Altamont Capital Management

Fourth Quarter 2006 Performance

Can anybody remember when the times were not hard and money not scarce?

Ralph Waldo Emerson

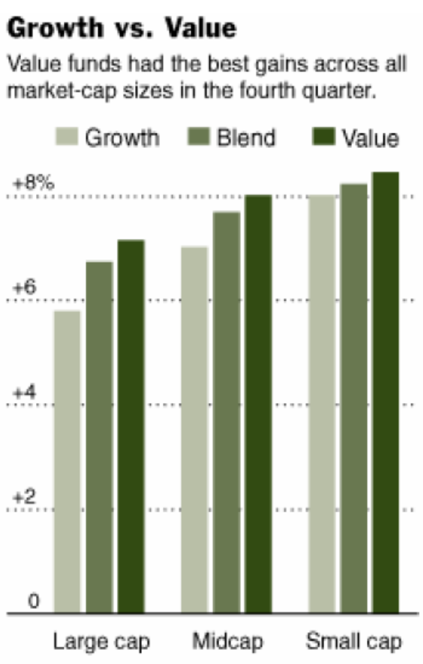
Most equity asset classes did well in 2006, with foreign investments clearly outperforming the U.S. stock and bond markets. The U.S. value indexes vastly outperformed their growth counterparts across all market caps.

Fourth Quarter and Year 2006 Benchmark Index Returns

	Fourth Quarter	Year 2006
Large-Cap Benchmarks		
S&P 500 iShares	6.7%	15.7%
S&P 500 Growth iShares	5.6%	10.8%
S&P 500 Value iShares	7.7%	20.6%
Mid-Cap Benchmarks		
S&P 400 Midcap iShares	6.9%	10.1%
S&P 400 Midcap Growth iShares	5.9%	5.8%
S&P 400 Midcap Value iShares	7.8%	7.8%
Small-Cap Benchmarks		
S&P 600 iShares	7.8%	14.9%
S&P 600 Growth iShares	7.2%	10.3%
S&P 600 Value iShares	8.4%	19.3%
Other Benchmarks		
MSCI EAFE Int'l iShares	10.2%	26.0%
MSCI EM Int'l iShares	19.1%	30.7%
Vanguard Total Bond Mkt Index	1.4%	4.3%
DJ-AIG Commodities Index	5.4%	2.1%

On the fixed-income side, domestic high-quality, intermediate-term bonds had a respectable year, with the Lehman Aggregate gaining 4.3%. Foreign bonds were aided by a currency tailwind, lifting developed markets foreign bonds to a 6.1% gain, while developing local markets bonds gained 12.3%.

A broad observation about returns in 2006 is that riskier asset classes outperformed. Foreign stocks in developed countries generated outstanding returns in 2006 of 26%, while the riskier emerging-markets asset class gained over 30%. Back home, the same thing happened in the bond market. In general the entire bond market rose a respectable 4.3%. The riskier high-yield bond benchmark was up almost 12%, while the riskiest bonds in the high-yield universe—those rated CCC and below—gained about 19%. In addition, smaller-caps turned in a strong performance and outpaced larger-caps if you use the broader Russell 2000 index as your proxy (benchmark). So in 2006 risk was rewarded. There have been many years when the reverse was true, the dot-com bust of 2000 for instance.



Investors' willingness to take on risk implies a shrinking risk premium (the amount of return earned for the amount of risk taken). In order to gain even a small return advantage investors are taking on substantial risk. For instance, high yield bonds are currently yielding just 300 basis points (100 basis points is 1%) above the 10-year Treasury. From a peak in late 2002, this is a dramatic decline. Back then, spreads were over 900 basis points. The current level is well below the historical average, suggesting that high yield bonds are overvalued. Please note, yield differentials typically reach 300 basis points during periods of healthy economic growth, so current spreads are not outrageous given our current level of economic growth. However, the high yield bond market is priced for perfection so, as the economy slows, high yield bonds will perform poorly. It is therefore not a good time to be investing in high yield bonds. On a risk adjusted basis, it would be far better to invest in the S&P 500.

Market Risks for 2007

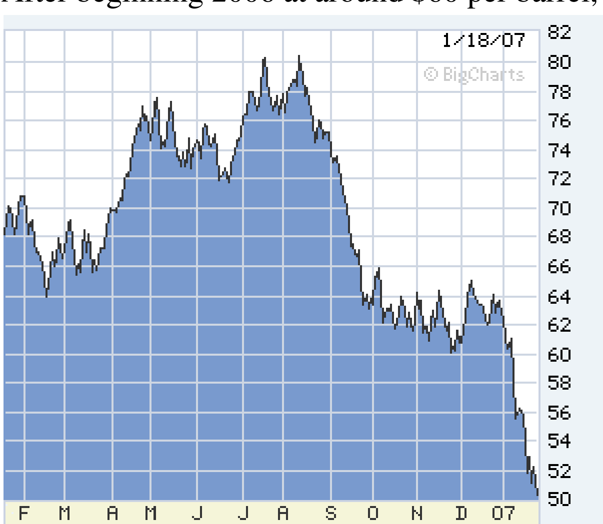
The most likely outcome for 2007 is slower growth and slightly higher inflation than current levels for the global economy. This soft landing scenario could be derailed by a plethora of events some known and, of course, many unknown. It is these key elements that are worth focusing on because they could tilt the markets in 2007, a few positively and many negatively.

Source: Datastream, Morgan Stanley Capital International, Lehman (12/22/06)

A housing contraction could still weaken the economy. There has been some stabilization in the rate of decline in the housing market, but inventories still remain high. Fortunately, there has been little impact on consumer spending from declining housing prices. The slowing housing market has helped curtail growth, but this phenomenon could intensify in the months ahead. Therefore the risk of a housing effect still remains, especially when coupled with other factors. For instance, if growth in disposable income were to moderate and were coupled with a downturn in housing, and amplified by the weakness in the auto industry the consumer could stop spending, which would drive the economy into recession. As long as income growth remains decent and the labor market keeps generating enough new jobs, the risk of a housing-related recession remains small.

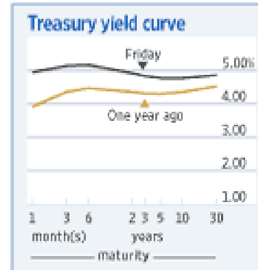
Inflation is one of the key variables that investors and the Federal Reserve will be closely monitoring in 2007. The rate of inflation has been increasing with the major culprits being increased housing rental rates, rising unit labor costs and higher energy prices. Energy prices are moderating which is good news.

After beginning 2006 at around $60 per barrel, oil peaked near $80 per barrel and fostered the belief among some industry watchers that higher oil prices would continue indefinitely (pundits were talking about $100 per barrel). The chart (to the left) is of Crude Oil (Nymex) price per barrel for the last twelve months ending January 18, 2007. The recent decline in oil prices has decreased inflation fears and helped bolster the stock market. OPEC has stated however, that the current price of oil is unacceptable and plans to restrict production until the price rises. I would expect to see prices back up in the $60 dollar a barrel range later in 2007.

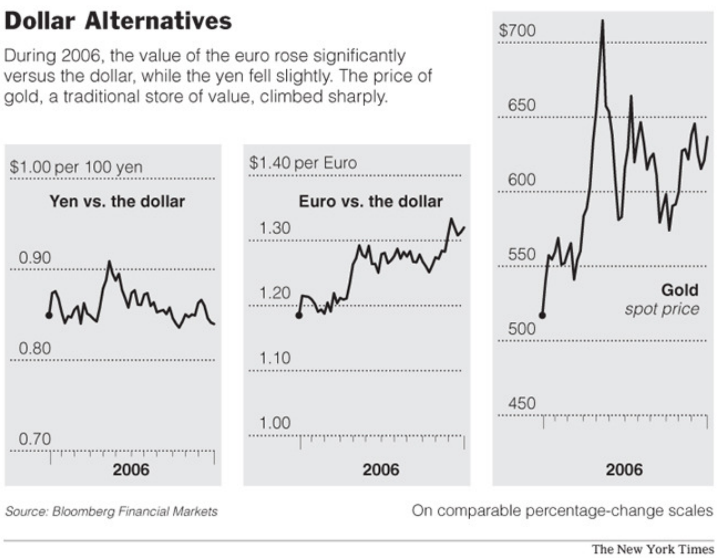


Financial markets currently see inflation as benign over the long term as evidenced by the moderate inflation expectations reflected in the market for long maturing TIPs (Treasury Inflation Protected Bonds). In the short term, the markets are hoping for modestly higher inflation that is well contained.

An inverted yield curve in the bond market is usually viewed as a recessionary indicator. This is when short term interest rates are higher than long term rates. Recent Federal Reserve studies show that when an inverted-yield curve has existed for more than three months the probability of a recession becomes very high. Of course, the yield curve has currently been inverted for longer than three months. It would historically be a rare occurrence, if we don't have a recession in 2007. None of the other recessionary indicators are at levels consistent with previous recessions so maybe the inverted yield curve is just an anomaly - or maybe not.



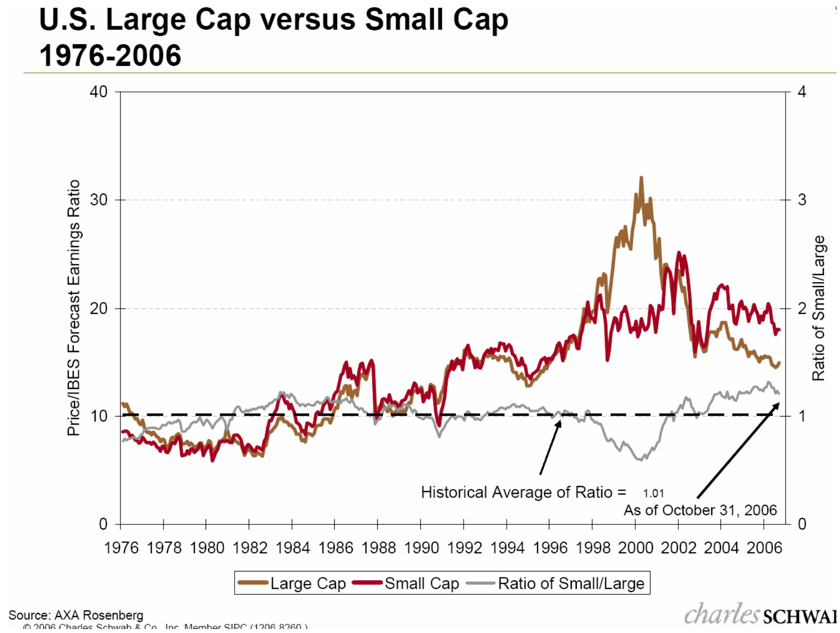
Emerging international markets were hot in 2006, generating almost a 31% return. These are developing countries such as China, Venezuela and Russia. Emerging countries will feel the negative impact of decelerating U.S. and European economies in 2007. They are still dependant on import demand from these developed countries. There is a tremendous amount of speculative investment and development in many of these emerging countries. This easy money would disappear instantaneously, causing further imbalances and disruptions if any financial or political trouble were to occur. The boom/bust cycle was repeated many times during the industrialization of America. In the next few years, it wouldn't be unusual to see a typical boom/bust cycle in some of the emerging market economies. The risk, while unlikely, might be enough of a shock to cause other disruptions around the world.



The dollar will continue to fall in 2007 against other currencies. Even OPEC is now pricing oil contracts in Euros and not exclusively dollars. The U.S. dollar has been the reserve currency of the world for many years. In other words, it has been the default currency used in many international transactions. Our economy has benefited from reserve currency status but we have abused that privilege in recent years. The U.S. government has accumulated a huge fiscal deficit, and our economy has amassed an enormous trade deficit. These twin debts are jeopardizing the value of our currency and could be signaling, the possible demise of the U.S. as an economic superpower.

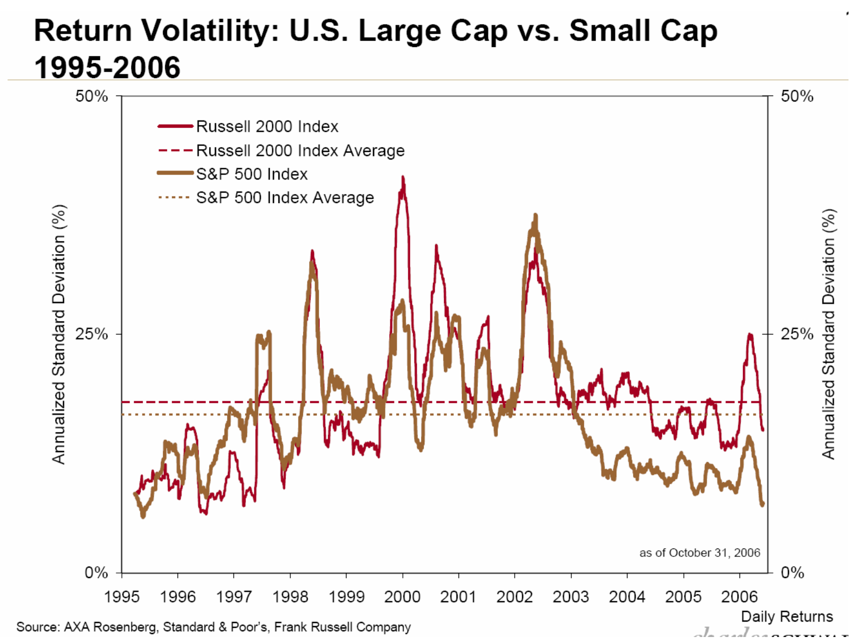
Fed policy was a big driver of the markets in 2006. Early in the year, investors were growing concerned about an interest-rate overshoot causing a recession. By summer, the Fed had hiked rates by another 125 basis points, and stocks suffered. Once the Fed announced that it was on hold for future hikes, the market spent the rest of the year bouncing higher. Today there is growing talk of the possibility of a recession that would lead the Fed to begin cutting rates again. This illustrates the fickle nature of short-term sentiment. In less than six months the market went from concerns about rising rates damaging the economy, to relief that the rate hikes were over, to fears of a cyclical recession (which would lead to falling rates). In the real world, underlying fundamentals seldom change that quickly. An over reactive strategy is a sure-fire way to get into trouble. Short-term investor sentiment rarely impacts long-term fundamentals. Though no one is buying the Feds tough talk, I think it is foolish to count on the Fed cutting interest rates in 2007. I am convinced that investors are pricing in lower interest rates. If these expectations aren't met the market could experience a correction in the first six months. Either way, the markets will definitely be more volatile in 2007. I think it will be a bumpy but profitable ride in 2007.

Equity Market Outlook



As a way to hedge against the possibility of a slowdown in the U.S. economy, I'll be overweighting large cap stocks. The long term trend of small-cap out performance is showing signs of breaking down. The P/E ratio of small caps versus large caps is at a level that has historically led to large caps outperforming. In other words, small caps appear expensive compared to large caps. This over priced relationship holds true on both a price to earnings and price to book ratio basis. On a fundamental basis alone, large caps should outperform small caps in 2007.

Volatility is increasing in the markets. This increased risk becomes apparent in the graph depicting return volatility. History has consistently shown that large caps outperform small caps during periods of escalating volatility.

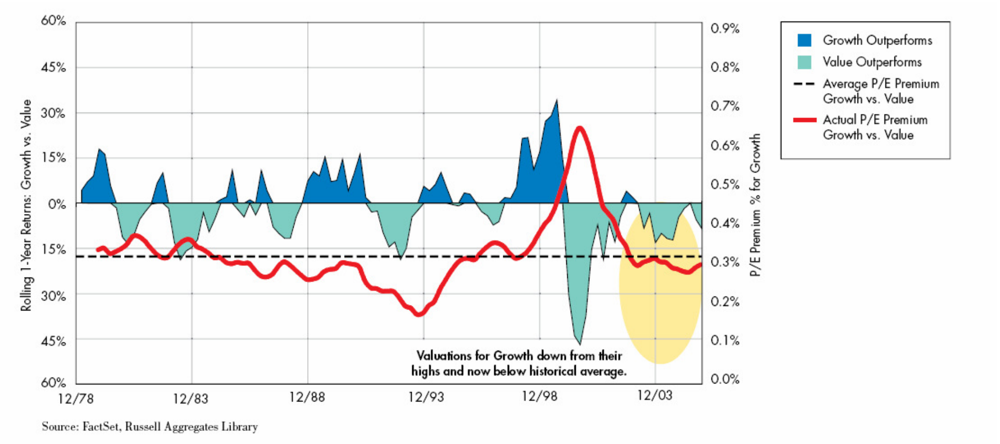


A weakening dollar also favors large cap U.S. stocks. The revenue of large multinational, corporations tends to increase as exports rise in response to a falling dollar. Smaller companies do not tend to have this advantage. They just face rising material expenses with no significant increase in exports. So a weakening dollar favors large cap firms.

In the last half of 2006, I began to underweight small cap and emphasize large cap domestic stocks. I will be continuing this trend in 2007.

The next question is will growth finally start outperforming value again? Believe it or not there is a positive correlation between Large/Small cap cycles and Growth/Value cycles. Large Caps and Growth stocks tend to outperform in similar periods. The flip side of this is Small Caps and Value stocks tend to perform well in the same periods. This correlation has grown stronger over the last ten years. Historical performance does not guarantee future performance but it is an interesting relationship. The indicators are currently mixed and it is unclear if growth will outperform in the next year. Growth stocks have historically traded at a 32% premium to Value stocks. From the graph below it is clear that growth stocks have come down from their highs reached during the technology bubble and are trading below their historic premium to Value stocks since 2002. In addition, this current Value cycle is the longest in duration and magnitude since style indexes were created in 1978. This does not mean that investing in Growth is a sure thing. It only indicates that Growth stocks could be moving toward a period of strong performance. It is my firm believe that the market will favor investors who are not slaves to style or market cap. I will continue to search for opportunistic managers who, irrespective of style, look for the best investments.

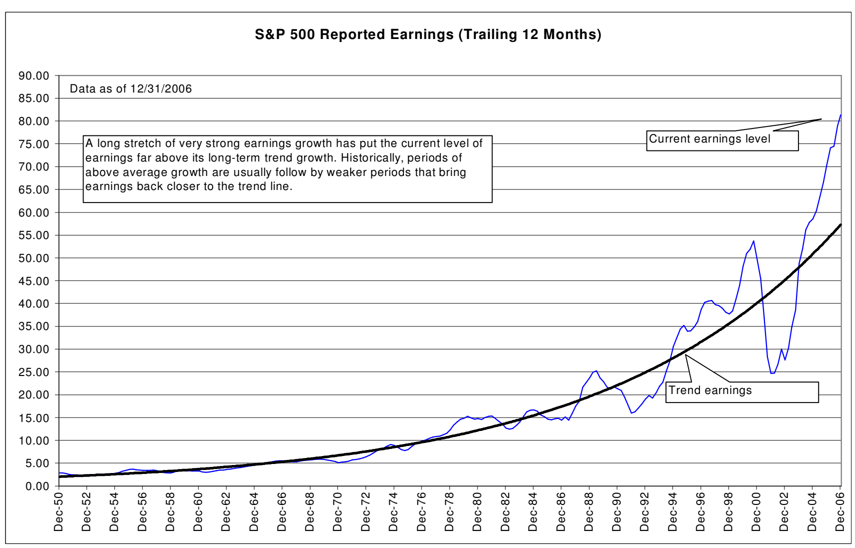
Russell 3000 Growth versus Russell 3000 Value (Rolling 1 year Performance with Relative Price/Earnings Ratio



With the S&P 500 putting up good numbers in 2006, and some market indexes reaching record levels, stocks may "seem" like they should be getting expensive. In truth, though, the valuation picture has actually changed very little. This is because earnings have gone up along with stock prices, leaving the relationship between prices and earnings at about the same place. The current new highs reached by some indexes are only now eclipsing levels that were first seen nearly seven years ago.

Where does this all leave us? Attractive valuations tell us the market is either cheap—meaning returns going forward are likely to be better than average—or that the market is discounting a meaningful decline in the fundamentals. Earnings growth is slowing and the economy is decelerating. This is probably just normal cyclical behavior and/or the slowdown in the housing market. In either case, it is clear that the spectacular earnings growth we've been experiencing is ending, and things are cooling off.

Earnings Growth Has Been Very Strong in Recent Years, But How Long Will the Party Last?



Based on current market fundamentals it appears that current valuation levels have a healthy margin of safety already factored into the market. That does not mean that the stock market won't experience a correction in 2007. I expect that if the market does drop it won't be drastic or long lasting.

Looking overseas, stocks in developing countries are still a good investment. Returns will not be as spectacular as 2006 when the foreign stock index rose 26%, but they will be decent. It is the developing countries that could be in for the roughest ride in 2007. I have avoided investing directly in emerging markets and have instead picked international funds that have a small exposure to these markets. Many of the international managers have been trimming their developing country exposure. I will continue to monitor the emerging market exposure in your international funds and may trim positions if it becomes necessary.

Please periodically take a look at my blog for more in depth and up-to-date investment analysis, tax and financial planning information. My blog is http://financialpragmatist.blogspot.com. Our website has a link to my blog as well. Our website address is www.altamontwealth.com.

Thank you for your confidence and trust.

Libby Mihalka