



STRATEGIC FINANCIAL
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The Revenge Of The Nerds

It's that time when everyone looks back at the year that was to see what lessons can be learned for use in the future. For most of us in the investment arena, it was a year that revealed things are not always as they appear to be. After early stops and starts, primarily due to the growing pains of a new Federal Reserve chairman, the broad equity markets began a rally in mid-July that lasted through the end of the year, resulting in returns nearing 16% for 2006. In spite of a number of unsettling events, that ranged from a short war in the Middle East to oil prices over \$70 a barrel to fears of a crash in the residential real estate market, stocks experienced a year much better than most predicted at the beginning of the year.

What then was the problem for investment managers in 2006 as the market indexes became difficult hurdles for many? This was a year that saw the longest period of market outperformance by an investment manager come to an end. Bill Miller, manager of the Legg Mason Value Trust, had outpaced the S&P 500 for each of the last 15 years...that is until 2006, when his performance was 5.9% to the market's 15.8%. In fact, Leuthold Weeden Research reported that 70 to 80% of money managers were trailing their benchmarks heading into the end of the year.

According to Leuthold's research, one of the key factors relating to the difficulties of active managers was the abrupt transition mid-year in market leadership from "the incumbent industry winners to one dominated by 'nerds' that had been bringing up the bottom of the rankings". In other words, you would have had to sell all of the stocks that had been providing above market returns for the last few years and invest in the worst performing stocks...at just the right time...to mirror the returns of the index.

What is the lesson that can be learned? Cyclical swings (short-term) in the economy and the markets can often obscure structural shifts (long-term) that will eventually be seen as the dominant forces in these areas. So what is behind the structural changes that have occurred that have made it so difficult to keep the cyclical moves in the proper context?

A New Force To Be Reckoned With

The driving force behind the continued rise in asset prices is global liquidity. When this increase does not result in rising inflation, then a structural change has occurred. The belief is the primary reason for global inflation remaining relatively low is the expanding economies of the former and existing communist blocks. These countries continue to export lower cost goods and services due to their low labor costs and improving technology. When that is coupled with the new technologies and improved productivity in the developed countries, corporate earnings have remained strong and liquidity has been freed up for capital investment. These changes have become structural forces...not cyclical...and are, at present, overriding the historical trends.

This long wave of economic expansion began in the U.S. in the 1990's with the advent of new technologies. When technology stocks collapsed in 2000, the cost to acquire the hardware and systems dropped dramatically. This became an opportunity for developing countries like India and China to get into the global economic race. When global demographic and economic trends are examined, it appears that this wave has a long way to go.

"We live in a moment of history where change is so speeded up that we begin to see the present only when it is already disappearing."

R. D. Laing
"The Politics of Experience"

SUMMARY:

Mid-year market rebound led by out of favor stocks rallying from the bottom.

Continued growth of U.S. economy with low inflation & interest rates indicates a structural shift.

Global liquidity & the export of lower cost goods from developing countries is fueling the long wave of global economic expansion.

U.S. stock valuations remain reasonable as earnings have remained strong.

Signs of slowing in 2007 persist but chances of recession appear remote.

Investment Strategies & Insights is mailed quarterly to our clients and friends. The intent of this publication is to share some of our most interesting views and research.



Inside the Economy

Inflation and Interest Rates

- Recent declines in fuel prices has resulted in lower inflation numbers.
- Core inflation, a measure that excludes the more volatile energy and food prices, has moved slightly higher than CPI, the broader inflation gauge.
- The Federal Reserve has voiced concerns that the core rate is too high, leading many to believe that their neutral stance on interest rates will continue and the prospect for rate cuts are not in the near future.
- Global inflation remains moderate as well, so inflation should remain subdued in 2007.

Economic Output and Direction

- U.S. economic output (GDP) is showing signs of slowing as we move into 2007.
- Most estimates for growth this year range between 2.5% to 3.0%.
- Most of the risks to the economy are seen to be deflationary so any corrective action, like a Fed interest rate cut, would add to the liquidity that is fueling asset price growth.
- The major risk to the projections for moderate economic expansion is a “hard landing” in residential real estate prices.
- A key indicator to watch is wages and employment since strength in these areas could soften the impact of falling real estate prices and provide a protection from forced sales and foreclosures.

Business and Consumer Indicators

- Consumer spending rebounded in the 4th quarter of 2006, but slowing remains a concern as we move into the new year.
- However, support for spending could come from recent increases in personal income and an improved employment picture.
- The measurement of manufacturing strength appears to have stabilized after a 4th quarter decline and is expected to improve gradually in 2007.
- The service sector indicator has retreated from last year’s highs, but remains in a range that suggests continued growth for this year.
- The impact of the slowdown in housing is being felt across the economy, but continued growth in the U.S. shows underlying strength and resiliency.

Inside the Markets

The Stock Markets

- The expected slowdown in corporate profits in 2006 did not occur as earnings grew at almost 20% for the year...the 18th consecutive rolling quarter of double digit growth.
- By the end of 2006, the performance of both Large and Small Cap stocks were in the same range of +15%.
- However, earnings growth was greatest in the larger companies, a trend that should continue in 2007.
- Currently, Small Cap stocks are trading at an 8% premium to their normal valuations relative to Large Cap stocks.
- Consequently, we favor larger companies that are deriving a large part of their profits from foreign sources.
- The international equity markets are showing continued strength and should play an increasing role in portfolio allocations in 2007.
- Emerging market valuations have gotten very high, but the positive longer-term outlook would suggest adding to positions on any weakness in prices.

The Bond Markets

- Interest rates continue to move within a fairly tight range as there is no real pressure for rates to go up or down.
- High liquidity and moderate economies keep interest rate volatility at a minimum.
- The interest rate spread between higher and lower credit quality bonds remains very narrow, indicating that there is no real reward for taking on the added risks.
- Global interest rates may be increasing in 2007 as central banks try to slow down some of the rapidly growing economies.
- With higher yields, high quality global bonds would offer opportunities to benefit from any weakness in the U.S. dollar.

Commodities

- Commodity prices continue to fall, led by sharp declines in oil and copper prices.
- It appears that this is more of a cyclical correction since the longer-term demand for these commodities remains.
- With developing countries increasing their consumption of commodities, the U.S. is no longer the ultimate arbiter of demand.



It is clear that the structural changes in the global economy are having a significant impact on the world financial markets. The old model of continued growth leading to higher inflation and decreasing liquidity is not being followed in this current economic cycle. Milton Friedman, a Nobel Prize winning economist, maintained the view that, "Inflation is always and everywhere a monetary phenomenon". If that were always the case, the Federal Reserve's attempt to stimulate the economy beginning in 2001 should have resulted in soaring inflation. However, the increase in the inflation rate was minimal, especially when the rapid rise in commodity prices during this time is factored in.

With this evidence on the impact of these global forces on historical trends, the question that must be addressed is whether they are sustainable over any length of time.

The rapid rise in global liquidity has been fueled by the rising savings rates in Asia. In China, the savings rate has averaged 22% per year from 2001 to 2006. The increase in the global supply of savings has also occurred at a time when corporations were reducing debt, which kept interest rates low. The result was that money moved into equities and commodities as investors searched for higher returns.

The key to the continuation of this savings trend is the demographics of the developing countries. Using China as an example again, the population was 80% rural in 1980. Today it has shifted to 60% rural and is projected to drop to 40 % over the next 25 years. The increase in industrialization in China will result in the continued production of lower cost goods, as well as a growing consumer based economy. As this trend continues, it is expected that the savings rate will ultimately decline as consumers spend more, but it will not have a noticeable impact on savings for at least 10 years.

The risks to the continuation of these structural shifts in the short-term are related to the stability of the economic expansion in these developing countries. A financial crisis brought on by corruption within the banking system is a potential issue since government support of the system has led to a lack of accountability. In addition, the threat of political turmoil due to the disparities between the rural and the urban populations is real as the governments struggle to provide services in remote areas while building the infrastructure to support the population shift to the urban areas.

If the short-term risks are managed properly, the longer-term impact of these structural shifts should be

maintained for the foreseeable future. As a result, the focus of investment advisors will be on identifying the differences between cyclical swings and new structural changes. We are not suggesting that the financial markets have changed forever. Money will ultimately seek the highest return compared to the risk that is being taken. At some point, equities and asset-backed investments will give way to other opportunities that are perceived to be more attractive and a new long-term cycle will begin.

For 2007, the U.S. economy should continue to grow at a moderate rate, with the continued signs of slowing intensifying later in the year. With that economic backdrop, interest rates and inflation should remain near their current ranges. The valuations in the stock markets are not near the euphoric levels of past bull markets and additional upside remains, especially in specific international markets. As a result, we believe, that under current conditions, the trends in the markets should continue for the near-term, but at a slowing rate.

Wishing you a healthy and prosperous New Year,

Strategic Financial Management Group

Investment Strategies & Insights

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