



## **2006 Investment Outlook: A Year of Contrasts**

The holiday season provides ample opportunity to watch some outstanding football. The NFL season is coming to a dramatic close and there were more college bowl games than you can count on fingers and toes. For those of us who enjoy watching these match-ups, it's a great time of year. Frequently, a team will come out strong in the first half and dominate the game. As they head for the locker room to prepare for the second half, it appears as though they can't lose. It's not uncommon for the tide to change in the second half of a game. What looked like a sure win begins to slip away as various factors conspire to dampen the domination in the first half. We believe the investing environment in 2006 could resemble that type of game. Expect a good first half: we're certainly off to an outstanding start. The second half of the year may prove to be more difficult.

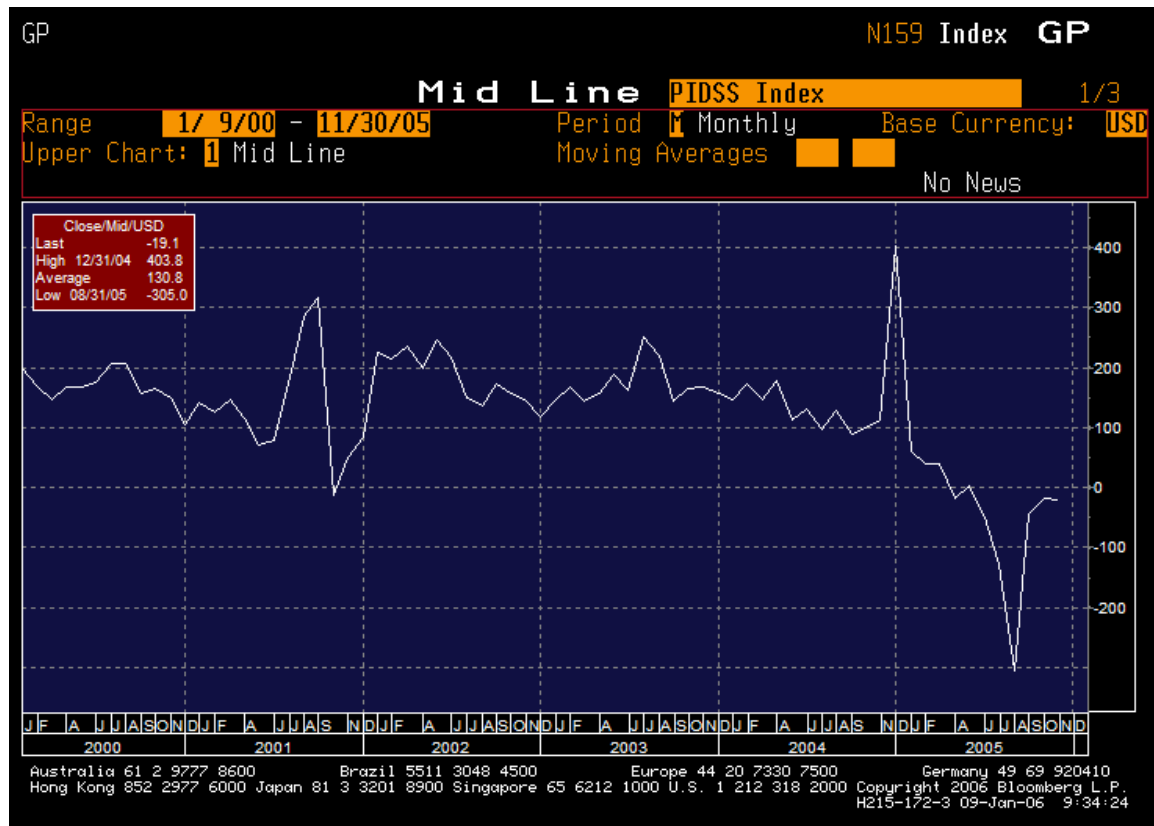
Our job isn't picking stocks. **We focus on pinpointing outstanding investment talent for our clients and constructing customized multi-manager portfolios.** As a result, identifying specific trends is an important part of our job. This piece will attempt to identify key investment themes for the upcoming year. These themes influence our asset allocation and portfolio construction decisions for our clients. Bill Supper, our Head of Financial Planning, will author a separate piece on the current tax and regulatory environment and how those potential changes may influence estate and investment planning decisions.

### **The American Consumer is Running Out of Gas**

Last year, American consumers spent \$39 billion more than they earned. The last time spending was greater than earnings was in 1933. That number represents a lot of big screen TVs and McMansions. Higher real estate prices and low interest rates have allowed families to increase their borrowing through mortgage refinancing and home equity loans. As one investment professional put it, "Americans have had ATMs in their living rooms." Those ATMs are beginning to disappear. We expect housing prices to stabilize or decline in most areas of the country as existing inventory builds and fewer buyers materialize. Lenders will pull back from "teaser" loans to reduce their exposure to the real estate cycle. *The Wall Street Journal* ran an article on January 19<sup>th</sup> entitled "Contractors Cut Prices as Remodeling Boom Slows". Some specific markets, particularly those where speculation has been rampant, are ripe for price deterioration. We are worried about certain segments of the condominium markets in Florida, Las Vegas, Phoenix, and New York City. Some projects that have been announced and "pre-sold" in these regions have subsequently been cancelled. The lack of affordability of housing in California has caused lending institutions to construct all sorts of creative mortgages that will expose today's homebuyers to much higher payments or negative

equity in future years. Housing has created a wealth effect. We can't count on that support for the consumer going forward.

Table 1 illustrates the severe decline in personal saving in the United States over the past five years.



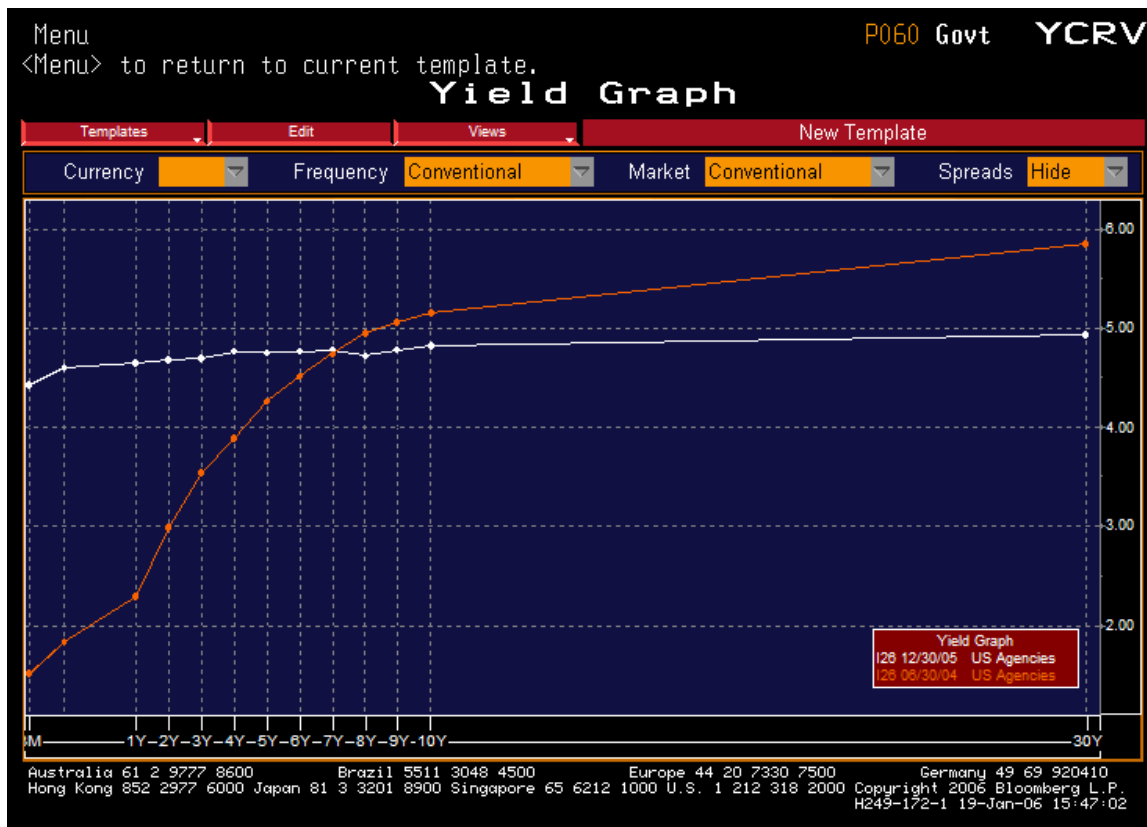
Source: Bloomberg

The good news is that consumerism is moving abroad. There is an emerging consumer class in China, India, and other developing countries. The turn in the Japanese economy is providing consumers there with the confidence to go out and spend again. Don't look for new highs for impressionist paintings, but luxury goods will have a great year in Japan. Companies with true global franchises will fare better than those with a narrow domestic focus.

During a recent trip to Asia, we met with one of Stewart's former colleagues, Peter Churchouse. Peter is, arguably, one of that region's foremost experts on real estate and property related stocks. He reminded us that publicly traded equities (i.e. REITS, homebuilders, property developers, etc.) are discounting mechanisms and don't always reflect the true value of the underlying assets. While Japan's real estate market has just begun to turn, the stocks have had significant moves over the past year and may currently be reflecting a great deal of optimism. On the flip side, several REITS listed here in the U.S. took a pounding and are now being taken over by people who believe they are over-discounting bad news. Be careful in this area. Expect a high degree of volatility.

**The Fed is Close to Finding an Equilibrium Point – Bonds are Telling us to Beware**

After a long string of interest rate increases, the Fed will soon pause. Fed funds currently stand at 4 ¼%. Higher energy prices, the stabilization of housing prices and a lack of fiscal stimuli will help to dampen economic growth. Short rates will top out soon. We expect one or two more ¼ point increases in the Fed Funds rate. Of greater concern is the flat or inverted yield curve. This is usually an indication of an upcoming recession, but yield curve inversions in 1995 and 1998 did not foretell a weak economy. The curve is flat because the world is awash with liquidity. Foreign buyers are attracted to U.S. Treasuries because they are safe, secure, and yield more than the bonds of most other developed nations. Our favorite fixed income manager pointed out to us that a recent study by the Federal Reserve claims that 10-year U.S. Treasury rates would be 150 basis points higher without foreign demand. This liquidity has also pushed up the price of gold as foreign central banks look to diversify their portfolios. This may change as Japan and Germany, two major growth engines, see their economies rebound. We don't see a recession on the horizon in 2006, but markets discount these events as perceptions change. Look for talk of a potential recession to rattle the markets a few times in the second half of 2006. When we talk to our network of CEOs, they remain constructive on their prospects for cost-cutting, increased productivity, opportunities in global markets, and earnings growth. We are not in the recession camp...yet.



Source: Bloomberg

### **Corporate America is Strong. U.S. Companies are Flush with Cash**

In contrast to the U.S. consumer, domestic corporations are stronger than ever. Balance sheets are flush with cash. Those enterprises with less pricing power are making acquisitions of smaller growth companies to help regenerate top line growth and maintain margins. Private equity and leveraged buyout funds are sitting on huge amounts of uninvested capital. Several large deals have already been announced in 2006. Companies have become more aggressive about buying back stock and are increasing dividend payments at a torrid pace. We expect that capital expenditures will rise and that technology companies will be primary beneficiaries. Corporate spending may help offset a weaker consumer as we move through the year. We expect markets to perform well in the first two quarters. Recession fears and the “worry list” (see below) could increase volatility in the second half of 2006.

### **Credit Risks are Rising for Municipal Bonds – Hire a Fixed Income Manager**

The ability to judge credit risk is becoming increasingly more important in the municipal and corporate bond markets. Municipal bond issuers defaulted on more than \$2 billion of bonds in 2005. The default rate in 2004 was \$1.1 billion. Several potential clients came to us last year after experiencing catastrophic losses in their fixed income portfolios. Brokers are there to sell you bonds. Often, they are paid more for selling you riskier issues. Our advice is to hire an expert to manage your portfolio. For those who use fixed income as an anchor for their portfolios, we advocate active management. The unusual shape of the yield curve and alternative minimum tax issues create opportunities for a good manager to add value. We urge our clients to focus on AA paper with a maturity of no more than 5 or 6 years. We would much prefer to own “true” AA or AAA credits as opposed to junk bonds wrapped in insurance to make them AAA. If you own such bonds, keep a close eye on MBIA, FGIC, and AMBAC, three of the primary insurers.

### **Risk is Still Mis-Priced**

The world is awash with liquidity. There is far too much capital chasing too few investment opportunities. This usually leads to a crescendo of capital destruction. The question remains, where are the vulnerabilities? We believe they lie primarily in the structured product area of the fixed income markets. We could dedicate an entire essay to this topic, but the bottom line is that the fixed income derivatives markets have injected tremendous risk and leverage into the financial system. Junk bonds, structured mortgages and emerging market debt are trading at historically low spreads to treasuries. The yield curve inversion puts investors in a position where they aren't paid for duration risk. If you aren't paid for credit risk and you aren't paid for duration risk, stay away! We are also concerned with the LBO and private equity markets. Very large transactions are taking place at record high valuations. Cheap money in the junk bond market allows financial buyers to “overpay” for assets. In this arena, we are focused on managers who focus on small to medium sized transactions in narrow sectoral bands or specific regions. Caveat Emptor.

**We Feel Good About Owning U.S. Equities For Now**

Stocks had a so-so year in 2005. They are off to a volatile start in 2006. We remain focused on firms who are benchmark insensitive, with bottoms-up stock pickers from multi-cap disciplines as our core managers. We like to build more “tactical” positions around these core managers.

Our overweight in Japan was very helpful last year. We visited Tokyo in November and remain convinced that the Japanese equity market will continue to provide good investment opportunities as the economy continues restructuring. The market remains quite inefficient and we would offset directional bets with alpha capture strategies. The drivers here are private capex (not the notorious government spending programs), domestic consumption, higher exports to Asia, the reflation of the Japanese economy, and improving corporate governance. Expect volatilities to rise here too.

We have started to taper back our exposure to emerging markets. This asset class has had a great three-year run. It is time to take some money off of the table. We continue to seek out talented long/short managers in this arena, believing that increased volatility will help their returns.

Several areas we would begin to overweight are technology, pharmaceuticals, and large cap growth (we understand there may be some redundancy there). Many world class franchises are selling closer to five-year lows. (Take a peek at the 5-year charts for Wal-Mart, Pfizer, Microsoft, Cisco, and GE, just to name a few.) With the S&P 500 and the Dow Jones approaching 5-year highs, we see opportunities in this area.

We have been underweighted in European equities for quite some time. We sense that economic growth is picking up and corporate governance is getting better. Don’t be surprised if we come to you at mid-year and suggest we increase our weightings to large cap Europe.

**Things We Should Worry About That May Derail Markets**

- Too much liquidity chasing too few opportunities
- Rising U.S. trade deficit
- Rising U.S. budget deficit and the perception that government spending is out of control (Alaska’s “bridge to nowhere”)
- The potential for a global pandemic (Avian Flu)
- The potential for a major terrorist act
- Rising energy prices
- Upward pricing pressure on industrial commodities

<b><u>Buy</u></b>	<b><u>Sell</u></b>
Managed Fixed Income	Bond ladders
Technology	Emerging Market Equities
Large Cap Growth	Emerging Market Debt
European Equities (2 <sup>nd</sup> half)	Junk Bonds
Japan Long/Short	U.S. Dollar (2 <sup>nd</sup> half)
Alpha Extractors	Beta Producers

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