Bellwether CONSULTING

Your Quarterly Update on the Financial Markets
December 31, 2006

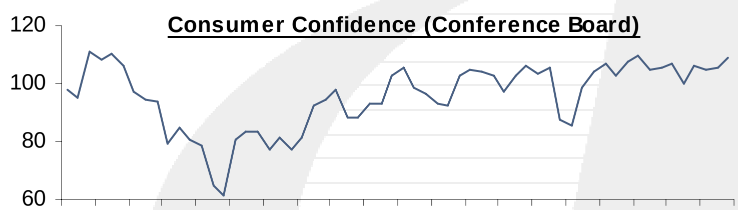
4th Quarter

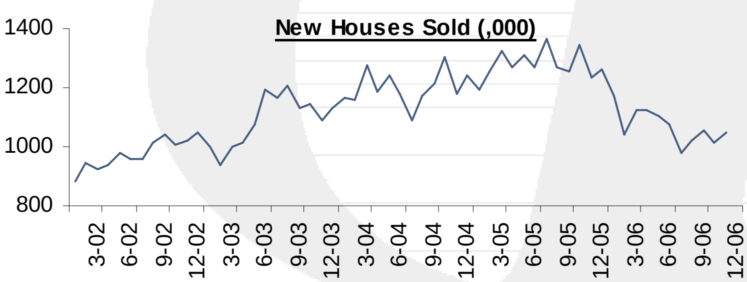
MARKET Recap

The Economy: *"Retail Rally Feeds Fed Anxiety"*

U.S. economic growth continued a moderating trend through the third quarter, increasing at a 2% annualized pace. The slowing pace was primarily due to acceleration in imports and a decrease in residential fixed investment, a lagging effect of the housing market slow-down we've discussed at length in recent issues.

Consumer spending however remained strong for the quarter, with personal consumption expenditures continuing to accelerate and outpace growth in personal income. The U.S. consumer simply switched spending preferences, favoring imported goods over services and real estate (and still showing no interest in saving). Interestingly the volume of new home sales stabilized in the third and fourth quarter. Although housing prices continued to decline, the pace was moderate. We believe this explains much of the increase in consumer confidence indicated by the Conference Board survey, which climbed to near-record territory. The shock effect of declining home prices has now made its way through the population, and the U.S. consumer is now more comfortable with the pace of the decline – the housing "bubble" does not appear to be bursting rapidly. Accordingly, people opened their wallets for the holidays. Retail sales surged in November, the first gain posted since July, completely erasing declines posted in September and October. Although comprehensive sales data for December are not yet available, initial data for chain store sales indicate a 2.8% increase for December; less than last year's 3.6% pop but hardly indicative of a slow-down.





Readers should note that the real estate correction is more pronounced in some regions than others (e.g., Florida), and that many in the construction industry don't share the consumers' confidence. Homebuilder Lennar cut its 4th quarter earnings guidance and posted a net loss due to write-downs and asset revaluations on January 2nd; management stated that they have "not yet seen tangible evidence of a market recovery."

It is debatable whether or not the Fed has raised interest rates sufficiently to bring core inflation down to 1-2% levels. Data for the quarter were mixed, but on balance seem to support a case that the economy is still on pace for uncomfortably strong growth. The Open Market Committee debated the issue at the December 12th meeting and, while they left current rates unchanged, the minutes provided little room to hope for easing anytime soon. If anything, the Fed appears more concerned about inflation, and further tightening later in 2007 is a distinct possibility. We believe the consumers' ability to digest slowness in the housing market and declining home prices is key. Should the market decline more rapidly and consumers close their wallets, we could in fact see rate cuts; otherwise the Fed will hold or tighten. Neither scenario is particularly good for the stock markets, so equity investors should hope for more "mixed messages" that keep policymakers frozen or undecided.

> "All meeting participants remained concerned about the outlook for inflation. Although readings on core inflation had improved modestly since the spring, nearly all participants viewed core inflation as uncomfortably high and stressed the importance of further moderation."
>
> -- Minutes of the December 12, 2006 FOMC Meeting

The U.S. Stock Market

The stock market ended with a bang in 2006 – well, almost. While stocks staged a rally in the fourth quarter of 2006 and all major indices posted double-digit gains for the year, end-of-December reports showing stronger than expected existing-home sales, consumer sentiment and manufacturing in the Midwest caused stocks to slip in the final days. Even though they limped across the finish line, all major indices turned in a solid quarter. Looking back over the year, stocks took investors for quite a ride. Markets approached record levels in the spring, but by mid-year all capitalization sectors were in a slump, with the best-performing sectors merely having the lowest negative returns. But declining energy prices, a halt to interest rate hikes, and healthy earnings along with solid consumer spending numbers combined to turn things around in the third quarter. By year-end, the markets had virtually resurrected. The Dow Jones Industrial Average hit record levels throughout the second half of the fourth quarter. The S&P 500 returned 15.8% for the year, well-above its 10.4% average for past eight years.

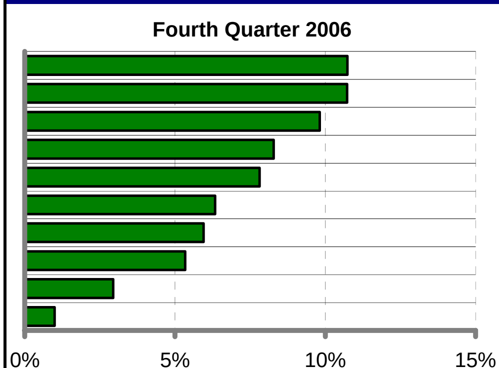
Stock Indices - Total Return

	4Q06	2006		4Q06	2006
Largecap Stocks			**Midcap Stocks**		
S&P 500	6.70%	15.79%	S&P Midcap 400	6.99%	10.32%
Russell 1000	6.95%	15.46%	Russell Midcap	7.67%	15.26%
Growth	5.93%	9.07%	Growth	6.95%	10.66%
Value	8.00%	22.25%	Value	8.50%	20.22%
Broad Markets			**Smallcap Stocks**		
NASDAQ Comp.	7.15%	10.39%	S&P Smallcap 600	7.84%	15.12%
Wilshire 5000	7.32%	15.88%	Russell 2000	8.90%	18.37%
			Growth	8.77%	13.35%
			Value	9.03%	23.48%

Small cap stocks fared best for the quarter, as the market's "flight to quality" in previous periods was put on pause. Earlier in the year it appeared that economic and geopolitical risks were causing investors to reconsider their risk tolerances and conventional wisdom was that big, blue chip stocks would finally recapture market leadership from small cap stocks. However, many risks failed to materialize in 2006. Oil facilities in the Gulf Coast were spared from damaging hurricanes, and oil prices fell back to the low $60's. The Fed stopped increasing rates in August, and many investors assumed inflation was under control and a recession had been avoided. Not surprisingly, as investors perceived less risk in the economy, risk tolerances went up and investors sought out small cap stocks.

Value issues once again outpaced their growth peers for the quarter. On an annual basis, this added up to returns almost twice those of growth issues. Sector performance continued its quarterly rotation. Materials and Energy, the two worst-performing sectors in the third quarter, led all S&P sectors this quarter each finishing up 10.7%. Health Care, the best performing sector last quarter dropped to worst, gaining less than 1%.

S&P 500 Economic Group Components - Total Return



Source: Standard & Poor's

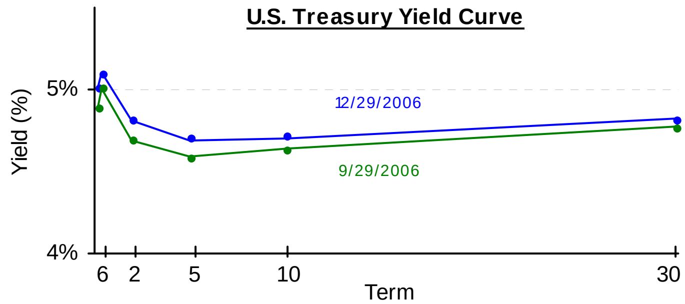
Sector	4Q06	2006
Materials	10.74%	15.73%
Energy	10.73%	22.22%
Consumer Disc.	9.82%	17.23%
Utilities	8.28%	16.87%
Telecom	7.82%	32.13%
Financials	6.33%	16.16%
Information Tech.	5.95%	7.70%
Industrials	5.34%	11.02%
Consumer Staples	2.94%	11.76%
Health Care	0.99%	5.78%

2006 saw a significant number of shares leaving the public market due to a boom in leveraged buyouts and corporate share repurchases. The contraction in the equity market, the largest in a decade, has been viewed by some observers as a partial explanation for the 2006 bull market in the form of a classic case of supply and demand. Others view the trend as a bullish indicator for 2007, reasoning that corporations are the best predictors of their own future profits and other fundamentals. If they are buying, it must bode well. However, with so many challenges to businesses and the markets on the horizon (e.g., fluctuating energy markets, mortgage defaults, increasing interest rates, not to mention geopolitical risks), strong fundamentals today may not be enough for success in 2007.

The U.S. Bond Market

Bond yields ended the fourth quarter of 2006 up slightly across the curve, with the short and mid durations rising about 10 basis points and the long durations rising about 5 basis points. The yield curve remained inverted and flat with 2-year and 30-year yields the same. Compared to the third quarter close, the fourth quarter ended with the yield on the 3-month bill up 13 basis points to 5.01%. The yield on the 10-year treasury closed the quarter up 7 basis points at 4.70%, and the yield on the 30-year treasury ended up 5 basis points at 4.81%. While an inverted yield curve is traditionally considered an indicator of recession to come and many saw a recession just around the corner, it never quite materialized in 2006.

The first three quarters were marked by investor conjecture on when the Fed would halt its unprecedented string of short term rate increases. But as soon as the first meeting passed without an increase, speculation immediately turned to when the Fed would cut rates. Some maintain easing will begin early in 2007, but the Fed has been very consistent in its messaging, noting that future actions will depend on "the outlook for both inflation and economic growth, as implied by incoming information." In other words, wait and see. After both the October 25 and December 12 meetings, the Fed's statement acknowledged that economic growth had slowed over the course of the year "reflecting a substantial cooling of the housing market." And once again, the Fed pointed to elevated readings on core inflation, but judged that "inflation pressures seem likely to moderate over time."



Source: Bloomberg LP

Not surprisingly, consistency in the Fed comments that economy was slowing and that inflation was moderating triggered another rally in the bond market in the fourth quarter. Returns were positive across all sectors at the end of the quarter and for the year. Bonds generally moved in lockstep with stocks, an uncommon occurrence.

Bond Indices - Total Return

Bond Index	4Q06	2006
Lehman Aggregate	1.24%	4.33%
Lehman Interm. Gov't	0.89%	3.84%
Lehman Long Gov't	0.57%	2.06%
Lehman Interm. Credit	1.27%	4.49%
Lehman Long Credit	1.59%	3.47%
Lehman High Yield	4.20%	11.85%

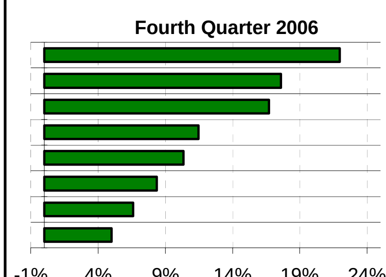
Bond issuance figures through the third quarter were slightly above those for the same period in 2005, according to Securities Industry and Financial Markets Association. While full-year issuance for 2006 is projected to be flat with 2005, by 3Q 2006 the composition was already quite different. Corporate bond issuance was up 30% over 2005 levels, reaching $748.8 billion by the end of September, driven by increased business spending, stock buybacks, and leveraged buyout and merger and acquisition transactions. Asset-backed securities (ABS) and municipal bond issuance fell during the period by 20% and 14% respectively. Slowing in the housing market and consumer spending drove the decrease in ABS issuance. Rising interest rates in the first half of the year reduced refunding volumes, and therefore new issuance, in the municipal bond market. Finally, net issuance of Treasury securities for the first three quarters of 2006 dropped more than 20% compared to the same period in 2005. Stronger than expected tax revenues and a higher volume of maturing Treasury securities are credited for the drop.

Overseas Markets

Global markets finished the quarter and the year quite strongly. All of the major developed markets closed the year in the black with the Eurozone more than doubling the annual return of the North American domestic markets. Emerging markets also returned to recent form as Latin American and Far Eastern sectors surged to close the year.

The European Central Bank's concern that companies and consumers have too much money led to another increase in the base interest rate in the fourth quarter. The ECB raised the key interest rate to 3.5%, the sixth increase in the last year, in an attempt to stem an 8.5% growth rate in the money supply. In Germany, improvement in confidence is shown by the IFO Index, the index of business sentiment in the sector. The index rose to 23.4 in December, a 4 point gain over November. The German Gross Domestic Product increased at an annual rate of 2.6% in the third quarter. Although this was less than the second quarter advance of 4.4%, the year over year increases show an increasing trend during the year. There appears to be a growing consensus that the current German expansion is strong enough to weather the impact of a strong euro and a tighter fiscal policy. This sentiment is tempered by a projection of slower growth to start 2007. The MSCI Germany Index was up 14.3% for the quarter. In France, data on what French households actually are spending on manufactured goods shows spending fell 2.7% between August and September, but August had shown an increase of 3.0% over July. While this decline was unexpected, fourth quarter employment prospects in the sector have strengthened and the consensus is that spending will show a strong increase once fourth quarter data are available. The MSCI France Index was up 10.4% for the quarter.

Net Total Return of Selected MSCI Regional Indices



Region	4Q06	2006
Latin America	21.97%	43.15%
Emerging Markets	17.60%	32.17%
Pacific ex Japan	16.70%	32.02%
Europe	11.46%	33.72%
EAFE	10.35%	26.34%
World Index	8.37%	20.01%
North America	6.62%	14.85%
Japan	5.00%	6.24%

Japan saw performance turn around from third quarter. The Bank of Japan's Tankan Survey in October showed a greater than expected increase in manufacturer confidence from 21% in June to 24% in September and was 5 percentage points above June, 2005. Falling oil prices and a weakening of the yen contributed to the increase in economic activity. Confidence in current conditions also improved for medium sized manufacturers from 13% to 14% while that for small manufacturers declined from 7% to 6%. While Japanese manufacturers were more confident in their appraisal of current conditions, they were less confident in what they believe the future holds. The index for large manufacturers' appraisal of the future fell from 22% to 21%. Despite a decline in consumer expenditures, the third quarter estimate of Gross Domestic Product for Japan was twice as high as consensus expectations. On a seasonally adjusted annual rate, Japan's GDP rose 2.0% while the expected increase was 1.0%. The MSCI Japan Index was up a modest 5.0% for the quarter.

China continues to be the story in terms of world market performance. Data shows that China set records for imports and exports in the third quarter. Chinese trade surplus was $15.3 billion in September, down slightly from August's record $18.8 billion. However, the September balance was the second largest monthly surplus ever. Exports rose to $91.6 billion, and imports surged $4.4 billion to $76.3 billion. The IMF estimates China's real GDP growth to remain at around 10% for 2007 with an expected increase in inflation to 2.2%. Even though the yuan has been allowed to appreciate slightly this year versus foreign currencies, China's government needs to do more to avert the potential fallout from a correction in global trade imbalances. The MSCI China Index was up 35.8% for the quarter and a whopping 83.8% for the year.

Latin American emerging markets rebounded to close out the year. According to the IMF, regional GDP growth is expected to close the year at 4.75% and slow to 4.25% in 2007. Performance in the region continues to be driven by external demand for commodities. Moderating inflation has allowed Brazil to begin unwinding its monetary tightening. The quarter began with the news of a higher-than-expected increase in industrial production which had a favorable impact on performance. The MSCI Brazil Index finished the quarter up 24.4% and the year up 45.3%. In contrast, strong growth in Argentina has led to some tightening of monetary policy in response to double-digit inflation. The MSCI Argentina Index was up 33.6% for the quarter and 67.3% for the year.

Focus On: *Leverage, Leverage Everywhere*

Leverage. It's burrowed into every nook and cranny of our lives. Look no further than your most recent credit card statement, your mortgage bill, the corporate balance sheets of the companies you invest in and you'll find it. If you're lucky enough to have a pension plan, it's probably in there too within hedge fund investments. Investors use margin accounts, options, futures and other forms of derivatives to create leverage. The amount of debt that both consumers and companies are using seems to be continually increasing. Webster's Dictionary defines leverage as "the use of credit to enhance one's speculative capacity." Leverage is a tactical tool that allows an investor, or consumer, to get more for less. But it does come with a price. From an investment perspective, leverage creates a multiplier effect that increases the potential profit or loss from small movements in the value or price of an investment. It is this magnification that leads to greater risk. The question is: should we be concerned with the increasing amounts of leverage being used?

Where is it?

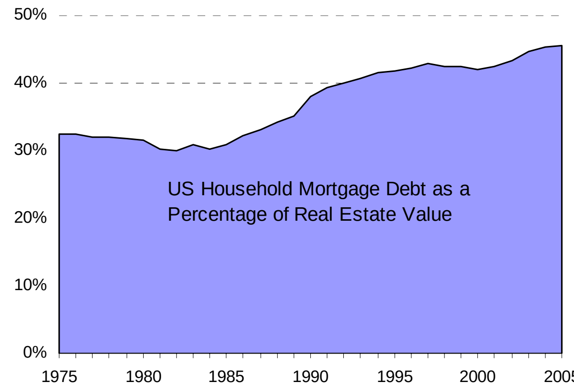
Consumers have been increasingly using credit to make purchases. Our negative savings rate shows that we are spending all of our income and borrowing additional funds against future earnings in order to consume in the present. (See our 2Q Market Recap for a more in-depth discussion of savings rates.) How are consumers leveraging themselves? They are using credit extended from banks and credit card companies and borrowing against the value of their homes. Statistics from the credit card industry tell an interesting story regarding the increasing use of consumer credit in the U.S. Data indicates that total consumer debt has increased 41% between 1998 and 2004 and average household credit card debt has increased by 167% between 1990 and 2004, the most recent year that statistics are available. In 2004, the consumer debt to net worth ratio was 21%, the highest level in 55 years, with consumers paying over 14.5% in interest charges on average. Of note is the fact that the highest leverage ratios are found among the least wealthy in the U.S. The latest Federal Reserve Survey of Consumer Finances from 2004 shows that the leverage ratio (debt as a proportion of assets) for the least wealthy 50% of families grew from 52% in 1989 to 62% in 2004. Corporations have been the main beneficiaries of increased consumer leverage, evidenced in continued strong earnings reports.

Leverage Ratio By Wealth Group

	Wealth Percentile					
	All	0-50	50-90	90-95	95-99	99-100
1989	12.1	52.2	19.2	9.5	5.3	2.4
1992	14.6	59.2	21.5	11.0	6.8	2.9
1995	14.5	56.8	21.0	10.9	7.9	3.3
1998	14.2	61.4	20.9	10.6	7.9	2.6
2001	12.0	56.2	19.4	8.9	5.9	2.4
2004	15.0	62.6	23.5	10.9	7.8	3.7

Source: Federal Reserve 2004 Survey of Consumer Finances

More interesting is the use of home equity to finance our lifestyles. Economic growth in the U.S. in the last ten years has been driven by consumer spending, much of it financed through the use of homeowner's equity. Beginning in 2003 through the first quarter of 2006 home equity growth was running at a rate of more than 10% per year making homeowners feel richer and providing cash to finance lifestyles, contributing to a "wealth effect" that Mr. Greenspan often referred to. While homes are still worth more than twice the amount that is owed on them, the continued growth in the use of leverage is a concern. Consumers have used up a good amount of their equity and have used products with risky features such as adjustable rates to finance purchases of homes that may have formerly been out of reach. The inherent risks of these actions include the economic distress caused by a drop in home values and/or rising interest rates that could put additional stress on homeowner finances once the rate adjustment period begins.



Source: Federal Reserve

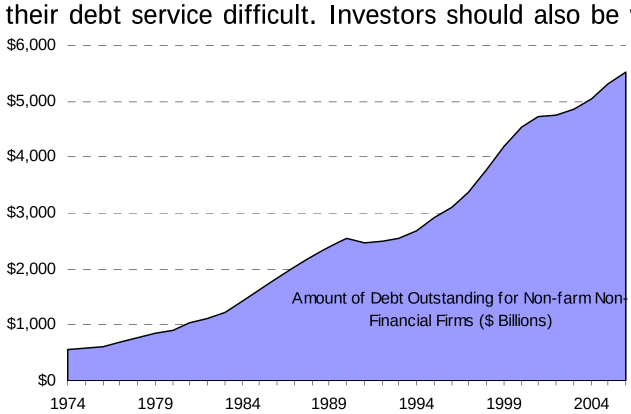
Companies are also using leverage in greater amounts to conduct business. According to Thomson Financial, during the first half of 2006 U.S. non-financial companies issued $84 billion in investment grade bonds, a 72% increase over the same period in 2005. Riskier junk bond issues were up 25% to $47 billion, for the same time period. Issuing debt has become a way for companies to raise capital for a number of reasons, not all of which are well received by investors or ratings agencies. One perk for companies that issue debt is that the interest payments made on the debt are tax deductible. With profits up in most sectors over the last few years, companies that have spent the time to strengthen their balance sheets have been borrowing, given the ease and availability of credit since 2001. However, the strategy has garnered some angst from bondholders who complain that companies are using debt to help fund stock buybacks and pay dividends with the end result being drainage of cash without creation of growth opportunities. When a company buys its own stock back it reduces the number of shares available in the market and pumps up the stock price – a boon for stock investors possibly made on the backs of bondholders. The use of cash also leaves a company vulnerable to ratings downgrades which would put pressure on bond prices as prospective lenders would demand higher yields to compensate for the additional risks of investing. Ratings agencies are beginning to take a closer look at the increasing debt loads of corporate America. According to S&P, through the middle of 2006 there were nearly 3 ratings downgrades for every ratings upgrade among consumer-oriented companies – nearly double the pace of 2005.

Where else?

Hedge funds have been ramping up leverage eight years after the melt down of Long Term Capital Management (LTCM) at the same time that asset flows to the sector have significantly increased. Between 1998 and 2006, hedge fund assets under management grew from just over $200 billion to just over $1 trillion. As there are fewer opportunities in the market to generate alpha, hedge funds must increase leverage in order to generate greater excess returns for their investors. According to Hedge Fund Research, in 2005, 70% of hedge funds had the ability to use some form of leverage for investing and leverage ran between two to five times capital.

Should we be worried?

The linking of risk between the consumer, corporate and investment sectors should be closely watched. Falling housing prices could render homeowners' debts larger than their home values, which could have an adverse impact on their ability to make purchases. Since consumer purchases have been such a large part of GDP, less consumption would lead to lower corporate profits. In the case of companies that have increased debt financing, lower profits have the potential to make their debt service difficult. Investors should also be wary of the trend of increasing debt in hedge funds. As hedge fund returns soared in the years since 2001 institutional investors, especially pension funds, have been drawn to these alternative investment strategies as return enhancers. The bets that hedge funds make, and the magnification of risk through leverage, leaves them vulnerable if the above scenarios play out. Any slowdown or deceleration in the economy due to consumer spending, corporate profits, recession or other factors could have a ripple effect throughout the markets and economy with broader impact than the LTCM melt down. Thus far the soft landing in the economy and housing market seem to have absorbed the higher amounts of leverage in the consumer and investment sectors, but as we know, nothing lasts forever.



Source: Federal Reserve

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