. The annual returns realized over the past five years have been 6.2%. While a return to a mass belief that "all stocks ever do is go up" would certainly be a cause for concern, the persistence of a level of skepticism seems to offer hope that the markets are not over extended. The following table (shared with us by Cleary Gull) highlights (albeit absent the occurrence of a 9% correction) that the current rally is still shorter in length than a number of other post World War II bull markets.

S&P 500: Longest Bull & Bear Cycles since 1926

Bull Markets		Bear Markets	
Dates	*# of Days*	*Dates*	*# of Days*
Oct 11, 1990 - Jul 17, 1998	1,963	Nov 9, 1938 - Apr 28, 1942	1,042
Jun 13, 1949 - Aug 2, 1956	1,889	May 29, 1946 - Jun 13, 1949	857
Aug 12, 1982 - Aug 25, 1987	1,273	Sep 7, 1929 - Jul 8, 1932	841
Apr 28, 1942 - May 29, 1987	1,211	Mar 24, 2000 - Oct 9, 2002	637
Oct 9, 2002 - ???	*1,053**		

**As of Dec 15, 2006 peak*

Source: The Leuthold Group

Reviewing the landscape, nothing much seems to have changed. Economic growth, while moderate is still expected to be between 2% and 2.5% in 2007. Inflation continues to behave and long-term interest rates are holding under 5%. Corporate earnings, while also moderating, are expected to grow by 9.5%. Price Earnings multiples (a measure of the expensiveness of stocks) have actually been declining the last three years as corporate profit growth has exceeded stock price appreciation. On the other hand, causes for concern continue to be the off again, on again fears over the ramifications of the price of oil as well as the war in Iraq. Further warning signs were raised last week in the sub-prime mortgage lending and housing markets. Finally, it is difficult to not at least raise your eyebrows over the money being borrowed and spent in private equity buyouts and the rush of more and more investors into the supposed privileged world of hedge funds.

Many recent commentaries have also been drawing comparisons between today's markets, aided by record private equity activity and the LBO (leveraged buy-out) "hysteria" proceeding the market decline in 1987. Martin Sosnoff opines in his most recent commentary that,

> *"what lead to Black Monday in 1987 was not deal hysteria, but the escalation of interest rates...12% money for deals*

was too hot to handle."

In addition, while hedge funds today represent 1% to over 3% (including leverage) of the world's financial assets (per a recent study referenced by Barron's), a lot of the strategies employed are quite similar. For every bet placed by one hedge fund, another hedge fund is often on the other side of the trade. This fad may begin to pass as investors begin to take a pass on 4% annual transaction expenses and 4% to 5% performance fees. A large percentage of the margin debt owed today is held by these funds. It is certainly beyond the scope of this writing to project the depth and duration of any crisis that might be triggered in this sector.

Another interesting point to consider is that recent market strength has not been as broadly based as one would think. In their fourth quarter market review, Altair Advisors points out that,

> *"data suggests that 2006 was a year in which the riskiest assets performed the best, benefiting passive indices which include all listed equities over active managers who generally focus on higher quality companies."*

Their commentary goes on to point out that less than 20% of large cap growth managers beat the Russell 1000 Growth Index and only 5% of large cap value managers beat the Russell 1000 Value Index. Many managers are holding stocks that have failed to move or have declined significantly. It seems logical to assume that they continue to hold these names because, in their opinion, they continue to see value.

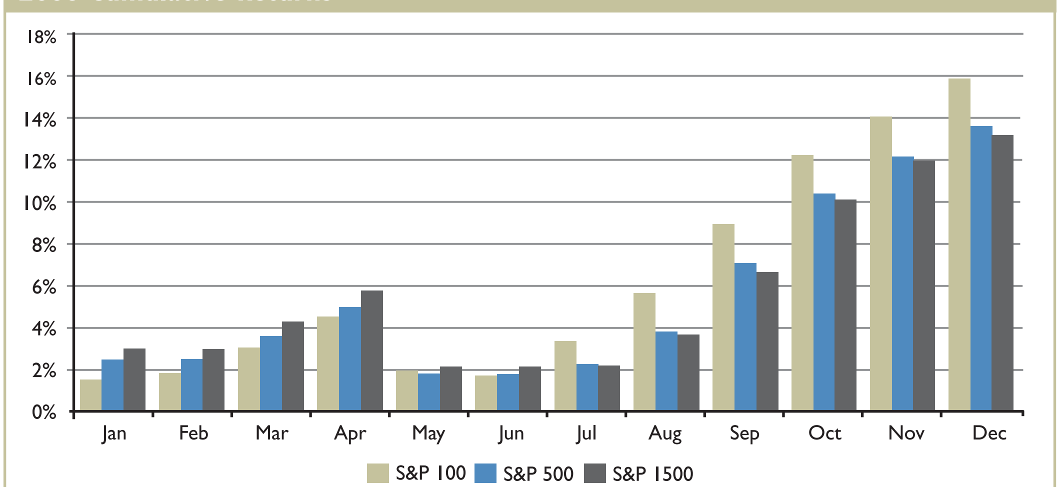
Another recent trend that appears to be developing is the re-emergence of large cap stocks. The table below illustrates the out performance of large companies represented by the S&P 100 since the summer market decline when compared to the broader large cap weighted S&P 500. Many managers are hopeful that this trend will spread to finally reflate the PE ratios of large cap growth stocks that have lagged since the bursting of the tech bubble.

So as we reflect on the prospects for 2007, a quote from Jeff Broncheik of Reed Conner and Birdwell, in his most recent commentary, seems appropriate:

> *"The simplest and probably the most effective way to approach stock market forecasting is to forget it entirely and move on with other activities, more correlated with success."*

For what it's worth, a preponderance of investment strategists out there still expect at least mid to high, single digit returns from stocks this year. PE ratios are still at a reasonable 15-16 times earnings, ten year Treasury yields are below 5% and we have modest economic growth and inflation. One could conclude, as does Altair, that "while investors should not bet the ranch, it does lend some support to remain steadfast in a commitment to equities."

2006 Cumulative Returns



Source: The S&P