

A Surprising Fourth Quarter

Can the stock market do it again in 2007?

By Paul Woods

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The biggest news in the fourth quarter of 2006 was the change in power in Congress. Democrats won virtually every close race and established majorities in both the Senate and House. The gist of their message was they weren't Republicans, but they were vague on how they would change things. With the stock market's usual distaste for uncertainty, it went into a funk for a few days after the election. However, it didn't take long for investors to remember what political gridlock did for the economy and the financial markets in the 1990s. A week later, the stock market was higher than before the election.

Like a glider gently coming in for a landing, economic growth is moderating. The fourth quarter was the first time in three years that real GDP growth dropped below 3%, and leading indicators of the economy imply further slowing. However, corporate profits remain stubbornly strong, with earnings for the S&P 500 Index still up over 15% from year ago levels. The inflation rate dropped dramatically during the fourth quarter and is now around 1%. Even so, the Federal Reserve is still using the threat of inflation as an excuse not to lower short term interest rates.

Before the election, there was speculation that more Democrats would negatively impact health care and oil stocks. On that, the pundits batted 50%. Excluding biotech, older health care companies did poorly after the election, but this wasn't new as they've been lousy investments all year. Oil stocks reacted to higher prices and ignored the change in Congress. During the fourth quarter, biotech, energy, and consumer spending stocks were the top performers while transportation and health care stocks brought up the rear. Smaller companies outperformed bigger ones, REITs kept going, and investors generally preferred value over growth. For reference, here's the stock market segment scorecard for the fourth quarter.

	<u>Symbo</u>	<u>9/29/06</u>	<u>12/29/06</u>	<u>% Change</u>
	<u>I</u>			
Microcap	IWC	53.40	58.45	9.46%
Small Cap. Value	IJS	69.75	75.34	8.01%
Small Cap.	IJR	61.29	65.99	7.67%
REITs	VNQ	71.89	77.00	7.11%
MidCap Value	IJJ	74.00	79.24	7.08%
Small Cap. Growth	IJT	119.50	127.96	7.08%
Large Cap. Value	IVE	71.81	76.89	7.07%
MidCap	IJH	75.44	80.17	6.27%
Large Cap.	IVV	133.75	142.00	6.17%
MidCap Growth	IJK	75.39	79.71	5.73%
Large Cap. Growth	IVW	61.70	64.92	5.22%

Source: Thomson One Financial

In addition, here's the stock market index and industry group scorecard for the same period:

	<u>Symbol</u>	<u>9/29/06</u>	<u>12/29/06</u>	<u>% Change</u>
		11,679.0		
Dow Industrials	INDU	7	12,463.15	6.71%
Nasdaq Composite	COMP Q	2,258.43	2,415.29	6.95%
S&P 500 Index	SPX	1,335.85	1,418.30	6.17%
Biotech	BTK			12.64%

		669.64	754.25	
Energy	SPENS	411.38	455.53	10.73%
Consumer Services	SPCCS	275.86	302.92	9.81%
Utilities	SPUT	172.33	186.60	8.28%
REITs	RMZ	1,010.20	1,090.63	7.96%
Financials	SPFN	465.83	495.31	6.33%
Commercial Services	SICSS	188.53	200.59	6.40%
Capital Goods	IXI	333.93	352.16	5.46%
Basic Industries	SPIN	306.29	322.63	5.34%
Technology	SPHTI	336.28	356.28	5.95%
Clean Energy	ECO	176.32	182.06	3.26%
Consumer Staples	SPCNS	260.75	268.41	2.94%
Transportation	TRAN	4,453.46	4,560.20	2.40%
Health Care	HCX	384.94	388.74	0.99%

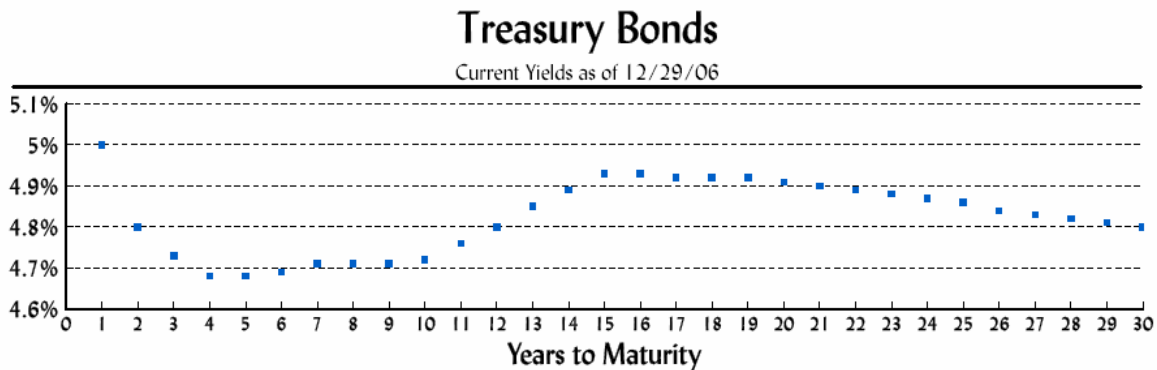
Source: Thomson One Financial

In the fixed income market, bond investors ignored our last quarterly letter and yields rose slightly during the fourth quarter. In spite of a slowdown in economic growth and inflation, bond investors waited in vain for some signal that the Federal Reserve would bring short term interest rates in line with the rest of the yield curve.

<u>Current Yield</u>	<u>9/29/06</u>	<u>12/29/06</u>	<u>% Change</u>
90 day Treasury Bills	4.89%	5.02%	2.7%
5 Year Treasury Bonds	4.59%	4.70%	2.4%
10 Year Treasury Bonds	4.64%	4.71%	1.5%

Source: Bloomberg LP

The yield curve remains inverted at the short end, and we still expect the next move in interest rates by the Federal Reserve to be down. Weakness in housing should allow economic growth to continue to moderate, and the inflation rate is also expected to be lower in 2007. We expect lower bond yields in 2007 and remain invested in the under 10 year segment of the market as the incremental risk of investing in longer maturities outweighs the incremental return. At present, yield spreads versus Government Agency bonds are highest at 4–6 years.



Source: Bloomberg LP

Overall, 2006 was a good year for investors. Interest rates ended the year with yields a bit higher than they were at the end of 2005, but bonds still produced a positive return. Although stocks produced an above-average return, this return about matched the underlying increase in earnings.

While some pundits expect returns to moderate in 2007, we're in the opposite camp. Valuations in the stock market have been rising since the summer. According to our model, stocks are still more than 16% undervalued relative to interest rates. As a result, we expect valuations to rise further in 2007. Although earnings growth will probably moderate, earnings are likely to remain strong enough to produce another double-digit return in stocks in 2007.

We're also excited about 2007 for another reason. There's now a light at the end of the tunnel when it comes to the constantly increasing demand for foreign oil. Electric cars with enough range, performance, and comfort to satisfy American drivers will begin hitting the market this year. Whether you worry about global warming or about the consequences of our

dependence on foreign oil, this is good news. If you'd like more information, please see our article at <http://www.nataliepace.com/np.php?fxn=home> in the January 2007 online magazine.

In the meantime, please feel free to contact us if you have any questions or if we can be of any service.

Best regards,

Paul

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