DIXON, HUBARD & FEINOUR, INC.

INVESTMENT COUNSEL

INVESTMENT OUTLOOK

Third Quarter 2006 Review and Outlook

by Whitney Brown

- Large cap stocks lead market higher.
- Bond yields retreat.
- Energy prices fall.
- Market outlook mixed.

The stock market began the summer quarter with a jolt. A new war in Lebanon and consequent spike in oil prices knocked stocks for a loop in July. Surprisingly, the market recovered quickly and ended the quarter on a positive note with the Dow Jones Industrial Average closing within a few points of a new all time high. Shortly after quarter-end the Dow went on to set a record high.

Looking a little more closely at the market action over the past quarter reveals some important clues to a market in transition. Dating back to October, 2002, the current cyclical bull market is among the longest on record. It is typical for small cap stocks to lead the early phase of a bull market and for large caps to lead late in the cycle. The recent rally has mostly favored large cap stocks. While the large cap indices such as the Dow and the Standard and Poor's 500 were up on the order of 5% for the quarter, a variety of small and mid cap indices were far more restrained with some actually down for the quarter.

Among sectors, energy and materials stocks fared poorly with industrials also lagging. These are the same stocks that have done so well over the past several years. In the meantime healthcare and telecommunications finally seem to be shaking off the hangover from the 2000-2002 bear market and showing signs of life. The market is shifting not only toward large cap stocks but also away from economically cyclical issues.

Market Measures		3rd Qtr 2006	YTD 2006
S & P 500		5.2%	7.0%
Dow Jones Industrial Average		4.7%	9.0%
NASDAQ Composite		4.0%	2.4%
Morgan Stanley EAFE		3.6%	14.0%
Lehman Bros. Intermediate Gov't Bond Index		2.9%	1.7%
	9/30/06	12/31/05	9/30/05
10-Year Treasury Bond Yield	4.63%	4.39%	4.33%
Three-month Treasury Bill Yield	4.88%	4.08%	3.55%

The September market surge was a classic example of the market confounding the majority. Based on seasonal tendencies and the four-year Presidential Election market cycle, many investors, including us, have been expecting the market to decline into a significant low sometime in the September to October period. We have referred to this four-year Presidential Election cycle in several issues of *Investment Outlook* over the past couple of years. Prior to this year we have seldom seen reference to it outside the proprietary market research we follow. This year, however, we noticed several articles about it in the

(Continued on page 4)

Also in This Issue

Federal Reserve Policy and the Housing Market

by Watt Dixon

The Federal Reserve began raising interest rates over 24 months ago in order to slow economic growth that was believed to be accelerating too swiftly. When the economy gets overheated or needs stimulation, the Fed responds by adjusting the Fed Funds rate . Changes in the Fed Funds rate trigger changes in both long and short interest rates that affect many facets of the economy. Employment, output, and prices of goods and services are affected by changing rates.

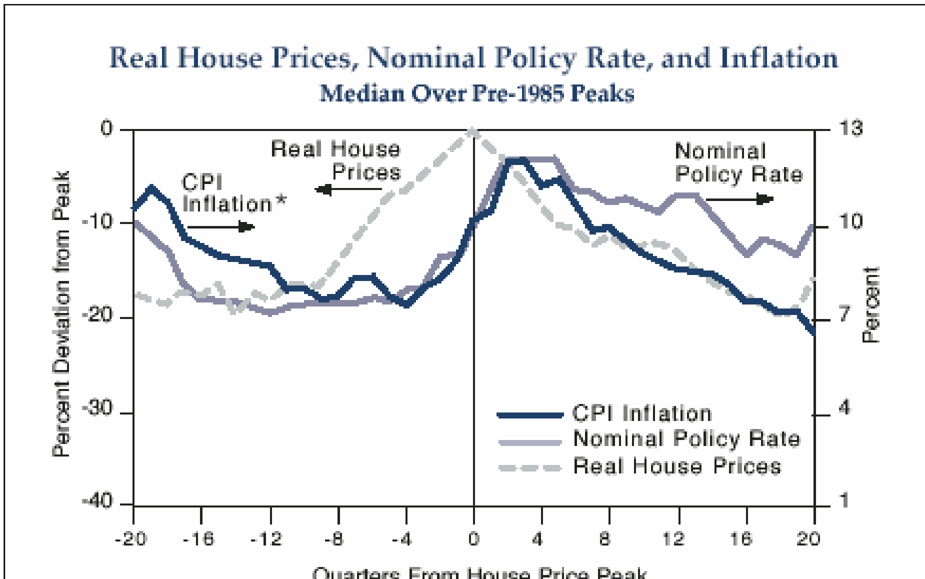
The Fed's actions over the past two years seem to have had the desired effect. The economy appears to have cooled on some key fronts. Consumption, employment, and capital spending have slowed and are even trending down. A recession does not seem likely. Instead, a more sustainable GDP growth rate of about 2% seems probable.

A rising interest rate environment typically is not good for the housing market. Homes and other big ticket items are usually financed with debt. When the cost of borrowing money is high, people are less likely to borrow and thus, less likely to buy or build new homes.

Not until very recently has the housing market slowed down. A recent report by the National Association of Realtors (NAR) reports that year–over–year housing price gains have all but disappeared and appear to be actually declining. A slow down in home sales is never good for the economy but may be particularly damaging now because the housing market has played such an unusually large role in our recent economic expansion.

The reversal in home prices has been more sudden and severe than most economists had anticipated. Nationally, new homes sales are down 17% from a year ago, and sales of existing homes have dropped 12%. Recent figures from NAR indicate that median prices for existing homes fell by 1.7% in the year through August, the first national drop since 1993. The median price of new homes fell 1.3%. To make matters worse, the supply of existing homes for sale is up 60% from a year ago, a 13 year high. The NAR expects housing prices will drop further.

Can any of this help us anticipate where rates are headed? As previously mentioned, because the housing market has played such a large role in our economy lately, we think it wise to look at how the housing market and the Fed Funds rate correlate. The Federal Reserve conducted a study entitled Housing Prices and Monetary Policy: A Cross-Country Study. The following key paragraphs and the chart



*Four-quarter percent change

Source: Board of Governors of the Federal Reserve

(Continued on page 3)

Federal Reserve Policy and the Housing Market (continued)

(Continued from page 2)
on page 2 show the relationship between home prices, inflation, and interest rates.

"We find that real housing prices are pro-cyclical and tend to reach a maximum near business cycle peaks, often after a prolonged period of buoyant growth in activity has raised output above its potential level and inflation pressures have begun to emerge. Subsequently, real house prices fall for about five years and their previous run-up is largely reversed. Real GDP growth slows during the first year or so after house prices peak as do growth rates of private consumption and investment."

"House price booms are typically preceded by a period of easing monetary policy with Fed Funds bottoming out about three years before house prices peak. Rates then reverse quickly in response to falling GDP growth."

This scenario seems to be playing out currently. The Fed Funds rate seemed to have bottomed out about three years ago (July 2003) before a housing peak in July 2006. Now, GDP growth is softening and the Fed has put short term rates on hold. With energy and commodity prices in retreat, inflation is likely headed lower. If the pattern holds true for this housing cycle, higher interest rates and inflation may not be a problem for several years to come.

The Pension Protection Act

by Molly Henry

On August 17, 2006 President Bush signed The Pension Protection Act into law. This legislation provides important provisions for 401(k) plans, profit sharing plans and other salary deferral plans. All of the provisions of The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001, which had been set to expire in 2010, will be extended. We have highlighted some key provisions to help you understand how the changes may affect you as an individual.

Higher Contribution Limits – The phased increase in contribution limits and catch-up contributions for participants age 50 and up will not expire in 2010 as previously scheduled:

Plan Type	2006 Annual Limit*	2006 Catch-Up Amount*
401(k) ,403(b), 457 & SARSEP	$15,000	$5,000
SIMPLE	$10,000	$2,500

**Amounts will be adjusted for inflation in $500 increments in subsequent years.*

IRA Contributions & Catch-Up Amounts – The phased increase in contribution limits for IRA owners age 50 and older, introduced in EGTRRA, will not expire in 2010 as previously scheduled.

Year	Annual Limit	Catch-Up Amount
2006-7	$4,000	$1,000
2008	$5,000*	$1,000

**Contribution limits will be adjusted for inflation in $500 increments in subsequent years.*

Rollovers by Non-Spouse Beneficiaries – Beginning in 2007, non-spouse beneficiaries of a qualified retirement plan can roll their distributions into an inherited IRA instead of having to take a lump-sum payment. This will allow them to take periodic distributions from the inherited IRA based on their life expectancy, but they will not be allowed to make additional contributions to the inherited IRA.

IRA Distributions to Charities – For the 2006 & 2007 tax years only, IRA owners who are 70 ½ and older can make a tax free donation to a charity of up to $100,000 from an IRA instead of taking a taxable distribution. This tax free donation may also be used to satisfy their RMD for the year.

DIXON, HUBARD & FEINOUR, INC.
INVESTMENT COUNSEL

PROVIDING INVESTMENT MANAGEMENT SERVICES FOR ...
INDIVIDUALS & FAMILIES
TRUSTS & ESTATES
RETIREMENT PLANS
ENDOWMENTS & FOUNDATIONS
BUSINESSES

WALTER M. DIXON, JR., CFA
W. STEBBINS HUBARD, JR.
EDWIN R. FEINOUR
C. WHITNEY BROWN, JR., CFA
WALTER M. DIXON, III
JONATHON E. GRACE
DAVID A. CAMPER

601 S. JEFFERSON STREET, SUITE 410
POST OFFICE BOX 2768
ROANOKE, VIRGINIA 24001-2768
TELEPHONE (540) 343-9903
FAX (540) 343-7684
E-mail: *last name*@dhfinc.com

Third Quarter 2006 Review and Outlook (continued)

(Continued from page 1)
financial press including *The Wall Street Journal*.

It is possible that the new found popularity of the cycle has in fact distorted it. It may be that the market sell-offs in May and July were the result of investors anticipating the fall low. Could it be that enough investors sold stock in anticipation of the impending correction that the correction has already taken place? Was the July low the low we were not expecting until October?

It's too soon to tell, but a number of factors are at work to keep a floor under the market: (1) Bond yields have retreated and the Federal Reserve has put short-term rate hikes on hold. The yield on the 10-year Treasury bond has fallen back down to the range where it has spent most of the past three years. The Fed has seen enough economic slowing that it is more confident inflation is under control. (2) Oil and gas prices have pulled back sharply. The real effect of high oil prices can be debated, but there is no question that the lower prices bring great relief to consumers and take the pressure off inflation. (3) Corporate earnings are still very good. Businesses are generally in sound financial shape and are operating very profitably. Corporate profits have been surging since 2002 and remain at very high levels.

Looking to the end of the year and into early 2007, stocks are likely to grind higher. While it is hard to make the case for a raging bull market, conditions are not yet ripe for a bear market in the near term. There are bound to be bumps along the way. The pending elections, geopolitical issues and increasing concerns about a housing bust tipping the economy into recession should provide plenty of opportunity for volatility. Longer term, we can't escape the cyclical nature of the market, and at some point the bears must have their turn. In addition, major economic imbalances related to budget and trade deficits, entitlement spending, low savings rates and high debt levels give us cause for concern. A flexible, diversified and balanced investment approach will continue to be very important.