
Letter From The Portfolio Managers

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Potential Surprises for 2007



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For the past several years, we have started off the year with a list of potential surprises for the coming calendar year. To qualify as a “surprise,” the prediction should be outside the consensus view and be more likely not to happen than to actually occur.



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At this point you may well be asking “why do you care about things that are not likely to happen?” Nonetheless, an exercise like this is important. Making investment decisions in an uncertain world requires one to consider the impact of various economic and market possibilities; even if their likelihood is less than 50%. Not only is it good to be prepared, but sometimes those lower probability events are attractively priced. And, almost every year, there are some lower-probability, out-of-consensus events that do, in fact, occur.

In recent years, our surprise lists have actually performed quite well. In 2006, however, the surprise list was a mixed bag. Let’s recap:

- **The Economy Slides Into A Recession**
Housing did start to falter and economic growth was slipping by year’s end, but 2006 clearly did not produce a recession.
- **The U.S. Stock Market Disappoints**
In mid-July, the stock market was barely holding a gain and performance was basically in line with cash and bonds, making this surprise look good. Then, thanks to a rally with nary a correction, the market finished the year with an above-average gain. The market definitely did not disappoint.
- **The Dollar Does Worse Than Expected**
The dollar was worse than expected. After gaining ground in 2005, it fell 8% against a broad basket of foreign currencies in 2006.
- **The Energy Sector Will Remain Strong**
Even though the energy sector makes up less than 10% of the over-all stock market in terms of market capitalization, it is expected to generate just over 50% of the S&P 500’s operating profits in 2006. This is even an improvement over the great earning years for energy in 2004 and 2005. The energy sector also outperformed the S&P in terms of total returns.
- **Inflation Will Be Less Than Expected**
The Consumer Price Index (CPI) was unchanged in November on a seasonally-adjusted basis after two consecutive 0.5% energy-price-driven declines. The CPI is up 2.0% versus a year ago, but down at a 3.9% annualized rate in the past three months. Break-even inflation spreads between inflation-linked bonds and Treasury bonds also slipped.

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- High Quality Should Outperform Low Quality
Low quality outperformed high quality last year in both fixed income and equities.
- Geopolitical Risks Will Reassert Themselves
At mid-year, with heightened conflict in Israel, along with a massive terror strike in India, coupled with essentially flat stock market returns in the U.S. and dismal investor sentiment, this looked spot-on. The last half of the year's price action changed that view though.
- The Biggest Risk To The U.S. Market Is Political, Not Economic
Given the President's low approval ratings, it looked like the Republicans might lose control of Congress in the mid-term elections. If so, a less-investor-friendly democratic leadership might jeopardize the stock market in the closing months of the year. The Democrats did indeed wrest control from the Republicans in November, but the market hardly batted an eye.

Surprises for 2007

We start with the belief that some 2006 surprises that did not materialize last year, are still in play for 2007.

1. The Economy Will Do Worse Than Many Expect.

While most economists seem to be looking for sub-par economic growth (and some better than that), few are actually calling for a significant dip in economic activity. To us, the primary driver of whether or not the economy underperforms the consensus view is state of the housing sector.

The consensus view on housing seems to be that the worst is behind us and the market will improve moving forward. Indeed, there are a number of recent data points that bulls take to indicate that the residential real estate market is stabilizing after significant weakness in 2006.

There are, however, other pieces of data that are not so favorable. There are nearly 6 million vacant houses currently available for sale or rent. That represents nearly 5% of all houses compared to an average of 3.5% during the 1990's. That means 1.3m houses need to be sold to get back to average. Plus over 1.6m new homes are expected to be built this year. Lastly, with the prime spring selling season coming in a few months, it is expected that more homeowners will be putting their homes on the market, so the inventory of homes available for sale could spike even higher. Given abundant supply, and remembering our Economics 101 classes from many years ago, it's hard to expect that selling prices won't have to go lower to clear some of the excess supply.

Another part of the consensus view is that even if real estate prices drop, the trouble will not spill over into the rest of the economy, and historically, that may have been true as housing was not that big a part of the economy. But today, it's probably more vital to the economy's over-all health than ever before both in terms of its impact on employment and spending.

In recent years, the housing boom has been responsible for the lion's share of job growth in this country. According to a study by Northern Trust, from 2001 to April 2005, nearly half (43%) of all new private-sector jobs were housing related.

Real estate has also had a major impact on consumer spending over this time frame. First there is the "wealth effect." When consumers feel wealthier, they tend to spend more. This effect has most often been associated with gains in the stock market, where it is estimated that a \$100 increase in stock market wealth translates into an additional \$4 in consumer spending. But estimates for a similar increase in the value of someone's home reveal a spending boost that is more than twice as high (\$9). And Since 2001, an amazing 70% of the increase in household net worth has come from rising home prices.

Second, in addition to the psychological boost from the wealth effect, consumers also directly tapped the rising equity in their homes to increase spending. Rising home prices and lower interest rates triggered a refinancing boom whereby homeowners withdrew significant portions of the increase in the value of their homes, which turbo-charged consumer spending. Typically such mortgage equity withdrawals (MEW) have averaged about 1% of disposable income, but during the housing boom MEW peaked at 10% in 2004!

With home prices no longer rising or perhaps falling, this prop for the economy is likely to continue to dissipate. In fact, MEW has already declined to 5% of income. Without the impact of MEW, it is estimated that GDP growth over the past three years would have averaged less than 1%.

In sum, if the prices of houses continue to fall, most likely consumer spending and the over-all economy will be negatively impacted.

2. The Stock Market Disappoints

Another holdover from last year is our concern that the returns on U.S. stocks could surprise on the downside. While we are not necessarily saying that stocks lose money this year (not a good bet since stocks do make money most years), we do think a reasonable surprise to the market could be a lower return to the stock market than many expect.

Individual and professional investor sentiment is extremely bullish. As regular readers of this commentary know, the market generally moves (at least eventually) in the opposite direction of sentiment extremes. The logic is that if everybody is bullish, who is left to buy and push the market higher; and vice versa.

Currently, according to a Business Week survey of 80 analysts, 89% are bullish for 2007. Only 8% are bearish, with only 3 of the 80 analysts expecting a decline of more than 10%. A 10% loss this year would definitely surprise the consensus.

Another survey testifying to the optimistic imbalance is the survey of financial advisors by the Russell Investment Group. They found that 86% of the advisors are bullish and only 1% expect a loss of 10% or more. Some of the sentiment measures are near, if not already at, historic highs.

This optimism from professionals is sort of remarkable given the market's incredible run in the second half of the year (never mind other fundamental factors). Ned Davis Research reports that this is now the longest bull market without a 10% correction in history. In fact, the 8% drop last spring was the shallowest pullback of any four-year market cycle since 1934. Not only that, but the market's ascent since then has been one of the smoothest on record. The market has not even experienced a 2% pullback since last July. This has happened only one other time since 1964.

3. The Dollar Is Stronger

Contrary to our (correct) view last year, we think the U.S. dollar could do better this year. While we remain long-term bears on the dollar, we could foresee the dollar having a bear market rally just as it did a few years ago. One of our surprises for 2006 that did not materialize – that high quality investments would outperform low quality – is actually the consensus view for 2007 and here we agree with the consensus. In such conditions, when the market is rewarding quality, or even in a more extreme case when there is a more pronounced “flight to quality”, the U.S. dollar tends to perform better than other currencies. Given the U.S.'s role in the global economy, particularly its size and economic advantages, the U.S. currency is generally seen as a safe haven. A stronger dollar would surely surprise many.

The implications from a stronger dollar are twofold. One, a rising dollar typically goes hand-in-hand with weaker commodity prices. While we are still believers in the notion that under-investment in commodity production over the last decade or two means that we are in a long-term bull market for commodities, the “fad” of commodity investing might be in for a rough year in 2007.

Two, a stronger dollar is not a plus for international stock and bond markets versus U.S. domestic stock and bond markets. Even if the international markets post gains, the gains could be reduced or eliminated due to currency losses. Despite the U.S. market coming in dead last among the major international indices (MSCI EAFE, MSCI EAFE Value, MSCI EAFE Growth, MSCI Small Cap, MSCI Emerging Markets) each and every year since 2002, it would not be unreasonable to see international stock market performance ebb versus U.S. performance. Not only is that trend mature, but relative valuations and growth rates are not quite as attractive as they have been for international securities against the U.S. market.

4. The Yield Curve Gets Steeper

The yield curve has been inverted this year (short rates higher than long rates), if the economy is weaker than expected, another potential surprise to the market could be a steeper yield curve courtesy of a Federal Reserve that starts to lower short-term interest rates. Though our general

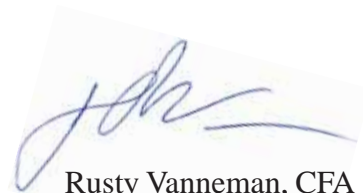
expectation is that the longer maturity bonds won't necessarily rise significantly, we don't think they will drop in parallel to the short end of the curve. Thus the curve starts to steepen again as long-rates become higher than short rates.

Most of our surprises for 2007 seem to hinge on the housing market. While the consensus view is that housing is on the mend, we think the probability is much higher than many think that it will actually get worse this year. If that is the case, many consensus views will surely miss there marks this year.

Sincerely,



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