As 2006 comes to a close, it is now time to take a look in the rearview mirror to compare our forecast of economic activity and bond market yields with actual results. Perhaps more importantly, we will examine the themes that we believe will be the most dominant in the upcoming 12 months.

Year in Review

One year ago, we predicted that the Federal Reserve Board would conclude their rate hike campaign during the first half of the year. This opinion was shaped by our base case forecast which called for the strongest period of economic activity to occur in the first six months followed by a dramatic slowdown in growth. In particular, we had reason to believe that the single family housing sales and prices would erode; surmising that consumers would react by curbing their insatiable spending appetite.

Given these views, our preferred scenario called for long term interest rates to work their way lower during the year. Our worst case hypothesis outlined the possibility of a "left field" event such as an inflation scare that would cause the yield on 10-year Treasury Notes to spike to a 5.10%. With a parabolic move in energy prices taking center stage during the first and second quarters, 10-year yields rose into June, peaking a bit beyond our projected cap to reach a 5.25%. Then on cue, the economy began to lose momentum, as the pace of GDP growth fell dramatically from the average first half pace of 4.10%. This provided the spark for a powerful bond market rally causing yields to decline to levels that were similar to where they began the year, as of early December.

2007 Prognostications

As we discuss our projections for the upcoming year it will become obvious that many of the themes and challenges from several of our previous reports remain dominant today. By taking many steps back from the sound-bite driven news commentators who tend to hype the daily events, we come to the realization that the economy will continue to slow for the first six to nine months of 2007. A key aspect in this forecast is our ability to correctly assess the future spending patterns of the consumer. Since it is one of the most important aspects of calling trends in the financial markets, nearly every economist and market participant has an opinion on this topic. In fact, one of the largest risks to the U.S. economy is whether American consumers stop spending and drag the country into a recession.

There are a number of forces at work which are serving to curb the individual's propensity to spend. For example, conflicts in the Middle East impact the price of oil which in turn pinches the dollars that are available for individuals to spend in non-energy related sectors. With oil now accounting for a growing share of consumer's total expenses (currently 6.2% versus the 10-year average of 4.90%), the importance of this segment's events should not be underestimated. In 2003, the median family spent about $1,900 (or about 4.8% of its income) on gasoline, natural gas, and heating oil. During the winter of 2006, with oil prices averaging $60 per barrel, these expectations climb by roughly 50% to nearly $3,000 (or about 6-7%) of median family income[1]. Still, we need to be mindful not to isolate the importance of any one component of the economy. Quite often it is the cumulative weight from a variety of sources that serves to break the spirit of the consumer.

Perhaps more important is the bursting of the housing bubble. This event is ultimately shrinking the household's income and spending power as they find it more difficult to convert wealth into consumption. Declining home prices coupled with rising "resets" on adjustable rate mortgage loans, courtesy of the Fed, are causing debt service obligations of bloated consumers to climb. Let's also not forget that the Fed has taken the Federal Funds rate up from 1% to 5.25%. It is a monetary tightening that the Fed's own rules of thumb suggest should already be knocking at least one percentage point off aggregate growth in real GDP.

Residential Housing: Has it really hit bottom?

We are coming off of one of the greatest housing booms ever recorded for a 6 year time period with collective home values increasing by roughly 4 ½ trillion dollars[1]. Based on the official housing statistics, you might have guessed that the sellers would have made out just fine, despite all the talk of a real estate slump. Data released in October by the Commerce Department showed that the median price for a new home sold for $ 217,000 or a 9% decline from September 2005 levels[1]. During this same time period, the year over year price decline for existing home sales was down 2.5%. Given these statistics, are we really to believe that the correction in home prices witnessed thus far is the full extent of the pain that the bursting bubble will inflict? For this to be the case aren't you hoping for a period of protracted nirvana?

The harsh reality is that the marketplace simply ran out of buyers willing to pay inflated prices for homes. This has caused the supply of new homes to skyrocket and applications for building permits to plunge (chart below). This has led Bernanke to finally characterize the residential housing market as having experienced a "substantial cooling" in the most recent FOMC statement on December 12th. With respect to their interest rate setting policies in general, Bernanke continued to categorize the Fed members as being data dependent. The potential problem with this approach is that economics is limited in scope and does not seek to predict the psychological impact felt by consumers as their wealth is negatively impacted. We believe that the weakest days for consumer spending still lie ahead, as sharper declines in residential housing prices are witnessed. Moreover, finding a bottom in the residential home sector should be a prerequisite for strong consumer confidence and robust consumer spending.

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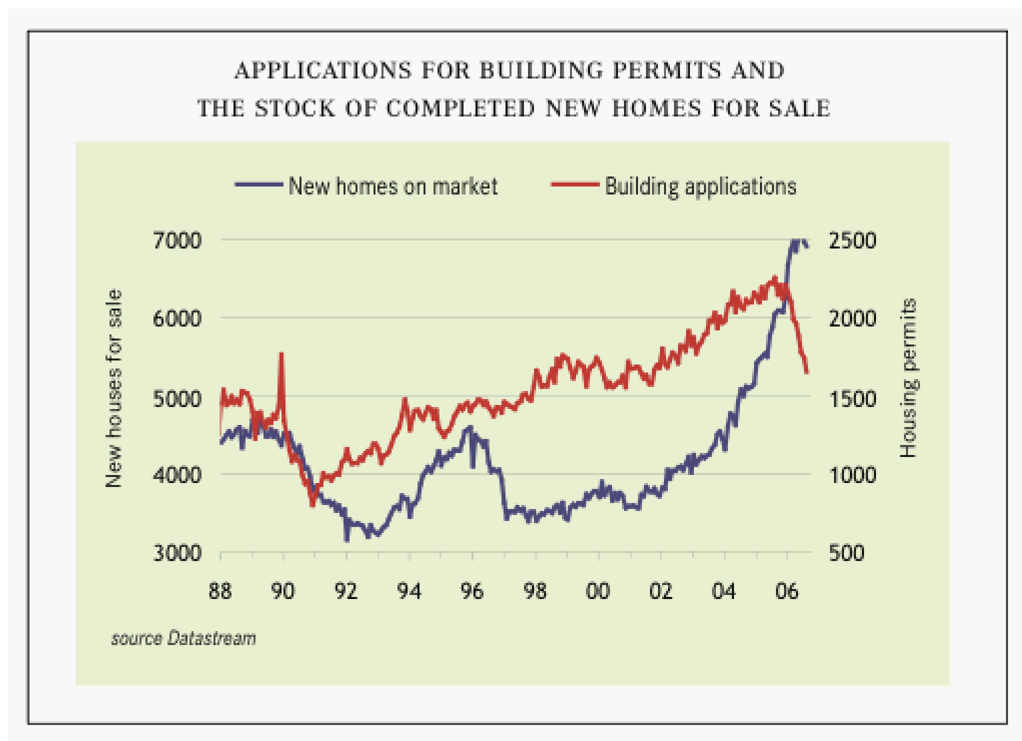
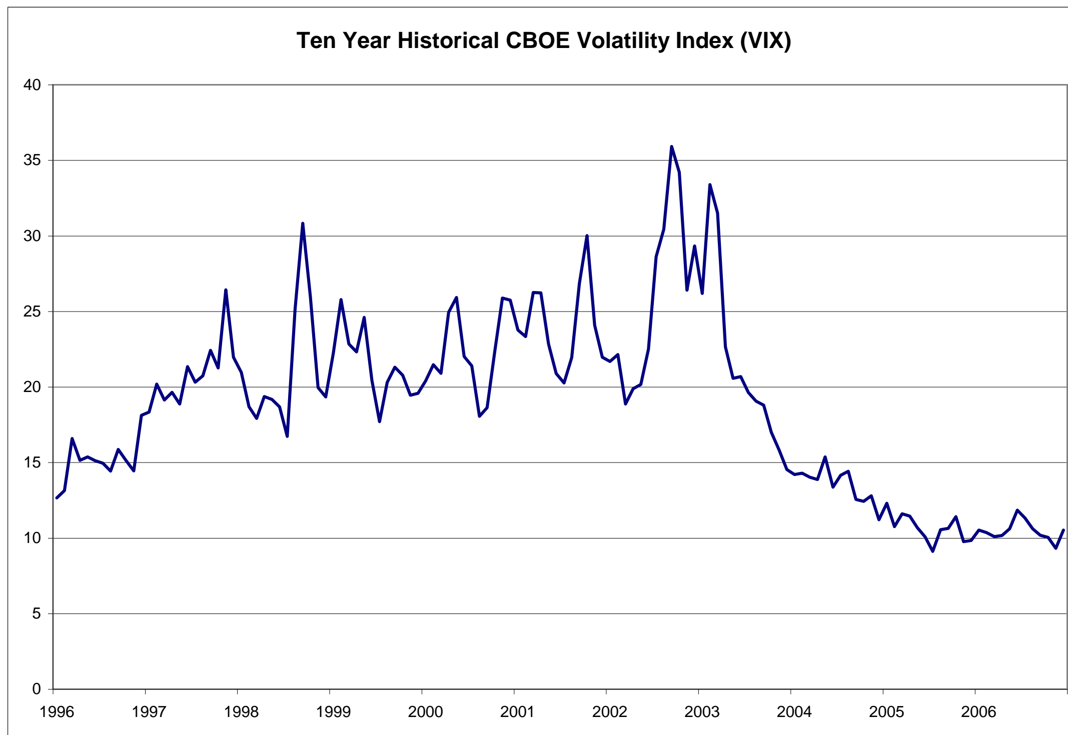
[1] Robert F. Westcott, Ph.D. , Securing America's Future Energy "What would $120 Oil Mean for the Global Economy?", April 2006.
[1] U.S. Senator Paul S. Sarbanes Speech to Center for American Progress in Washington, D.C., 12/8/06.
[1] "Home Prices Plunge by Most in 35 Years", Martin Crutsinger, Associated Press, 10/26/06.



<u>**Other potential shocks**</u>

When reviewing historical statistics covering previous Fed tightening cycles over the last 20 years, we can conclude that they rarely end well for the economy. The fallout from this latest tightening cycle however, has the potential to be more severe. We also have a number of other forces aside from housing and elevated energy costs which are pulling at the economy. Some examples include: a shift of balance within the political arena, nasty geopolitics, an inverted yield curve, falling domestic auto production, and sub-prime lenders who are feeling the pain from an increase in delinquency rates and soaring levels of debt arising from Private Equity deals.

What we find interesting is that in this volatile and uncertain environment, many of the risk based markets aren't compensating investors to run through the fire and risk getting burned. As a proxy in highlighting the current level of complacency, we can look at historical volatility using the CBOE Volatility Index (VIX – chart below.) Specifically, the VIX measures the expected stock market volatility over the next 30 days and is calculated by using real-time stock index option prices.



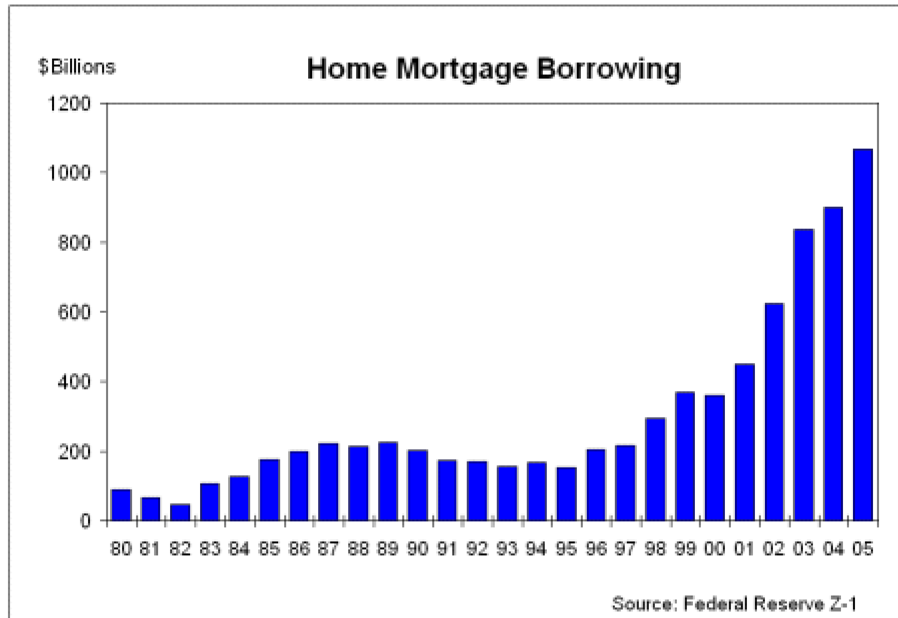
Inflation fears remain overblown

Inflation pressures seem to be quickly subsiding. Aiding in this process are consumers who have adopted a skeptical view on prices and seem to be waiting for discounts before making purchases. There are also a number of factors at work which are keeping a lid on the level of inflation. Emerging economies with vast pools of cheaper labor, technological advancements, vigilant central banks, and the globalization of the world's economies remain key elements in the case for lower inflation. The capacity that the world is creating is now akin to an engine that has an ever expanding need to be fueled by the consumer. This vast network of industrial production could also serve to become an anvil as the competition to sell "stuff" is intensified and/or global economies slow. Bottom line: The opposite of inflation is deflation.

U.S. Recession: Is it likely?

If you line up the confluence of powerful shocks to the system, namely, oil, housing, and 425 basis points of Fed tightening - we would conclude that a recession is probable. In particular, the housing sector impacts the U.S. economy in a more significant manner today than the role that the tech sector played in the overall activity in 2001. The wealth effect of the tech bust was primarily limited to investors who acquired securities using non–borrowed funds (savings). The opposite is true in real estate investing, as individuals have the ability to acquire an asset on a leveraged basis with little or no money down (chart below). Lastly, the employment effects of housing are serious; 23% of the 4.9

million jobs created since late 2003 were due directly and indirectly to housing and housing related industries[1].



Monetary Policy and Interest Rates

We believe that the pace of economic activity will remain weak throughout much of 2007. As inflation continues to cool, the combination of slow growth and well contained inflation lead us to conclude that the Fed will lower interest rates during the first half of the year. For the full year, we expect the Fed to lower official rates by 50 to 75 basis points, bringing the fed funds target to approximately 4.50% from today's 5.25% level. Since the Interest Rate markets have already priced in much of this move, the impact to the market may initially be muted. However, should a recession scenario unfold, we do see the potential for 10-year yields to pierce 4%. Our less favorite/worst case scenario calls for 10-year yields to trade in a relatively tight range with the high end being a 4.90% to 5%.

Municipal Bond Perspective

As 2006 comes to a close, the municipal bond market is on track to turn in strong relative and absolute returns. Many economists and market participants were waiting for interest rates to climb throughout the year and were caught "short" as yields assumed a downward trajectory. While yields rose modestly on longer-dated Treasury securities during the year, interest rates in the tax-exempt arena actually fell over the last 12 months. Shorter-dated municipal bonds did not fair as well however, as their yield levels tracked the increase in Treasury yields.

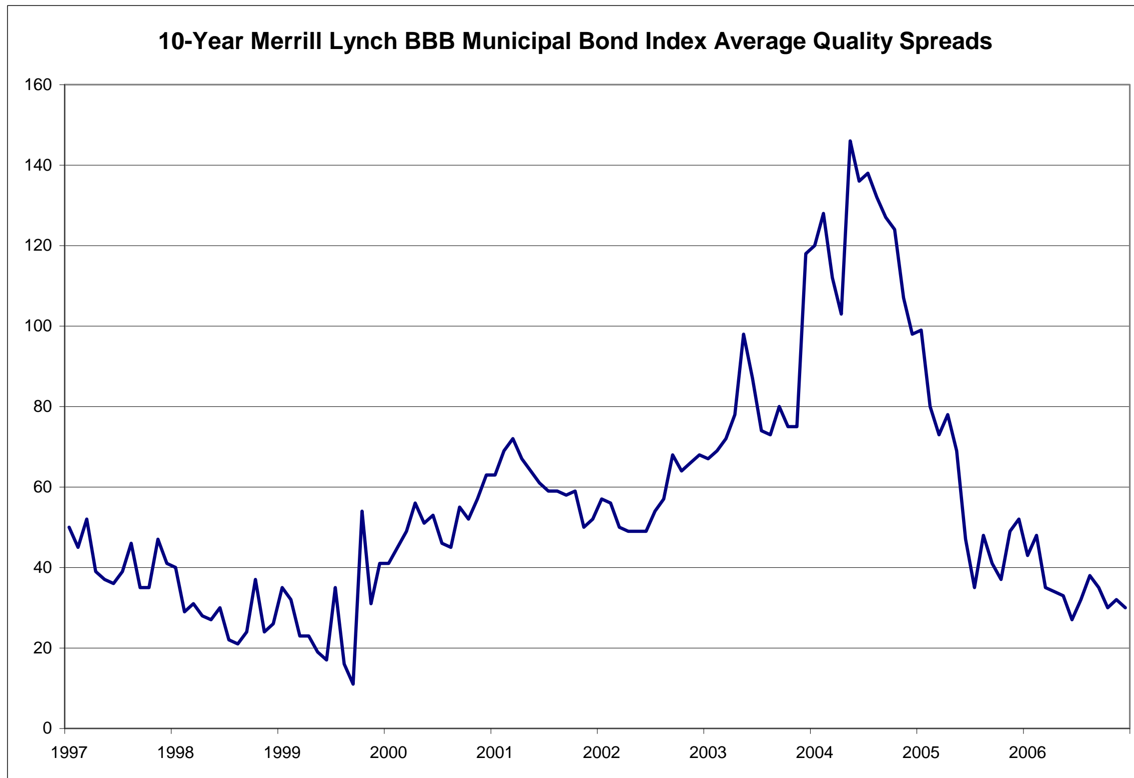
[1] "A Housing Slowdown Can Put the Brakes on Jobs", Mark Whitehouse, The WSJ, 6/27/06.

Throughout the year the municipal bond prices were anchored by a strong market technical position. New issue supply was down roughly 8% from 2005 levels while the sources of demand continued to broaden. New money issuance was roughly in line with last years pace but refunding activity slowed. This stemmed from the fact that many issuers have already taken advantage of the lower yields witnessed during the 2002-2005 period. On the demand side, the buying was impressive and broad based. Of note, Arbitrage investors escalated their purchases as they sought to take advantage of the relatively steep slope of the yield curve. Property and Casualty Companies also stepped-up their buying as they were flush with cash on the back of lower than anticipated hurricane activity.

As we entered 2006, many Municipal Bond investors were concerned about the possibility of a sweeping tax reform. What a difference a year makes! Now the Congress is controlled by the Democrats and the likelihood of lower tax rates has virtually been rendered null and void. In fact, this political shift contributed to the strong out-performance of longer maturity tax-exempt bonds compared to their taxable brethren.

Looking 12 months out, we see a relatively stable investment environment for high quality tax-exempt securities. We believe that the economic landscape is bond friendly and in particular judge the supply to demand dynamics within the tax-exempt arena to be robust. Municipal demand should remain in force as individual investors seek the relative safety and stability of the marketplace. The market has also witnessed an increase in activity by the top 5% of the population as the chasm between the "mega wealthy" and middle class continues to widen at an unprecedented pace. In just the last 5 years, the depth and breadth of the marketplace has broadened and deepened tremendously. New sources of demand have emerged serving to stabilize bond prices during periods of interest rate volatility. For example, Tender Option Bond programs (leveraged Investors) have grown by leaps and bounds and are attracted to the marketplace due to the relatively steep slope of the tax-exempt yield curve compared to the taxable bond market. In addition, European investors are now acquiring municipal bonds as they enjoy the favorable tax treatment of their transaction.

Although we remain constructive with respect to high quality bonds, the current environment is not as conducive to investing in lower-rated securities. The chart below highlights the difference in basis points between higher yielding (rated BBB) and high quality tax-exempt bonds. Lastly, this again serves to underscore our remarks above about investor complacency. There is usually a place for riskier investments (of course depending on each investors risk tolerance and investment objectives) in a portfolio but we believe the time is less than optimal to venture into such assets.



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