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From May 10th to June 13th, 2006, markets fell 20% in Japan and 30% in Latin America and even gold, generally stable, fell 22%.¹ Of the 142 stock, bond and real estate sectors tracked by Sharper ♦ Granite, only 18% finished the 2Q06 quarter with positive gains. Returns for some key sectors included: networking -18%, biotech -12%, semiconductor -11%, software -9%, technology -8%, small cap -6%, and health care -5%.¹

In that second quarter, market volatility registered some of the highest readings in years.² Higher volatility levels typify interest rate inflection points, which we saw six months ago. High volatility also signals worry in the market. (see “The Importance of Time Frames for Stock Market Volatility”, *Summer 2006* at www.sharpergranite.com).

However, investors who stayed on track through the summer were rewarded. The much anticipated end of the oil price and interest rate advances finally arrived. These positive effects combined with low inflation, strong corporate profits, record private equity acquisitions, strong consumer spending and high global liquidity to support a nice stock market rally in the second half of 2006. By December, volatility levels were the calmest since 1993,³ and we are now hoping for the rare event of a fifth straight positive year for the stock market. For a closer look at the importance of global liquidity, please read this quarter’s research feature, “Effects of the Current Extreme in Global Liquidity”.

This year should serve as a reminder to investors that a long-term approach is best, and that changing investments to match the mood of the day will result in lower performance over time. We continue to keep our focus on oil prices, inflation and the movements of short-term interest rates as dictated by the Federal Reserve Board. For a detailed view of our key forward-looking economic parameters, please read the “Fourth Quarter 2006 Economy Review”.

Financial Markets Summary

The oil price decline and continued expectation of flat to lower short-term interest rates extended this quarter, driving the major indexes to a terrific quarter and a healthy overall 2006 gain.



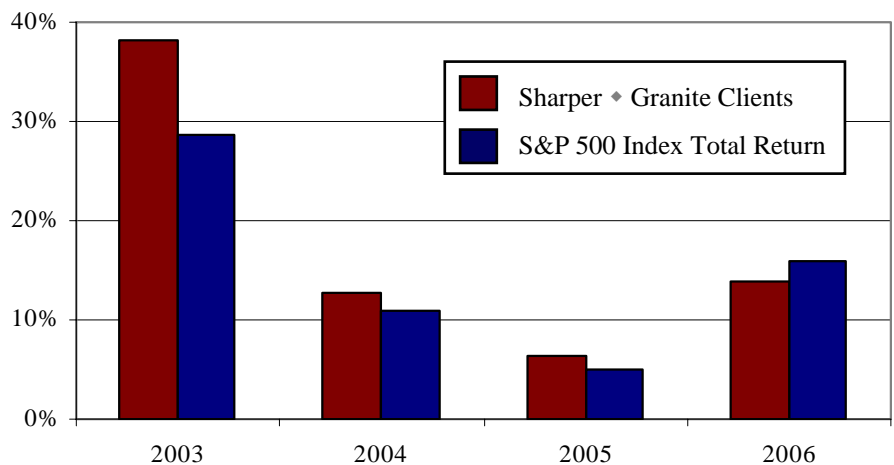
This quarter the S&P 500 Index returned 6.7% (stock price gain + dividends). This was the best quarterly gain since 4Q03. Meanwhile, the Lemman Aggregate Bond Index, which Sharper ♦ Granite uses as the benchmark for its taxable bond investment performance, returned 1.2% (bond price gain + interest payments) to bondholders.

The average of all Sharper ♦ Granite client portfolios gained 5.5% (net of fees) this quarter and maintained a risk level 24% less than the S&P 500 Index. If normalized to the same level of risk as the S&P 500 Index, Sharper ♦ Granite client portfolios would have finished up 6.9% (net of fees).⁴ Thus, the average of all Sharper ♦ Granite client portfolios narrowly beat the S&P 500 on a risk-adjusted basis this quarter.

For the year, the S&P 500 Index total return including dividends was 15.8%, and the NASDAQ total return was 9.5%. The Lemman Aggregate Bond Index gained 4.3% with dividends, about 1% below its long-term annual average.

For 2006, the average of all Sharper ♦ Granite client portfolios, when normalized to the same level of risk as the S&P 500 Index, would have finished 13.8% (net of fees).¹ Thus, the average of all Sharper ♦ Granite client portfolios slightly trailed the S&P 500 Index total return on a risk-adjusted basis this year. ●

Sharper ♦ Granite Returns Vs. S&P 500 Index⁴



Effects of the Current Extreme in Global Liquidity

One of the principal forces acting upon global markets today is the high level of monetary liquidity around the world. It is contributing to stock and bond market advances as well as many of the “extreme” economic conditions we see today such as an inverted yield curve (short-term interest rates are higher than long-term interest rates), low market volatility, and low risk premiums – meaning that investors get historically little extra return for investing in risky areas like junk bonds or emerging-market bonds as compared to safe U.S. treasuries.

There are a couple of reasons for this excess of cash around the world. While personal savings levels in the U.S. are not especially high right now, they are generally high in U.S. corporations and around the world. In fact, Fed Chairman Ben Bernanke frequently refers to this situation as the “global savings glut”.⁵ Furthermore, reviewing world economic conditions, this glut is unlikely to dry up anytime soon.

Second, global financial markets around the world are extremely “open” today. They are open in terms of government low-interest lending. 10-year Treasury rates are 4.8% in both the U.S. and U.K., 4.0% in Germany and 1.7% in Japan.⁶

They are also open in terms of the increasing ease with which money can be invested across borders. While the U.S. Fed, Bank of Japan, and the European Central Bank used to be all that mattered, now the People’s Bank of China, Expected to have \$2 trillion in reserves by 2010, and other Asian central banks contribute to the flood of cash. Adding to that are the reserves of the oil producers in the Middle East, Russia and Norway, which collectively produced a trade surplus of \$500 billion in 2006.⁷



Finally, the advent of new financial products has made it easier for the less credit-worthy – individuals, corporations and countries – to borrow money, which can then be used to make purchases or to invest. Risky loans are now securitized – that is, combined, sliced, and resold – such that the debt bundle is diversified and of lower risk than the sum risk of its parts. Additionally, certain derivative products now act as insurance for debt holders, which further spreads risk and encourages lending.

This increased global liquidity has impacted several key economic factors, changing the global investment landscape. These directly impact Sharper ♦ Granite portfolio manager tilts, or investment biases, within client portfolios.

Many of these effects are positive for the general economy. Foreign governments prefer to put much of their cash to work by investing in the safest of assets, long-term U.S. Treasuries. This demand has helped to push the 10-year treasury yield down to 4.7%, one of the lowest levels on record and even lower than the Fed-set, target short-term rate of 5.25% (a rare historical occurrence). This has, in turn, kept mortgage rates, which are mostly long-term loans and thus driven by long-term rates, quite low and helped ease the impact of the U.S. housing decline.

Additionally, as the long-term, “safe” U.S. Treasury investment option offers such a low rate, investors are looking to place their cash into riskier areas, and they are looking to all corners of the world. This demand has been positive for investors in that it has driven up the prices of risky foreign asset classes like emerging-country market bonds, and emerging-country stock markets, the latter of which is up 230% since 2003.⁷

Just as this cash glut, eager for return, is flowing into remote geographies, so too is it flowing to remote investment worlds. Money in “alternative investments” like hedge funds and private equity funds now totals \$3 trillion.⁷ This, even after private equity completed a record year of buyout deals in 2006 including Vivendi, Four Seasons Hotel, Outback Steakhouse, Burger King and J. Crew.^{8,9}

However, with all of this liquidity driving many asset classes to new price highs, there is increasing risk that bubbles could develop then burst due to a financial system shock, such as a major currency decline or a default by a money-center bank or government. The current benign global conditions will one day come undone, but there is no way to tell how or when. As always, the best strategy is to stay well-diversified, with a portfolio balanced against several types of risk. ●

Fourth Quarter 2006 Economy Review

The delicate economic balance currently sits near perfect equilibrium. Corporate valuations are reasonable as companies are delivering surprisingly powerful profit gains and buying back their own stock, active private equity funds and cheap money across the globe are driving demand for alternative investments, oil is retreating, and most believe the U.S. Fed will maintain steady-to-lower interest rates. On top of all that we are entering a historically positive point in the political and market cycles.

While the recent shifts in U.S. political power and Iraqi War strategy are important world events, Sharper ♦ Granite research implies that they will have less impact on investments than oil prices, interest rates (see “Historical Impact of War on Investments”, *Spring 2003*), and global liquidity effects.



The biggest intermediate-term concern may be that with so many economic variables sitting in such positive position, there is more chance of negative surprises than of positive surprises. However, even this risk may be mitigated somewhat by the high level of global liquidity.

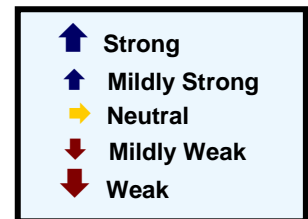
A second concern is the length of the current bull market. The Dow Jones Industrial Average has now gone 912 days without a one-day 2% drop, the longest such streak in the history of the Dow,^{3,10} and this is easily the longest duration bull market without at least a 9.6% retreat.¹¹ On the other hand, we did get a significant 8% drop in the S&P 500 Index in the spring (much higher in international markets), and during this four-year bull run the Dow is up only 66% -- the Dow has gained less in each of the next five longest bull runs¹¹ -- implying that stocks may not be overextended after all.

Leading Economic Indicator Summary

↑ **Market Cycle:** Looking forward, the first quarter of each year tends to be strong, powered by January which has been the third strongest of the months for the S&P 500 since World War II.¹²

January is a good month but primarily for small caps and international stocks. Small caps have averaged 4.8% return in the month of January since 1925. In foreign countries, January returns account for 30% of the total annual return on average.¹²

The only point working against the market cycle currently is that we have just completed four positive years in a row, and five winning years in a row is rare. This market advance has gone longer without a 9% pullback than any in history.¹³



↑ **Political Cycle:** We are entering the third year of President George W. Bush's second term. Traditionally, the third year in the presidential cycle is the strongest as elected officials typically try to boost the economy to improve chances of re-election. Since 1948, the third year of the presidential cycle has seen the S&P 500 Index post an average gain of 23.3% (21.9% with Republican presidents), far in excess of the other years of the cycle.¹² Since 1960, every third year of a president's term has been positive, and all but one year has had a double-digit gain.¹⁴

Specifically looking at the third year of presidential cycles when the U.S. was at war, the stock market has also surged. The average gain of the S&P 500 Index was 18.4%.¹⁵

↑ **GDP Growth:** Gross Domestic Product (GDP) is the official measure of the U.S. economy. It is a measure of all goods and services produced in the United States. 3Q06 GDP was revised upward to a 2.0% annual rate.¹⁶ This rate is neither high enough to fuel inflation fears nor low enough to fuel recession fears. This represents the 20th consecutive quarter of expansion, or positive economic growth, since the official recession of 2001. GDP is expected to be a modest 2.4% next year, just keeping up with inflation.¹⁷

Positive but low GDP growth may be the best result right now for the economy as higher growth rates could push inflation measures, which are currently at the upper boundary of acceptable levels (see Inflation below), high enough to force the Fed to tighten money supply.

↑ **Purchasing and Manufacturing:** The Institute of Supply Management (ISM) Index, the key manufacturing indicator, is hovering in the region of slow growth.¹⁸ This was the twelfth consecutive quarter of expanding manufacturing activity despite the month of November which dipped into the range of slight contraction.¹⁹

The NAM/FORTUNE Manufacturing Survey suggests that the manufacturing expansion will continue into 2007 for small, medium and large companies, but at an even slower pace.²⁰

- ➔ **Inflation Control:** The most widely accepted measurement of inflation is the Consumer Price Index (CPI). The core CPI, which excludes volatile food and energy prices, advanced at a rate in the upward range of that targeted by the FOMC. As of October the twelve-month core CPI rate is 2.7%.²¹ The Fed's preferred measure of consumer prices, the Core Personal Consumption Index, rose at an annualized rate of 2.3% in the fourth quarter.²²

While these primary indicators seem okay for now, two unofficial indexes, the Cleveland Fed's Median Consumer Price Index, and the Dallas Fed's trimmed version of the Core Personal Consumption Index mentioned above, were more worrisome at 3.6% and 2.5% respectively.²¹

- ⬆ **Consumer Spending:** Consumer spending remained strong this quarter. There was an unexpected rise in November consumer spending, and preliminary indications of the holiday shopping phase were strong, though not outstanding.^{22, 23} A growing percentage of gift cards now account for holiday shopping. Revenue from the gift cards is not recorded until the cards are redeemed, delaying revenue recognition in accounting books.

According to both the Conference Board²⁴ and the University of Michigan Consumer Confidence Survey,²⁵ consumer confidence surged in December after mild October and November readings.²²

- ⬆ **Business Capital Spending:** Capital spending is a measure of how much companies spend on new buildings, machines and software. Decreases in capital spending usually coincide with recessions. For the past three years capital spending has remained in the 7 to 9% growth range and is forecast to decrease slightly, moving toward the bottom end of that range for 2007.¹⁷

Capital goods orders have, in fact, been rising since summer 2001. Domestically, balance sheets remain strong and companies are spending on new commercial space.²⁶ Export growth has also been robust as growing global businesses are building factories, warehouses and offices.²⁷

- ⬇ **Investor Sentiment:** After a brief respite, investor sentiment has turned decidedly more bullish. As of late November, the number of bulls in the published investment community had risen to 56.4%, the third highest level of the year, while the proportion of committed bears shriveled to 22.3%, the smallest reading since January, 2006.²⁸ The UBS Index of Investor Optimism and AAII indexes were also trending higher this quarter.⁶ The bullish sentiment in these measures is considered a bearish leading indicator for the stock market as it indicates that investors may already have invested their available cash.

- ⬆ **Corporate Earnings:** 3Q06 S&P 500 company profits increased 12% over a year ago.²⁹ This was the 17th quarter in a row of double-digit increases. 4Q06 estimates are in the 10% range.³⁰ Furthermore, analysts have been aggressively revising S&P 500 company estimates upwards since September, 2006.³¹ Corporate earnings are expected to slow to 6% for 2007.³²

- ⬇ **Insider Trading:** Significant insider buying implies that managers have positive information about their company's outlook. Insider buying has dropped to a 10-day moving average of \$5 million/day after reaching \$50 million/day in August, 2006.³³

- ⬆ **Investor Cash Potential:** While plenty of money flowed into stocks and bonds last quarter, a sizeable stash of sideline cash also accumulated. This is good news for stocks as it represents potential buying power, ready to invest at any moment.

One way to gauge this potential is to measure the assets in retail and institutional money-market mutual funds, a proxy for cash, as a percentage of the capitalization of the Wilshire 5000 Index, the broadest U.S. stock index. This measure has currently climbed to 16.8%, one of its highest readings in the last 15 years. Since then, high readings have frequently presaged sustained market runs.³⁴

↑ **Merger and Acquisition Activity:** 2006 was the strongest merger and acquisition year to date by dollar volume. There were 16 U.S. and 13 international mega-deals of over \$14 billion and 55 total deals of over \$10 billion,³⁵ with buyers paying higher-than-usual price-to-sales ratios than in the past five years.^{36, 37} The average market premium over market price paid in 2006 was 17.2% vs. 30.2% in 2001.³⁸ This activity indicates that big buyers, at least, are willing to bet that stocks are cheap, which is positive for the stock market.

Furthermore, there appears to be no immediate end to the M&A activity. The Brown Brothers Harriman Liquidity Index moved to an 18-month high in the final week of the year, implying that buyout firms have hundreds of billions burning holes in their pockets. “Private equity firms, like sharks, must keep moving or they die.”¹³ ●

Notes and Acknowledgements:

1. Indexes used: Morgan Stanley Capital Index Japan (EWJ), S&P Latin America 40 (ILF), streetTRACKS Gold (GLD), Goldman Sachs Network (IGN), NASDAQ Biotech (IBB), Goldman Sachs Semiconductor (IGW), Goldman Sachs Software (IGV), State Street Technology (XLK), Russell 2000 Small Cap (IWM), and Vanguard Health Care (VHK)
2. Based on the VIX volatility index as reported in *Barron's*, July 3, 2006
3. “Barely Blowin’”, *Barron's*, January 1, 2007; and Birinyi Associates
4. Arithmetic average used for return measurement. Asset-weighted average beta used for risk adjustment to market-risk level within each portfolio. Performance includes assets tracked for clients that lie outside Sharper ♦ Granite direct management, which amount to less than 10% of total assets. All client portfolios weighted equally in calculation
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Questions?
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