



<u>4<sup>th</sup> Quarter 2006</u>	<u>Close</u>	<u>Performance</u>
Dow Jones Industrial Average:	12,463.15	↑11.78%
Standard & Poor's 500 Index:	1,418.30	↑11.66%
10-Year Treasury Yield:	4.708%	

## **Investment Outlook** **December 31, 2006**

Dear Investors,

The year ended with a strong surge for global equity markets that was fed by lower energy prices, strong corporate profits, ebbing inflation, resilient consumers, and strong liquidity flows from investors determined not to miss out on the rising markets. The Dow Industrials advanced 11.78% in the quarter while the S&P 500 Index increased 11.66%. The vast majority of global markets put up solid performances as well. Back here in the U.S., bonds had a relatively uneventful year. Credit spreads between high-grade and low-grade bonds remained narrow throughout the year and bonds traded in a fairly narrow range throughout the year. The interest rate on the benchmark 10-Year U.S. Treasury note started the year at 4.393% and ended the year at 4.708%. This slight increase in yield means that bonds prices slide modestly during the year.

Corporate profit growth remained strong throughout 2006 but it is now beginning a gradual slowdown. When companies have finished reporting their 4<sup>th</sup> quarter results, they may just fall short of double-digit percentage gains from the year-ago quarter. If this happens, it will be the first time in three years that profits have not managed at least a ten-percent gain. Fourth quarter earnings growth will still be high by historical standards, however, but the rate of growth must inevitably slow from the extraordinary level it has achieved over the last few years. Despite the fact that corporate profit growth is slowing, however, there may be a silver lining for investors. Over the past few years the energy sector has been the single biggest contributor to the market's earnings growth. In 2007, stagnant or declining earnings from the energy sector will likely weigh on the overall growth rate, but will probably modestly help the earnings of companies who are large consumers of energy.

Another potential worry for investors is the toll that a persistently weak housing market could take on the U.S. economy. So far, despite drops in home prices and rising home inventories, consumers have continued to spend at a reasonable rate. Many investors suspect that a slowing U.S. consumer could lead a global economic downturn. While this is certainly possible, my view is that other areas of the world are finally ready to pick up any economic slack from the U.S. China, for example, is forecast to grow its GDP by more than 9% in 2007. India continues to grow rapidly and even Europe may

eclipse 2% growth. Japan's economy continues to limp along, but with continued work toward economic reforms it may emerge from the doldrums in 2007.

As we move into the new year, the U.S. economy appears to have slowed somewhat in the last few quarters but is maintaining moderate momentum. Job growth is adequate, consumer spending is stable, and the threat of inflation seems to be receding somewhat. The Federal Reserve has kept short-term interest rates steady for the past several months, and it may be that we have seen the last of the increases. Many bond market participants are betting that a slowing economy in the first half of 2007 will force the Fed to change its focus from fighting inflation to easing interest rate policy to help keep the economy moving. Indeed, the current very low long-term bond yields indicate that bond market investors are quite confident that inflation will be contained.

In addition to having had a profitable 2006, stock investors can be further cheered by the following statistic: over the last three years, stock price performance has lagged the rate of corporate profit growth. This is not a happy statistic for years prior, obviously, but it means that even as the market has moved higher over the last three years, the valuation of the overall U.S. market has become more attractive. At the end of 2006, U.S. stocks were trading for roughly 14 times their estimated earnings for 2007. This level is roughly in line with the long-term market average. Attractive valuations do not, of course, ensure that the market will move higher still, but they are infinitely more desirable than stretched valuations and may provide investors a cushion to the downside if the economy hits choppy waters in 2007.

I wish you all a happy and healthy 2007, and as usual I welcome your comments and feedback.

Best Regards,

Peter

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