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Q4 Market Review ~ The Real Story in 2006...

January 2007 - In the final quarter of 2006, financial markets continued their upward ascent begun in the third quarter. Robust corporate profits, declining oil prices, and a flood of merger and acquisition activity all combined to rocket stock prices higher. International stocks topped the performance charts in the fourth quarter, with Emerging Markets surging 17.6% and Developed Markets swelling 10.4%. Domestic stocks were also up across the board, as Large Cap sectors added 5.9% to 8.0% and Small Cap sectors jumped 8.8% to 9.0%. Real estate stocks continued their advance, gaining 8.9%.

The Federal Reserve maintained its on-hold posture during the fourth quarter, leaving the Fed Funds rate at 5.25%. At quarter end, the yield on the 10-year Treasury Note was 4.70%, up seven basis points for the quarter and 31 basis points for the year (the yield as of January 12th was 4.78%). Stable interest rates and strong equity prices helped the riskiest segments of the bond market move higher, with U.S. Corporate High Yield strengthening 4.5% and International Emerging Markets rising 4.1%.

Below are rates of return for selected market indices for the fourth quarter of 2006, full-year 2006, and the three, five, and 10-year averages as of December 31, 2006.

	4Q:2006	YTD-2006	3-Yr. Avg.	5-Yr. Avg.	10-Yr. Avg.
Equity (Stock) Indices					
Domestic Large Cap					
Russell 1000 - Growth	5.93%	9.07%	6.87%	2.69%	5.44%
Russell 1000 - Value	8.00%	22.24%	15.09%	10.86%	11.00%
Russell 1000 - Blend	6.95%	15.46%	10.98%	6.82%	8.64%
Domestic Small Cap					
Russell 2000 - Growth	8.77%	13.35%	10.51%	6.93%	4.88%
Russell 2000 - Value	9.03%	23.48%	16.48%	15.37%	13.27%
Russell 2000 - Blend	8.90%	18.37%	13.56%	11.39%	9.44%
Real Estate (Dow Jones Wilshire REIT)	8.85%	35.97%	27.26%	23.79%	15.27%
International Developed Mkts (MSCI EAFE)	10.40%	26.86%	20.52%	17.02%	9.96%
International Emerging Mkts (MSCI EM)	17.64%	32.59%	31.03%	28.67%	13.99%
Fixed-Income (Bond) Indices					
Lehman Brothers					
Global Aggregate	2.15%	6.64%	3.81%	8.09%	5.75%
U.S. Aggregate	1.27%	4.33%	3.70%	5.09%	6.31%
U.S. Corporate High Yield	4.51%	11.85%	8.57%	10.66%	6.97%
Municipal	1.15%	4.84%	4.28%	5.55%	5.82%
International Emerging Markets	4.14%	9.96%	11.37%	14.66%	11.31%

Source: www.russell.com, www.wilshire.com, www.mscibarra.com, www.lehman.com

The Real Story in 2006…

Stocks and bonds delivered sweeping gains in 2006, but the year wasn't without its bumps in the road. Market indexes moved ahead at a nice pace through the beginning of May, began a collapse which ended in July, and then propelled ahead for the balance of the year. Notably, July marked the high point for oil prices, while August was when the Federal Reserve stopped raising the Fed Funds rate after 17 consecutive quarter-point increments. The Fed had boosted its benchmark short-term rate in 25-basis-point steps from 1.0% beginning in June 2004 to 5.25% in July 2006.

Stimulated by record company earnings, lower energy prices, steadying interest rates, and a high level of deal making, nearly all stock sectors and two bond sectors posted double-digit upside moves. Domestic Large Cap sectors rose 9.1% to 22.2%, while Domestic Small Cap sectors climbed 13.4% to 23.5%. In the bond arena, U.S. Corporate High Yield and International Emerging Markets also participated in the multiple-digit realm, tacking on 11.9% and 10.0%, respectively.

But "The Real Story in 2006" was the benefit of diversification provided by the returns from real estate stocks (as measured by the Dow Jones Wilshire REIT Index) and international stock markets, not broad-based domestic sectors. Driven by private-equity deals, in which companies are being bought out at huge premiums above where their shares are trading, REITs extended their winning ways by skyrocketing 36.0%. This marked the seventh consecutive year of REIT-stock increases, six of which were double-digit.

Nevertheless, the international markets were the most impressive performers in 2006. Emerging Markets vaulted 32.6%, Developed Markets rallied 26.9%, while the average International Small Cap mutual fund in the Morningstar universe grew more than 26.0%. This marked the fourth year in a row in which broad international markets were up by multiple digits. These returns demonstrate the importance we continue to emphasize regarding the role of diversification on portfolio performance. The best returns continue to be experienced in markets outside the United States.

As widely reported, on October 3rd, 2006, the Dow Jones Industrial Average hit an all-time closing high of 11,727.34, surpassing its record of 11,722.98 set on January 14, 2000, and has since moved ahead to close above the 12,500 mark (See *Dow Jones Hits New High: Big Deal!?* at www.kaloramawealth.com/news.html). Meanwhile, despite four successive years of advances, many domestic and international major-market indices are still, in some cases significantly, below their all-time highs:

Index	12/31/2006 Close	2006 Gain	All-Time High/Date	% Off All-Time High
S&P 500 Stock Index	1,418.30	13.6%	1,527.46 / Mar. 24, 2000	7.2%
NASDAQ Composite Index	2,415.29	9.5%	5,048.62 / Mar. 10, 2000	52.2%
FTSE 100 (Britain)	6,220.80	10.7%	6,930.20 / Dec. 30, 1999	10.2%
CAC 40 (France)	5,541.76	17.5%	6,922.33 / Sep. 4, 2000	19.9%
XETRA DAX (Germany)	6,596.92	22.0%	8,064.97 / Mar. 7, 2000	18.2%
Nikkei 225 (Japan)	17,225.83	6.9%	38,916.00 / Dec. 29, 1989	55.7%

Source: www.finance.yahoo.com

Several Emerging Markets Indexes also logged an impressive 2006-performance: Argentina leapt 35.5%; Brazil expanded 32.9%; China soared 109.8%, India tacked on 51.0%, Mexico bounced 48.6%; and Russia shot up 55.9%.

The Outlook for 2007

As we begin 2007, the stock market still appears to be relatively inexpensive as measured by earnings multiples (price divided by operating earnings). Based on estimated 2006 and 2007 operating earnings for the stocks in the Standard & Poor's 500 Index, at the end of 2006 the earnings multiple was 16.2 and 14.8, respectively. This compares with a multiple near 30 when stock prices were peaking between 1999 and 2001, and an average earnings multiple of 19.5 since 1988, a period covering two recessions, the tech-stock boom and bust, corporate scandals, and terrorism.

Corporate earnings have been nothing less than impressive since the last recession, while stock-market performance has been lackluster. If estimates for 2006 hold, earnings from the companies in the S&P 500 will have posted a record five years of double-digit growth. From a recession-induced low of $38.85 per share in 2001, S&P 500 operating earnings have increased at a compound annual rate of 17.7% to an estimated $87.81 for 2006 (and are anticipated to expand another 9.5% in 2007). Over the same period, the compound annual total return of the S&P 500 has been a miserly 6.2%.

Turning to the bond market, most pundits expect lower interest rates in 2007 as the Fed shifts course to stimulate the economy and prevent a housing-influenced recession.

Lower interest rates would bode well for bond prices, augmenting returns for fixed-income investors. This would also benefit international investments, as lower interest rates typically lead to a lower dollar value.

In my opinion, investors whose portfolios have grown by multiple digits over the past years have not focused their assets only in domestic markets. The return enhancement provided by diversification is significant. If you are not sure your portfolio is adequately diversified, Kalorama Wealth Strategies can help you create a plan to invest your assets in a manner providing professional management, diversification, marketability, and liquidity. For more information, please see our web site at www.kaloramawealth.com.

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