

Economic and Social Outlook: *January 2007*

Last year the market was a rising tide that didn't lift all boats. We expect market breadth to improve in 2007. With inflation fears easing and confidence in the economy growing investors will turn their attention to the much broader spectrum of companies that fuel and benefit from continued, if more moderate, economic expansion.

Market Overview: Bad Breadth

2006 was an odd year in the stock market. While the Dow Industrials and the S&P 500 showed very good gains, most investors won't see similar results when they open their statements this month. That's because last year was a rising tide that *didn't* lift all boats. Indeed, for the first time this decade a majority of stocks in the S&P 500 actually did worse than the benchmark itself.

Such a state of affairs is referred to by market analysts as "bad breadth" (not to be mistaken for halitosis). It means the gains shown by the broad indices were not, in fact, broadly distributed. This narrowing of the market left quite a few well-known investors out in the cold last year. One was Bill Miller of Legg Mason fame. His 15-year streak of besting the S&P 500 was broken in 2006 as Miller trailed the S&P by a full 10 points--gaining 6% to the S&P's 16%. Fidelity Magellan, one of the world's most widely held mutual funds, showed a similarly subpar return of 7%. And these weren't aberrations. The Lipper organization that tracks mutual fund performance found the average return for large-cap growth funds last year was 4%.

The last time markets were this narrow was in the late '90s when technology stocks in particular and "growth" stocks in general hogged all the gains. As happened then, such narrow participation often foretells a change in market leadership—a final stampede as the herd is about to change direction. We think something similar happened last year as energy stocks in particular and "value" stocks in general soaked up the market's gains.

Inflation, Speculation and Commodity ETFs

For most of last year the psychology driving stock market action was a peculiar blend of inflationary fear and speculative greed. The Federal Reserve had spent two years raising interest rates in an effort to cool the economy and nip inflationary pressures in the bud. Many investors figured if the Fed was worried about inflation they should be too. And so investment dollars were directed to a narrow band of stocks that would benefit if inflation drove up the prices of their underlying commodities: oil and gas, gold, real estate, etc.

That was the fear side of the equation. On the greed side Wall Street naturally devised a way to cash in on these fears by inventing new ways for investors--particularly retail investors--to play the commodity markets. Exchange-traded funds or ETFs that trade like stocks but invest in commodities have seen unprecedented growth in the past two years as investors stampeded into the red-hot commodity sector.

This dramatic increase in demand drove up the prices of the commodities held by the ETFs, which in turn drove up prices of the related oil & gas, gold, and other commodity stocks. This isn't to say increased global demand--particularly from the BRICs (Brazil, Russia, India, China)--wasn't pushing up commodity prices as well. Only that those fundamentally driven increases were turbocharged by an entirely exogenous factor: Wall Street marketing.

continues on reverse

2006 Major Market Performance

	4th Quarter 2006 % chg.	Full Year 2006 % chg.
DJIA	7.38	19.04
S&P 500 (large cap)	6.70	15.79
S&P 1000 (small/mid cap)	7.27	11.89
S&P 1500 (all cap)	6.77	15.34
NASDAQ	6.95	9.52
Lehman State G.O. Municipal Bonds	0.99	4.46
Lehman Gov't/Corp. Intermediate-term Bonds	1.03	4.08

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Inflation, Speculation and Commodity ETFs (cont'd..)

A vicious cycle then took hold. Speculative demand drove up commodity prices. Rising commodity prices drove up the related stock prices. Both of these were then taken to confirm that inflation really was a problem. Which spurred further demand for commodities, etc.

Our claim all year has been that inflation wouldn't be a problem, that speculation was driving a lot of the price increase in commodities, and that when the speculative bubble in commodities burst the associated stocks would fall. And that's what has happened.

Hard Data

The Consumer Price Inflation report for the fourth quarter of 2006 just came out showing inflation running at a subdued annual pace of 1.4%. Oil prices have fallen 35% since September, gold prices have fallen 15%, and US housing prices fell 3% in 2006 for the first year-over-year decline on record. Energy stocks are down 10% from their December highs and are dead last among stock sectors as the New Year comes out of the starting blocks.

A Soft Landing and What it Means for the Markets in 2007

With the important US housing sector slowing as house prices decline and construction falls off sharply, the general economy is bound to lose some steam in 2007. We think this is a good thing. With the BRICs, Japan and Europe all enjoying healthy economic growth, some moderation in the US economy won't result in recession. Indeed, the main risk we see to our outlook is that the economy won't slow enough and so put the Fed on inflation watch with an accompanying uptick in interest rates. This would likely cool investors' appetite for stocks.

While that's a risk--and one we might flirt with during the year--we don't think it's the likely outcome. We rather expect slowing but continuing economic growth—a so-called soft landing. This should ease inflationary pressures and keep US interest rates low and possibly heading lower. With corporate earnings and balance sheets strong, unemployment low and real wage growth perking up, we're not sure what we'd have to complain about. And best of all, stocks are cheap as earnings growth has far outpaced price appreciation over the past three years.

Perhaps most importantly we expect market breadth to improve in 2007. With inflation fears easing and confidence in the economy growing investors will turn their attention to the much broader spectrum of companies that fuel and benefit from continued, if more moderate, economic expansion. The history of such "soft landings" is quite encouraging and we think the odds are decent that 2007 will be an above-average year for stocks.

M&A, the Global Savings Glut and the Presidential Cycle

One factor that drove the "value" bias in the markets last year was mergers and acquisitions (M&A) activity. Two examples in our portfolios were BellSouth's buyout by AT&T and pipeline giant KMI being taken off the public market by private investors. This will continue in 2007. Though the US savings rate is reported to be perilously low (the press loves all things perilous), cash is nonetheless piling up around the world. Petrodollars are gushing throughout OPEC and Russia. China, India and Japan are powerful economic engines with low consumption and high savings rates. And cash holdings at US corporations are at record levels as earnings have boomed.

All of this cash is constantly looking for a profitable home either through direct investments or indirectly through hedge funds, private equity pools and other intermediaries. The implication for US stocks is that demand is increasing and supply is decreasing. That implies higher prices. With "game over" flashing across the real estate and commodities markets and stock valuations attractive, we think this cash will look for a home in US equities.

Lastly we'll note that 2007 is the third year of a presidential term. The last time the market was down in the third year of a presidential term was 1939 as the US was coming out of the Great Depression. Even then, stocks lost less than 2%. In the 16 third-years since, stocks have been up by double digit percentages in all but two instances. This is no accident. Incumbents do whatever they can in year three of a presidential term to insure that the economy will be booming come election time in year four. The market sniffs this out and rises accordingly in year three. We expect 2007 to follow the script. Given this outlook we continue to overweight equities relative to bonds. As ever, this overweight is calibrated to each client's overall risk profile and objectives.

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Social Advocacy Outlook

On the social advocacy front, this fall we filed nearly twenty shareholder proposals on issues including animal welfare, environmental health, executive compensation, global warming, political contributions, and sexual orientation nondiscrimination. Some of these proposals have already yielded commitments to change company policies on sustainability reporting at American Express, executive compensation at Pfizer, and transparency of political contributions at General Electric and Hewlett-Packard. At Pfizer, the company has agreed to allow for an annual shareholder advisory vote on senior executive compensation packages. For more details and updates on our advocacy, visit our website at www.trilliuminvest.com.

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