

## INVESTMENT UPDATE

### Executive Summary

- Despite the modest slowdown in the second half of 2006, we expect the economy to grow at a sustainable non-inflationary rate of +3.0% in 2007.
- Economic expansion will be driven by continued growth in corporate profits, wages, new jobs, exports, and nonresidential investment. The negative impact from the housing slowdown will lessen in 2007.
- Inflation remains well contained at approximately +2.5%.
- The Federal Reserve should hold interest rates at current levels for most of 2007, as economic growth and the inflation rate are both at acceptable levels.
- Rising corporate profits will eventually be reflected in the stock market. The S&P 500 price/earnings ratio (P/E) at 14.5x is attractive for long-term investors.
- The long-term bond market remains slightly overvalued given continuing economic growth and the current level of inflation. We believe that the yield on the 10-year Treasury Note will climb to 5.25% during 2007.

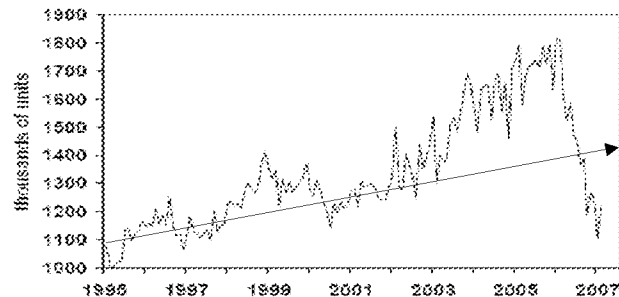
### Economy

In order to understand our outlook for economic growth in 2007 an understanding of 2006 is helpful. The U.S. economy grew by +3.1% in 2006, the same as in 2005. However, economic growth slowed in the second half of the year as a sharp decline in the housing market subtracted -0.7%, -1.2%, and -1.2% from GDP growth in the 2<sup>nd</sup>, 3<sup>rd</sup>, and 4<sup>th</sup> quarters, respectively. Excluding housing, economic growth was relatively strong and stable at +3.2%, +3.2%, and +3.4% in the 2<sup>nd</sup>, 3<sup>rd</sup>, and 4<sup>th</sup> quarters of 2006, respectively. Without the negative impact from housing, the rest of the economy grew faster in 2006 (+4.0%) than in 2005 (+2.8%) and strengthened in the fourth quarter versus the third. As we look forward to 2007, the drag from the housing market should diminish while the rest of the economy should continue growing at an above-average rate, resulting in a sustainable non-inflationary rate of growth at +3.0% in 2007.

While the housing market will continue to subtract from economic growth in 2007, the magnitude of last year's decline will be hard to duplicate. In 2006, residential construction spending declined by approximately \$100 billion or -12.5% from the end of 2005. To have the same impact in 2007, residential construction would have to decline by another 15%.

With new home construction housing permits stabilizing, we are encouraged that the housing market's negative impact on the economy will be less than \$50 billion in 2007. Housing may actually add to growth in 2008.

**Chart 1: The Housing Market's Drag on GDP Should Diminish in 2007.**  
Single-Family Housing Starts



The non-housing portion of the economy appears poised for another strong year led by growth in consumption, business investment, nonresidential construction, consumer spending, exports, and job growth. For instance, consumption growth increased to +3.6% in 2006 from +2.9% in 2005, final sales increased to +3.3% from +3.2% in 2005, export growth grew in 2006 at +9.3% versus +6.7% in 2005, and unemployment fell to 4.5% in 2006 from 4.9% in 2005.

Overall, the underlying fundamentals driving economic growth remain in place and, unless there is a significant mistake in fiscal, trade, or monetary policy, we believe the economy should continue to grow around its 30-year average rate of +3.1%. The Federal Reserve has engineered a soft landing and interest rates remain in a neutral range. This allows the powerful forces of capitalism, entrepreneurship, and free trade to drive continued growth in the U.S. economy. The results show up in strong growth in corporate profits, healthy growth in wages, very low unemployment, a record level of consumer net worth, strong growth in exports, and modest inflation.

### Federal Reserve

The Federal Reserve has orchestrated a near perfect soft landing for the economy with the growth drivers of the economy moving beyond the interest rate sensitive housing and auto markets to other parts of the economy. Current monetary policy should continue to support economic growth at a sustainable non-inflationary level. The fact that inflationary pressures have eased, the dollar has remained in a relatively

