Argent Wealth Management

QUARTERLY
Investment Outlook

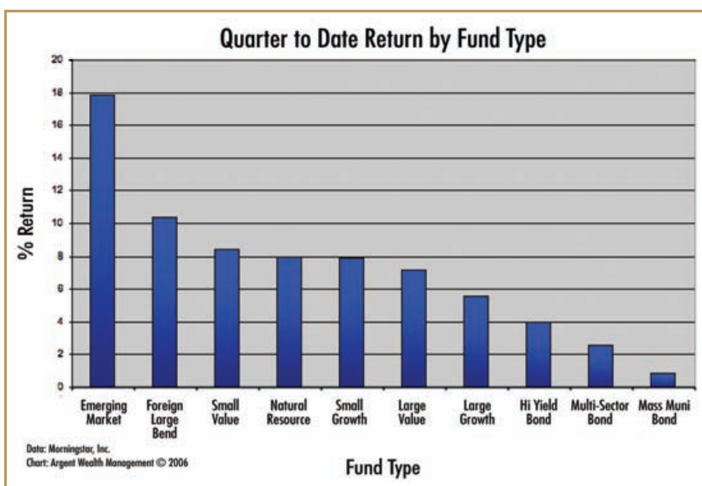
Winter 2007

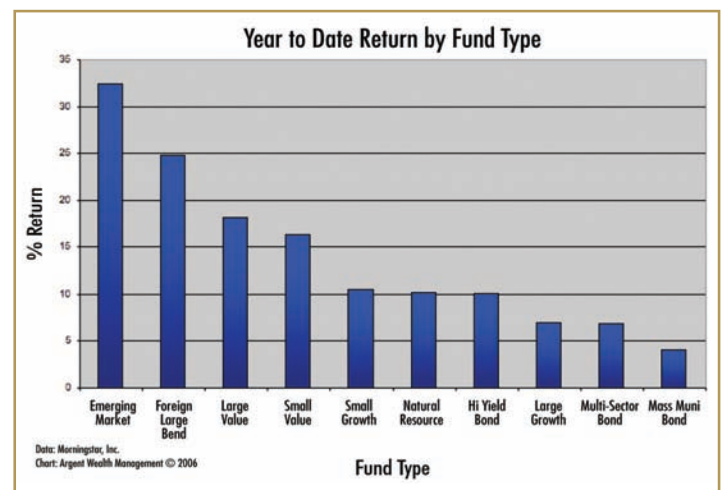
# First Quarter 2007 Investment Outlook

## Fourth Quarter and Full Year 2006 Review: All Systems Go!

The performance of capital markets in the fourth quarter of 2006 was superb, extending — and in some cases improving upon — the prior quarter's solid record. By any accounting, returns in the year's final three months were excellent across the board. Stocks, bonds, commodities, international funds, and virtually every other investment category participated in the rally. There were only a few exceptions, such as hedge funds that sought to limit downside risk by selling stocks short.

This terrific market was due to an ideal combination of circumstances. U.S. economic growth slowed to a pace that allowed the Fed to end its string of interest-rate hikes after 17 consecutive quarter-percent increases. But while economic growth was indeed slower, it was still sufficiently robust to allow companies to keep cranking out tremendous profits. Earnings of companies in the S&P 500 have now grown at a double-digit rate for 18 quarters in a row. Such levels and durability of profits growth have stunned even the most bullish strategists.




While there were plenty of concerns for investors to fret over during the period, none of them became problematic for the markets. Geopolitical risks in Iraq, Iran, and North Korea were all contained. Mid-term elections resolved uncertainty, and big gains by Democrats didn't upset investors, as incoming party leaders seemed sensitive to business concerns. Weakness in housing and autos intensified, but didn't spill over into other parts of the economy. Finally, inflation began to recede towards the Fed's target zone.

In sum, the "Goldilocks" economy lives on. Conditions that are "not too hot and not too cold" are the ideal environment for investors. Too-hot growth would cause the Fed to resume its tightening; too-cold growth would depress earnings. Either extreme would be negative for financial markets.

## Taking Stock of Last Year's Predictions

We find it sobering, and instructive as a basis for our 2007 forecast, to grade ourselves on our prognostications for the year just ended.

Early in 2006 we outlined five key themes for the year: 1) Emphasize international markets, 2) Tactically overweight growth versus value, 3) Exploit select opportunities in bonds 4) Consider alternative asset classes, and 5) Avoid pitfalls, particularly real estate.

Rating ourselves on each of these themes in turn:

- *Emphasize international markets.* Grade: A

International markets crushed U.S. stocks for the year. The average return for international-equity mutual funds approached 25%, continuing a streak of four consecutive years of besting U.S. equity funds. We expect this trend to continue.

- *Tactically emphasize growth over value.* Grade: C-

Value funds trounced growth funds last year, a big surprise. However, most of value's outperformance was generated early in the year, and we began 2006 with an overweight to value, gradually moving to an emphasis on growth later in the year. We explain the persistence of value leadership by observing that market trends often last longer than may seem rational. One reason for this phenomenon is that many investors — to their eventual detriment — chase last year's winners.

While we understand and respect the influence of momentum, we often move against it to profit from what we foresee will be the next leading style. Of course, the process of moving into a lagging but attractive area of the market can be uncomfortable. Our initial steps are small; but when a turn in market leadership finally arrives, we prefer to take bigger steps toward the new leading style and then maintain that overweight over a longer period of time.

We expect to be vindicated in our preference for growth over value in 2007, as growth investing finally gains market leadership.

- *Exploit select opportunities in bonds.* Grade: A

Our fixed-income strategies worked exceptionally well last year. We entered 2006 conservatively positioned, correctly anticipating that the Fed would prolong its tightening campaign more than the market was expecting. As interest rates peaked last summer, we exploited some of the resulting bargains, particularly in some closed-end bond funds that were trading at wide discounts.

Interest rates fell sharply during the year's second half. This led to handsome absolute gains in bond prices, but also limited opportunity.

We expect the first half of 2007 to roughly parallel last year's initial six months in terms of interest-rate movements. Rates should rise in the first half as expectations about the timing of Fed interest-rate cuts are pushed back.

- *Consider alternative asset classes.* Grade: B

Alternative asset classes generally performed well in 2006. Most of our investments in this category produced excellent returns, and our asset-allocation strategies delivered just what we had expected: reasonable returns with significantly reduced risk. We experienced a major disappointment, however, with results from a "market-neutral" hedge-fund manager. That strategy lost money from shorting stocks as the year's broad market rally indiscriminately lifted share prices across the board.

We expect greater use of alternative-investment strategies in 2007. These types of investments provide clients with the ability to enhance returns over time while at the same time reducing the portfolio's volatility. Therefore, such vehicles are increasingly becoming an essential part of prudent portfolio diversification.

- *Avoid pitfalls, particularly real estate.* Grade: B

Residential real-estate markets contracted much more rapidly and severely in 2006 than most analysts had anticipated. However, real estate investment trusts (REITS), which focus on commercial properties, enjoyed yet another year of huge returns. REITS began 2006 greatly overvalued by most traditional metrics; and with their rise over the past year, valuations in our view are now approaching Never-Never Land.

But regardless of when and if sectors that are now richly valued experience a correction, we expect risk management to play a greater role in 2007. While it rarely captures the attention of investors when everything is going up, risk reduction is a requisite for longer-term investment success. That is why we begin our consideration of any investment with this question: If all goes wrong, what is the downside? When the downside is too great compared to potential return, we pass on the investment.

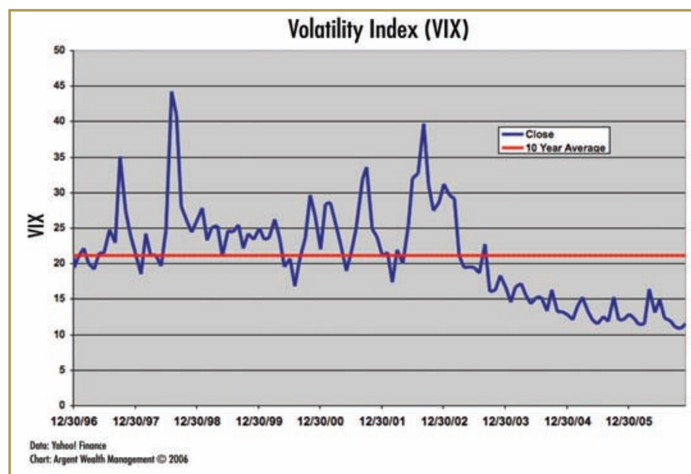
Summing up our overall record for 2006, we give ourselves a solid B.

## Key Strategies for Success in 2007

In 2007, we anticipate that market returns will be positive, that managing volatility will become increasingly important, and that tactical adjustments to portfolios will be key performance differentiators.

The current economic climate is excellent for investors. Global economic expansion continues unabated, and the U.S. economic slowdown should prove temporary and non-recessionary. Inflationary indicators are receding, allowing the Fed to hold interest rates steady for now. Economies outside the United States are expanding briskly, along with most national and regional capital markets.

Yet financial-market volatility will almost certainly rise in 2007. While this prediction may sound dire, the good news is that volatility is starting the year at one of its lowest levels in history (see chart). Only a prolonged continuation of the "Goldilocks" scenario would allow volatility to stay at its current rock-bottom level or to fall even further.



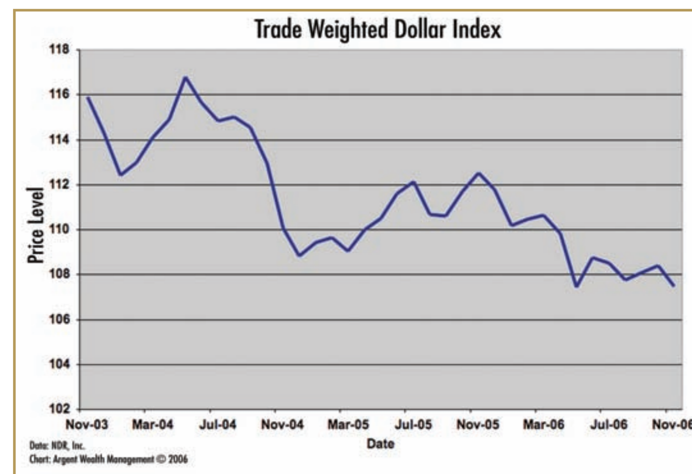

Volatility is now so low that any material change to the investment landscape — an acceleration or deceleration in economic growth, a geopolitical shock, a change in fiscal or monetary policy, a blow-up by a major market participant — would likely cause it to spike. And history suggests that markets are overdue for a return to more normal levels of volatility. Reversion to the mean is a powerful and widely observed — though sometimes delayed — phenomenon in financial markets.

A well-balanced portfolio allows investors to exploit any increase in volatility. That is why we think that now is a very good time to rebalance portfolios. Four years of excellent returns from equities have skewed asset allocations in many portfolios away from targeted levels, simply by virtue of the passage of time and market appreciation. The market's best-performing segments, such as small-cap value equities, have risen so sharply that their relative weight (and attendant risk) have become excessive if left unchanged. It's time to rein risk back to levels consistent with long-term objectives.

## International Stocks Will Continue to Outperform U.S. Equities

We continue to favor international equity markets, even after four consecutive years in which they have outpaced U.S. stocks. We are by no means bearish on the prospects for U.S. markets, but conditions in many overseas regions still promise relatively faster earnings growth. And price-to-earnings multiples in most foreign markets remain attractive, particularly in light of their earnings-growth potential.

Moreover, the U.S. dollar appears poised to keep sinking against most of the world's other major currencies, which would enhance the returns of foreign securities for U.S.-based investors. The dollar fared well in 2005 and into the first several months of 2006 as rising short-term interest rates and surging economic growth in the U.S. drew large amounts of foreign capital to U.S. securities. But these supports to the greenback should fade in 2007. Overseas economies seem poised to grow faster, and many foreign central banks will start or continue raising their interest rates while the Fed seems done (or close to it). Capital is likely to flow increasingly to these faster-growing economies and better-performing markets.



## The Bond Market: It's Déjà Vu Once Again

Bond-market returns were painful in the first half of 2006, and rewarding in its second half. Investors who added exposure to bonds in the teeth of the final phase of Fed tightening had a great year.

In 2007 the pattern should be somewhat similar, but for different reasons. Currently, the bond market expects the Fed to begin lowering interest rates by mid year, perhaps as soon as March. We strongly disagree.

U.S. economic growth has moderated, but by no means to a degree that would induce a recession or prompt easing by the Fed. With the Fed having held interest rates steady since August, the economy may in fact re-accelerate back toward trend economic growth of about 3% in 2007.

Moreover, Fed Chairman Bernanke, still fairly new to his job after a year, wants to build his credibility and demonstrate inflation-fighting zeal. The next shift in Fed policy will carry great weight in terms of market psychology, and is likely to be the first in a series of steps that will form a major change in direction by the Fed. The central bank will not give such a major signal without clear evidence of a sharp slowdown in the economy or a precipitous drop in inflation.

So while the Fed's next directional decision may well be to lower interest rates, we expect such a move no earlier than the second half of 2007. That timing will be difficult for the bond markets. The yield curve is now inverted, an atypical situation in which yields on shorter-term bonds exceed those of longer-term issues. If the Fed does not signal its intent to lower short-term rates, bond investors will not continue to tolerate lower yields on longer maturity bonds.

In the current environment, we suggest that bond investors adopt a defensive posture. Specifically, new investments should be liquid and short in maturity. Opportunities to profit from positions in longer-maturity bonds should emerge later in 2007.

## Alternative Investments Are Essential Building Blocks of A Well Built Strategy

The word "alternative" refers to any investment apart from cash and publicly traded stocks and bonds. This broad category includes (but is not limited to) hedge funds, private equity, structured notes, and commodities.

Increasingly, alternatives are becoming a mainstream element of modern investing. If carefully chosen, they are effective in diversifying a portfolio and gaining exposure to investments (for example, commodities) that may do well when traditional stocks and bonds perform poorly. Some types of alternatives, such as private equity, are ways to target very high returns.

Finally, alternatives can be essential tools for managing a specific risk or outlook in a portfolio. Examples include cushioning the potential impact of holding a large position in a single company's stock, managing the tax consequences of selling positions that have sharply appreciated, or providing a fixed-income portfolio with a floor on minimum returns.

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