



# INVESTMENT UPDATE

JANUARY 2007

## THE MOST WONDERFUL TIME OF THE YEAR?

Although it may appear that we simply have rolled forward our forecasts from last year, in reality, we spend significant time and energy contemplating the future. We dedicate entire meetings to this endeavor and take time away from day-to-day activities to consider the truly long-term possibilities. The demand for forecasts never seems stronger than when the calendar page turns to a new year. What surprises will be in store for investors this year? How different will be the investment and economic outcomes from the prior year? Should investors make big changes in portfolio strategy? In last month's *Update*, we cited some of the reasons that markets did unexpectedly well in 2006. While a number of those factors may remain intact during much of 2007, their market impact may be different.

Our economic forecast for 2007 includes:

- 1) U.S. economic growth moderation, but not recession, due to the housing market weakness;
- 2) continued global economic growth;
- 3) somewhat stable energy prices;
- 4) a further downshift in U.S. inflation and inflation expectations;
- 5) gradual Fed easing beginning in mid-2007 in response to the slowing economy; and
- 6) a resumption of the downtrend in the U.S. dollar.

## IT'S NOT A SURPRISE IF EVERYONE KNOWS

Our economic expectations reflect a mid-cycle slowdown scenario. In several past such episodes, a slower-growth economy, coupled with slowing inflation and an accommodative Fed, provided potent

fuel to lift stocks. We acknowledge the possibility of experiencing a repeat of the very strong returns of the 1995 mid-cycle slowdown, but think it more likely that stock returns will be subdued in 2007. At issue is the virtual unanimity with which this expectation is held. Have you ever agonized over making some announcement, finally made it, then found out that it was a non-event because everybody already knew? In our *2006 Economic and Investment Outlook*, prepared late in 2005, we posited that the economy might be in store for "Goldilocks Redux." In other words, we expected a repeat performance of the mid-1990s economy, when economic growth remained warm enough to drive profits, but cool enough to quell inflation. We may not have been the lone voice in the wilderness, but there was sufficient uncertainty that our call was somewhat bold. Now that these events appear to be unfolding we are hearing this thought from many others. Alan Abelson's November 27th *Barron's* column featured a chart indicating that the word Goldilocks had been found in more than 25 news articles in the last month alone! Even more telling, in a chart Abelson titled "Cliché Alert," he showed that the phrase "soft landing" had been cited roughly 900 times over the last 12 months. Developments that move markets are those that typically come as a surprise. It is hard to put this one in that category any longer.

## CAMP CONSENSUS

No one likes to stand out for the wrong reason. I was in the high school marching band (I know, it explains a lot about me to some of you). I recall the band performing at a football game halftime and me pivoting left, instead of right with the rest of the band. It was perhaps a stellar opportunity for Mom to say, "That's my boy!" and was more than a little embarrassing. Add potential career risk in the financial arena, and you can see why no one wants to be alone, "standing in the field," so to speak. Even with this in mind, it still is surprising the degree to which strategists have exhibited consistency in their 2007 forecasts. Whether looking at the recent *Barron's* 2007 outlook or the *BusinessWeek* 2007 forecast in which Mellon was included, strategists' expectations for economic conditions, equity returns, and bond yields varied little. The last time I can remember such alignment towards a positive outcome was coming into 2001. As you may recall, those forecasts did not pan out so well. It is possible that events will unfold as universally expected, but history teaches us to be skeptical.

Our forecast for lower equity returns over the next 7-10 years remains intact. We recognize that there will be years in which returns are stronger than the average, just as unfortunately there will be years when returns fall below. If only we could know in exactly which years these would occur! The strong returns achieved last



year did not change valuation dynamics as much as they sometimes do. Often stocks become more expensive after a year with returns as strong as 2006 because prices rise more than earnings, resulting in a higher P/E multiple. This can result in lower future returns as multiples revert to more reasonable levels (think 2000–2002). Last year, however, earnings were up even more than stock prices, so that the P/E ratio for the S&P 500 actually declined modestly. On this basis, stocks remain fairly valued in light of the low interest rate, low inflation environment, which we expect to continue.

#### DOES THIS SOUND FAMILIAR?

If economic events pan out according to our base case scenario, returns from stocks and bonds again could be above normal in 2007. Reduced inflation pressure and slower economic growth could promote a more accommodative Fed willing to ease rates. While earnings growth rates for stocks are likely to be much lower than in 2006, we expect that they will remain positive. This combination might cause investors to revalue equity P/E multiples higher, increasing returns. However, as we have discussed, this outcome is widely expected, reducing the potential for a positive surprise. On the flip side, investors will remain concerned about a potential recession depending on the severity of the unfolding housing recession and its negative impact on employment, mortgage equity withdrawal, and, by derivation, the consumer. Investors have not experienced so much as a 10 percent correction for several years – almost a record. Should a correction develop, some may question whether the lengthy bull market is over.

There appear to be enough unfavorable events that could transpire to keep investors from bidding up equity prices much beyond the rate of growth that will be provided from earnings and dividends. We would love to be positively surprised again, but feel it warranted to project single-digit large cap stock returns, and possibly a bit less for small companies which have had a tremendous run for a lengthy period. Given our expectation for a declining dollar and the continued economic strength of a number of other countries, combined with globally low inflation, our outlook for international equities remains positive. We have some concern about the rampant inflows to both developed and emerging market equities, and this is reflected in our current asset allocation recommendations.

Current bond yields are reflective of the widespread belief by investors that economic growth will slow. We expect rates to fall modestly in the early part of this year, then to rise later in the year as economic growth accelerates. It is possible that rates could end the year a bit lower than they are now, but probably not by much. Recent economic growth has been on the stronger side. Were this growth to continue, it would be a big surprise to the consensus view, resulting in higher rates and increased volatility. We expect growth will moderate as the impact of the housing market decline is seen in higher unemployment and in consumers increasing their savings. Both of these events should slow the economy. While we do not believe that these factors will induce a recession, we will monitor closely any recessionary indicators. Very slow or negative economic growth might be favorable for lower bond yields, but it would likely have quite negative consequences for equity returns and volatility.

Considering these factors, we believe our existing recommended allocations are appropriate as we begin the year. These recommendations reflect a neutral exposure to stocks and bonds (adjusted for each client's specific objectives, risk tolerance, and timeframe) and within most of the asset classes we recommend. While relative valuations on stocks appear attractive to other asset classes, it is the word "relative" that we may be a little hung up on. With the widely prevailing positive sentiment towards stocks, enough things could go wrong that we are more restrained in our optimism than some. One analyst recently put it well. He described the relative attractiveness of equities as the best house in a bad neighborhood. We were amused by the analogy; even if we don't think the old neighborhood has gone bad, it may have a few shady characters we hope are only passing through.

Over the next few months, we will provide a more detailed look into several asset classes.



Christopher Sheldon

Director of Investment Strategy

