



INVESTMENT STRATEGY UPDATE

December 29, 2006

2007 – THE YEAR AHEAD

Tempus fugit, another year passes into the history books. In hindsight, stock market returns were better than we had been expecting. We opened last year's annual look at the year ahead with what has become our customary disclaimer, citing the late Niels Bohr's proclamation that "prediction is very difficult, especially about the future." We went on to note that while we were attempting to forecast the future, our continued success as investment managers would depend much more upon our ability to interpret and adjust to trends and events as new information became available. In few years was that statement more apropos than 2006.

We began 2006 with a cautious outlook toward the market. Stocks had risen quite strongly during the previous three years and the market was entering what was historically the weakest part of the four-year presidential cycle. In fact, since the early 1950s, the second year of a presidential term has almost always contained the four-year cycle stock market low. The exception was 1986, which was followed by a sharp stock market correction in October of the following year.

In the end, the widely expected 2006 stock market retrenchment failed to occur. Fortunately, as the year progressed, our investment staff was able to adjust to the changing fundamental landscape, and our clients' portfolios fared quite well. But what now lies ahead?

Bullish investors cite a favorable economic outlook, the likely end of the Fed tightening cycle, and plentiful liquidity. They also note that we are now entering the third year of the traditional four-year cycle, which historically has been the sweet spot for stock market returns. Conversely, those in the bearish camp think there is heightened risk of a consumer-led recession. They also believe that the four-year cycle low has simply been postponed – an event they see as still looming over the stock market.

So which is it? What follows, with all appropriate disclaimers still in place, is our outlook for 2007 – the year ahead.

The Economy

There is little doubt that the economy is 2007's financial market focal point and currently it is slowing. Early in 2006, GDP was growing at a healthy 3.7% annual rate, but as measured over the last six months, that rate has slowed to 2.3%. The question is whether the slowdown will be temporary and mild, or whether it will worsen, perhaps sliding the economy into recession. To set the stage, we look back to mid-2004. An economic expansion was underway and as it gained momentum, inflationary risks began to increase. So on June 30, 2004, the Federal Reserve Board started raising short-term interest rates. It was to be the first of sixteen consecutive one-quarter point increases in the federal funds target rate, culminating on May 10, 2006, when the target rate reached 5¼%. Since that time, the Fed has been on hold, pending further economic data.

Looking forward, the bearish camp contends that recession risks have risen. They think the Fed may have pushed interest rates too high, much as it had done during several previous tightening cycles. They also note that in the post-WWII era, the average economic expansion has lasted just 57 months. By that measure, the current growth cycle is getting long in the tooth.

But recessions tend to occur when the Fed is fighting spiraling inflation, and that is just not the case currently. And while energy prices are certainly very high historically, the recent drop in gasoline prices combined with the wealth effect from rising stock prices should serve to buoy consumers' willingness to spend. Furthermore, U.S. corporate balance sheets are currently highly liquid, and profits continue to benefit from increased productivity and a healthy, but moderating global expansion.

In recent decades, the economic cycle has been less volatile and expansions have been getting longer. One reason is that a significant portion of our manufacturing sector has been outsourced to other countries. Another is that with better access to more timely economic information, Federal Reserve Board decision making has improved. So while the U.S. economy may slow further, we believe the Fed was sufficiently preemptive in its monetary tightening and has gotten it just about right. Therefore, the most likely economic scenario, in our opinion, is a mid-cycle slowdown with two or three quarters of sub-par growth, after which the expansion will reaccelerate.

Despite our positive outlook, we also recognize the difficulties inherent in economic forecasting, and are well aware that there are some very real risks to the downside. For one, if the future core inflation numbers come in too high, the Fed will have to tighten further. Concerns about future inflation could also prompt foreign central banks to raise their short-term interest rates by too much, thereby meaningfully slowing the global economy. Another risk is that some combination of rising energy prices and further housing weakness seriously dampens consumers' propensity to spend. The latter would not surprise us, given that housing affordability remains so low. The real estate downturns of the 1980s and 1990s lasted years rather than months and coincided with economic recessions. However, we think that this time the weakness will largely be confined to the real estate sector itself. Mortgage debt is much less concentrated in the banking system currently, as a substantial portion of outstanding mortgages have been securitized and sold to investors.

Inflation and Interest Rates

The world economy is in the midst of a massive supply-side boom. As world trade grows and emerging nations continue to develop, millions of new workers are being integrated into the global labor force. And with plentiful capacity to manufacture almost everything, companies strive to become the low-cost producers by enhancing productivity and reallocating resources to the most cost-efficient countries. In this environment, wages and unit-labor costs will almost certainly remain contained. The competitive pressures are such that manufactured-goods inflation should stay low for years to come.

The combination of rising disposable incomes in the U.S. and falling traded goods' prices provides a continuous supply of excess liquidity. That liquidity should further fuel rising prices in certain asset classes, such as stocks. Ironically, it will also serve to raise inflation in the services sector – things such as restaurant meals, hotel rooms, and movie tickets, which are not included in the CPI.

Interest rates are basically a function of the supply of funds, the demand for funds, inflationary expectations, and the risk of default or currency debasement. There is a glut of global savings, in our opinion, particularly among the producing countries of Asia, resulting in a more than ample supply of funds to lend. On the demand side, U.S. companies are flush with liquidity and have little need to borrow. Also, with contracting values and slower growth in the housing sector, there is less demand for new mortgages. And, as we have already implied, inflationary expectations are likely to remain low.

So there seems little reason for interest rates to rise. But unless we are about to enter a recession, which we do not anticipate, neither does there seem much potential for significantly lower interest rates. Fixed-income investors have had a wonderful run since the early 1980s as inflation and interest rates retrenched from much higher levels, but we believe that process is largely behind us. We would not be surprised if the slowing economy and lessening of inflationary pressure allows the Fed to modestly lower short-term interest rates this year. However, our expectation is that long-term interest rates will remain close to current levels for some time to come. The bottom line is that while we see little interest-rate risk, we also doubt that that fixed income returns will be much in excess of current coupon rates.

The Stock Market

During the last half-century, the average annual stock market return in the years following mid-term elections is a highly impressive 23.6%, with no years showing negative returns. However, the current administration has not followed the traditional presidential-cycle scenario of tightening fiscal policy early in its term and stimulating later, in order to boost the economy in time for the next presidential election. So the economic weakness and accompanying stock market correction that typically would have occurred some time during 2006, the second year of this cycle, never did. Why then should one expect the third year to play out according to historic precedent?

Still, when considering the current fundamentals, we find numerous reasons to be positive on stocks. For one, a slowing economy will almost certainly mean an end to the trend of Fed tightening. For another, past mid-cycle economic corrections have generally led to rising stock market valuations, as investors began to look beyond the slowdown toward additional years of earnings growth with little risk of inflation.

Also positive for stocks are the global economy, which continues to expand at a healthy rate, abundant investor liquidity, and the fact that stocks remain attractively valued, particularly when one considers the current environment of low inflation and relatively low interest rates. Stocks also seem attractively valued when viewed in the light of the major investment alternatives such as bonds and real estate. Furthermore, the combination of strong corporate balance sheets, low U.S. interest rates, and the huge amount of money still flowing into private equity funds should enable a continuing high level of merger and acquisition activity. That, in turn, should serve to place a floor under equity valuations.

Of course, there are risks to our stock market forecast, including geo-political problems, persistently higher energy prices, a more severe downturn in housing, higher than expected inflation, and the economic turbulence that could be created by a sharp drop in the dollar. Also, we recognize that the stock market doesn't rise or fall in straight lines. With the economy now slowing, corporate profits will slow too, and the stock market seems well overdue for a correction. But a correction is just that, not a bear market. Our expectation is that the bull market will remain in force and that stock market investors will be rewarded with positive returns in the year ahead.

Regarding sectors, value stocks have handily outperformed growth stocks since the bursting of the stock market bubble in March 2000. As a result, some of the stocks that we at BTR have wanted to own but formerly considered too expensive, now seem relatively cheap. Thus, in recent months we have been able to accumulate stock in a few of the large capitalization companies that have more traditionally been owned by growth investors.

Additionally, as highlighted in our most recent *Investment Strategy Update*, we continue to favor the natural resource sector, particularly energy, as well as both U.S. and foreign companies that benefit from the ongoing expansion of international trade. Also, after several years of retrenchment following the stock market bubble, we are increasingly warming up to the technology sector as a beneficiary of what we expect to be rising growth in corporate spending.

Conclusion

We enter 2007 believing that while the U.S. economy has softened, the slowdown will serve as a pause that refreshes, reducing inflationary pressure and allowing the Federal Reserve Board to stay off the brakes. Interest rates should hold close to current levels, so we see neither much value nor much risk in the bond market. And, as we expect continued growth

in corporate profits with little measured inflation, the stock market should remain an attractive arena in which to invest.

There is little question that America's position in the world economy is changing. With the rapid industrialization of China, India, and other emerging nations, and with the increasing openness of world trade comes major opportunity. Hundreds of millions of consumers around the world are rising into the middle class. Their collective buying power is huge. But with the changing global economy has also come a significant degree of dislocation. America is manufacturing less and becoming more and more of a service economy. And for those Americans whose roots and well being are based in the manufacturing sector, that shift has become a major problem.

The widening gap between the haves and the have-nots in this country, and the rhetoric that has accompanied the changing political landscape present a serious long-term risk. The question is, what will be this nation's response? Do we retrench and turn inward, or do we recognize the opportunities and realities of the evolving global economic landscape by enhancing our educational standards, retraining those in need, and fostering the entrepreneurial spirit that has made this nation great? To quote from Alan Greenspan's July 2005 congressional testimony: "In a democratic society, such a stark bifurcation of wealth and income trends among large segments of the population can fuel resentment and political polarization. These social developments can lead to political clashes and misguided economic policies that work to the detriment of the economy and society as a whole." Whether we like it or not, today's economy is increasingly global. Our economic future is dependent on our entrepreneurial enthusiasm and our commitment to free and open trade. One can only hope that logic and reason rule in 2007 and beyond.

As a final note, we wish all of our friends and clients peace, joy, health, and prosperity in the new year, and for many years to come.

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