

U.S. Stock Market Outlook First Quarter, 2007

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Executive Summary

Our long-term outlook for stocks remains positive given favorable valuations and a constructive view about future economic growth and inflation. However, in the short-term, we think that investor sentiment has become too optimistic and the market is overbought.

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U.S. Stock Market Valuation

The majority of valuation indicators we monitor suggest that the U.S. stock market is relatively cheap compared to other asset classes and represents good value.

Valuation measures help us identify the relative attractiveness of stocks compared to their own history, relative to inflation and relative to other competing asset classes. Absolute measures such as the Price/Earning (P/E) Ratio tells us if the P/E multiple is high or low compared to its long-term history. While absolute multiples provide some information, they can be misleading. Multiples tend to shift over time as the economic environment changes. During periods of high inflation, multiples tend to compress as interest rates and the discount factor move higher. In addition, during these periods, bonds, cash and other asset classes provide greater competition for investor funds. This is why most of our valuation measures evaluate the stock market relative to underlying inflation and compared to other asset classes.

There are a number of problems with valuation measures as investment tools. Although value tends to win in the long run, valuation measures can be notoriously early in identifying market bottoms and tops. To avoid being early, we tend to remain close to our long-term norm allocation until an asset class becomes extremely over or under valued. We also use other non-valuation tools to help us determine buy and sell points.

Valuation measures can also be misleading at cyclical turning points. At the end of the economic cycle, revenue growth, profit margins and earnings tend to be at cyclical highs and P/E's tend to be lower. To help smooth out cyclical swings in earnings that can distort multiples, we normalize earnings by using the average earnings over a number of years.

U.S. STOCK VALUATION MONITOR

Indicator	Current Bias
Bailard P/E Model	Bullish
Operating P/E relative to:	
Inflation	Bullish
T-Bill yield	Neutral
10-Year Treasury Yield	Bullish
BAA Yields	Bullish
Fed Model Forward (Forward EPS/Treasury Yield)	Bullish
Ned Davis Research Valuation Composite	Bullish
Real Bond Yield to Dividend Yield	Bullish
Normalized E/P relative to Bond Yield	Bullish
Absolute Level of P/E:	
Median Reported EPS	Neutral
Operating EPS	Neutral

Sources: Bailard Research, Ned Davis Research, Yardeni Research, Bear Stearns

U.S. Stock Market Environment

We believe the current market environment for stocks is positive and conducive to value recognition. The economic outlook remains constructive, the earnings cycle although slowing is positive, inflationary pressures are subsiding, Fed Policy is neutral, and there is only mild upward pressure on bond yields.

We use a number of indicators to help us evaluate the stock market environment: economic conditions, inflation pressures, Fed Policy, interest rates and other miscellaneous factors. In general, a positive outlook for the economy is good for earnings and positive for stocks. However, if economic conditions lead to high and accelerating inflation, the environment for stocks becomes less attractive. A deteriorating inflation outlook leads to higher interest rates and tighter Fed policy, which tend to restrain stock prices since higher interest rates work to slow an overheated economy, dampen earning expectations and kindle recession fears.

Conversely, as economic conditions weaken, inflation and interest rate pressures ease and set the stage for economic recovery. The best time to buy stocks is in the midst of recession as inflation pressures ease, the Fed becomes less restrictive and long-term interest rates are declining. The prospect for

improving economic conditions helps boost earning expectations and stock prices. While stocks have their most powerful moves off the bottom, they also perform well during periods of moderation and stability. In Greek mythology, Icarus is cautioned by his father Daedalus to "fly the middle course," between the sea spray and the sun's heat. Unfortunately for Icarus, he

did not heed his father's advice. He flew too close to the sun, melted the wax of his wings and fell to his death. Like Icarus, investors should prefer times of moderate economic activity because that is when stocks are likely to do well.

U.S. STOCK MARKET ENVIRONMENT MONITOR

Indicator	Current Bias
Bailard Base Economic Scenario	Positive
Ned Davis Research (NDR) Economic Composite	Positive
Leading and Lagging Indicator (y-y)	Neutral
Real M2 Industrial Production (y-y)	Positive
NDR Monetary Composite	Neutral
Monetary Fiscal and Currency Policy	Positive
Earnings Growth (y-y)	Neutrak
Earnings Acceleration	Neutral
Earning Surprise	Positive
Profit Margins	Neutral
Crude Oil (26 wk)	Positive
Inflation (y-y) vs. 6-month smoothing	Very Positive
Inflation vs. 5-year trend	Positive
NDR Inflation Model	Very Positive
Fed Funds Rate Momentum	Neutral
Fed Policy Bias	Neutral
T-Bill Yield	Neutral
3-Year Treasury (y-y)	Positive
10-Year Treasury Yield (y-y)	Positive
L-T Treasury Bond Reversal	Neutral
Moody's Baa Yield (y-y)	Positive
DJ Utility Price Divergence	Neutral
Seasonal Tendancy	Neutral
Presidential Cycle	Positive

Sources: Bailard Research, Ned Davis Research, Yardeni Research, Bear Stearns.

U.S. Stock Market Trend, Momentum and Breadth

Trend, momentum and breadth indicators help investors stay on the right side of the market. Currently, the balance of these indicators is very positive. The only caveat is that they may be too strong.

Trend indicators (trend lines, moving averages, reversals) help to keep our strategy in harmony with the direction of the market. The problem with trend indicators is that acting on these signals in the short term can leave investors vulnerable to whipsaws within a longer term upward or downward trend. Fortunately, trend sensitive indicators can help keep investors on the right side of big up moves and act as a stop loss to help minimize the downside of a major downtrend.

Momentum indicators help to evaluate the strength of the overall market. High and rising momentum tends to be positive for the market, while low and falling momentum tends to be negative. Monitoring reversals in momentum after extreme moves can help identify market turning points. Momentum indicators used together with other indicators can also provide useful signals about the direction of the market and turning points. The Ned Davis Research (NDR) Momentum Composite is a good summary indicator of the market's internal health. It nets the bullish and bearish readings of over 100 different indicators into a single model.

Breadth indicators include the number of new highs and lows, advancing vs. declining issues, upside/downside volume and the percent of stocks above/below moving averages. When a lot of stocks are trading above both their 10-week and 30-week moving averages, breadth is high. High and rising breadth readings tend to be positive for stocks. However, extremely high breadth reflects over-bought conditions. When a lot of stocks are trading higher and begin to reverse, a significant shift in the overall market momentum may occur. Extremely low breadth occurs near market lows and indicates lower risk.

Monitoring the number of stocks hitting new highs compared to new lows gives us another indicator of market breadth and internal strength. When a lot of stocks are hitting new highs while many

stocks are hitting new lows, breadth divergence and a potential top are indicated. When there are a lot of new highs and few new lows, the market is moving in-sync. When there are few new highs and many new lows, a selling climax and a market bottom is indicated. Advance/Decline measures can be utilized in the same manner to determine the market's internal health.

Rising volume tends to be bullish for stocks, while relatively light volume tends to be bearish. Because the amount of trading volume on the NYSE has tended to rise over time, high and low volume should be evaluated relative to trend.

U.S. STOCK MARKET TREND, MOMENTUM AND BREADTH MONITOR

Indicator	Current Bias
Trend of 200-day MAV	Bullish
Price Relative to 200-day MAV	Bullish
Trend Reversals	Bullish
NDR Momentum	Bullish
Trend Momentum Relative to Bonds	Bullish
FFR and NDR Momentum	Bullish
Monetary Composite and Momentum	Neutral
Breadth and Momentum	Bullish
Advance/Decline Line	Bullish
New High-to-Lows	Bullish
% of Stocks Above 200-day MAV	Neutral
% Above 10-week and 30-week MAV	Neutral
% of Stocks on Bullish NDR Ratings	Bullish

Sources: Bailard Research, Ned Davis Research, Yardeni Research, Bear Stearns

U.S. Stock Sentiment Indicators

Currently, most of the sentiment indicators that we follow are either optimistic or extremely optimistic. This suggests the market is becoming vulnerable to bad news and that risk has increased.

Sentiment indicators attempt to measure investor psychology by looking for periods of over optimism or over pessimism. As good news is discounted, optimism drives stock prices higher. When optimism becomes excessive, the market becomes vulnerable to bad news. During periods of pessimism, the reverse is true. The general rule is, "Go opposite the crowd at extremes".

The one problem with sentiment is that it can stay overly optimistic or pessimistic for long periods of time. In order to lessen this problem, we use many different measures to evaluate the psychology of different types of investors. Individual investors are known for being wrong at turning points, buying at the top and selling at the bottom. Investment professionals; strategists, advisors and hedge fund managers also tend to be wrong at sentiment extremes. Mutual fund data can also be used to evaluate sentiment and gauge when it is excessive. When mutual fund investor allocations to money market funds are low and equity mutual funds are holding

little cash, there is usually less liquidity available for investing in stocks. This begs the question, "Who is left to buy?" and is negative for the stock market outlook.

U.S. STOCK SENTIMENT MONITOR

Indicator	Current Bias
Wall Street Strategists Poll	Extreme Optimism/Bearish
Hedge Fund Sentiment	Net Long/Too Optimistic
UBS Investor Optimism Survey	Optimistic
Bull/Bear Advisory Sentiment	Extreme Optimism
Bull/Bear Sentiment (adjusted for monetary environment)	Optimistic
Bearish Advisors+Ned Davis Research	Extreme Optimism
American Association of Individual Investors	Neutral
Domestic Mutual Fund Cash/Assets	Extremely Low
Money Market Funds/Total Mutual Funds	Low
Ned Davis Crowd Sentiment Index	Extreme Optimism
% of Stocks Above 10-Week MAV	Overbought
Deviation from Trend	Overextended

Sources: Bailard Research, Ned Davis Research, Investors Intelligence, Yardeni Research, Bear Stearns

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