

THE MARKET OBSERVER

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The stock market shook off its fear of a global economic slowdown and bounced back sharply during the third quarter. Stocks (as measured by the S&P 500) advanced nearly 6% between July and September after giving back its early-year gains during May and June. This momentum has continued with the S&P 500 now up 12% through November. Small-cap stocks (as measured by the Russell 2000) are up 16% so far this year.

Concerns over rising oil and commodity prices, inflation and interest rates and a possible fallout from the housing sector seem to have abated. Bulls are now concentrating on the expected continued

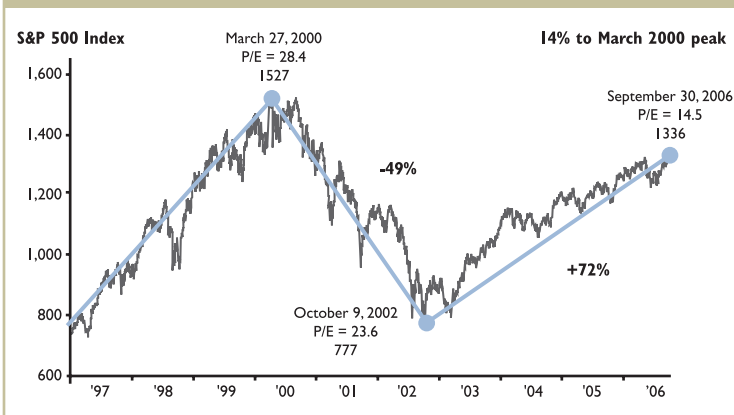
growth of corporate profits, albeit more slowly, and the appearance that stocks still appear reasonably priced at approximately 15 times, 12 month estimated earnings. Despite this recent momentum, a comment in the 11/6/06 Barron's Money Manager Survey appears to touch on the negative sentiment that still permeates the markets:

"Doubts have dogged investors all the way up - about the economy, the consumer, corporate profits and not least, the ability of the big-cap averages to make new highs after six long years in a desert...It's been hard, even for professional managers, to trust the fundamentals. The psychology among most investors has been fitted to

a secular bear market." (David Ware, Barrington Capital)

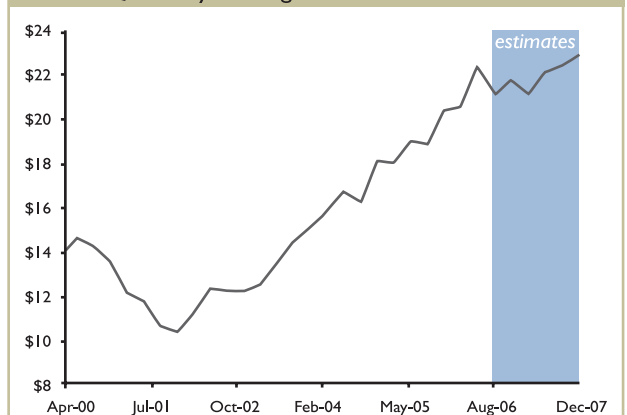
Amidst the euphoria (as well as paranoia) over this recent performance, it is interesting to note that the S&P 500 is still about 8% below its peak reached in March, 2000. The two charts below provide an interesting perspective when expanding our view of recent performance to also encompass the period surrounding the "tech bubble" of the late 1990's. Consistent growth of corporate profits have underpinned the rise in share prices from their lows in October, 2002. Profits have slightly more than doubled in that time while stock prices have risen approximately 80%. It would seem that advances

S&P 500 Index at Inflection Points



Source: JPMorgan Asset Management, Guide to the Markets September 30, 2006

S&P 500 Quarterly Earnings Per Share



Source: Neuberger Berman, Third Quarter 2006: Market Commentary

predicated on real earnings have a better chance of sustainability going forward.

Another interesting comparison to note is the relative performance of growth stocks. Risk averse investors have been flocking to the seemingly safe havens of REIT's, utilities, and financials while growth names have lagged. Martin Sosnoff commented recently on Forbes.com that,

“today we are on much firmer ground (than in 1999 and 2000 when GE traded at 30 times earnings and Cisco traded at 60 times earnings). GE trades at a little more than a market multiple of earnings. Same goes for Wal-Mart stores and Cisco Systems.”

Sosnoff goes on to point out that, “very seldom do you get to buy an iconic property at a price - to - earnings -to - growth ratio of 1. Usually the ratio is closer to 1.5.”

The key variable in this landscape would seem to be patience. Just as value investors were rewarded in '99 and 2000 by sticking to their discipline and not jumping on the growth bandwagon, growth investors today hope to be rewarded by not wavering from

their stock selection methodologies.

Another phenomenon becoming widely prevalent during this period of high corporate profitability is the wave of mergers, acquisitions and buyouts led by private equity firms. On 11/20/06, the Wall Street Journal reported the announcement of four separate deals totaling more than \$52 Billion. Dealogic reported recently that:

“Global M&A activity has hit new heights with a massive \$3.37 Trillion in total deal values so far this year.”

On one hand, the pessimist in us might be concerned with the potential negative ramifications of Blackstone Group potentially “overpaying” in its \$20B buyout of Equity Office Properties (the nation's largest office building owner and manager). The buyout price of \$48.50 per share represents an 8% premium over its close the previous Friday which is 50% above its price a year ago. On the other hand, the pragmatist in us might notice that the recently announced buyout of Clear Channel Communications at \$37.60 per share is at a price more than 50% below

where it traded in early 2000. The Journal article goes on to comment that

“the continuing boom in deal making stems from several factors, including a worldwide glut of capital. Having restructured after the stock market meltdown earlier in the decade, corporations have built up massive war chests they can use for acquisitions. Interest rates are also near historic lows, giving buyers ample access to the credit they need to pull off massive transactions.”

Perhaps investor hesitancy to move back into large growth names has created this window of opportunity for private equity investors.

Reflecting on all of this it is important to remember a few things. Good news sometimes is actually a good thing. Bad news, while usually a cause for legitimate concern, often represents opportunity. Obviously, someone at Blackstone still sees some value in the potential unbundling of Equity Office's huge real estate portfolio even at today's prices. The Clear Channel transaction also represents an unwinding opportunity as a number of its vast radio and television properties are likely to be sold. While this trend bears monitoring, it does not by itself seem to indicate another “bubble” in the making.



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