

INVESTMENT OUTLOOK

Fourth Quarter and Year 2006 Review and Outlook

by Whitney Brown

- Strong fourth quarter rally for stock market.
- Federal Reserve remains on hold.
- Oil prices stable.
- Conditions favorable for further market advance.



Market Review - A persistent market rally over the last four months of the year caught a lot of investors off guard. Many were very pleased though some skeptics were left wondering what had just happened. While for the year the market progressed somewhat as anticipated, an expected low in the September-October period may have been too widely anticipated and actually occurred in July at the height of the Israeli-Hezbollah conflict and the ensuing spike in oil prices. The market rallied more or less continuously from August through year-end.

For the year all the major market indexes except the NASDAQ turned in double digit performances, an unexpected result given the age of this current bull cycle. While the bull market dating back to October 2002 has not been one of the most robust in historical terms, it is among the longest on record. International markets performed exceptionally well for the quarter and the year. For the fourth consecutive year foreign stocks easily out gained U. S. markets.

Nearly all types of stocks, large cap, mid cap and small cap, growth and value, participated in the rally. Active managers found it especially difficult to beat the indexes in 2006 as the market has not been very selective in the recent rally. Measures of return by various investing styles show that returns are more compressed than they have been in several years, meaning there has been little advantage in recent months to choosing one style over another such as large cap over small cap or value over growth.

At least two important factors are at work in supporting the positive climate for stocks. (1) Despite the negative implications of the slowing U.S. economy, the shaky housing market and persistently high energy costs, there is a growing confidence that the Federal Reserve is handling monetary policy in a competent and appropriate manner. (2) Perhaps more important to the big picture for financial assets, there is a tremendous pool of liquidity looking for investments. On a global basis there are large amounts of excess savings generated by booming emerging economies feeding this pool of liquidity.

<u>Market Measures</u>	<u>4th Qtr 2006</u>	<u>YTD 2006</u>
S & P 500	6.2%	13.6%
Dow Jones Industrial Average	6.7%	16.3%
NASDAQ Composite	7.0%	9.5%
Morgan Stanley EAFE	10.0%	23.5%
Lehman Bros. Intermediate Gov't Bond Index	0.8%	2.5%
	<u>12/31/06</u>	<u>12/31/05</u>
10-Year Treasury Bond Yield	4.71%	4.39%
Three-month Treasury Bill Yield	5.02%	4.08%

Interest Rates - We have commented numerous times over the past several years that longer-term interest rates such as the yield on the 10-year Treasury note appear to be in the process of bottoming out after declining for well over twenty years. This process can take years before rates really reverse and start rising in earnest. The past year has seen these longer rates marking time and remaining in a broad trading range. The Fed is on hold with regard to short-term rates, and there appear to be few catalysts to move longer-term rates one way or the other. The efficient movement of capital on a global basis, as well as the overall disinflationary effects of globalization of the economy, is helping keep rates low.

Energy and Commodities - Crude oil prices have moderated from the summer peak of \$77 per barrel, but \$60 per barrel is still not cheap by standards of recent years. A healthy global economy, continued strong emerging market demand from countries like China and India, a concerted effort by OPEC to manage production, and the sharp correction in July that took a lot of the speculative excess out of the market are all factors that should work to support prices at or above current levels.

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Warren Buffett Revisited

by Walter Dixon



Warren Buffett in late 1999 stated that investors likely would be disappointed by returns from stocks over the next 10-20 years. In a

Fortune magazine article based on a talk by Buffett, he commented on investors' unrealistic expectations for equities, which had developed gradually during the great 17-year bull market that got started in 1982.

Two important economic variables had contributed to the stock market's outstanding returns:

1. Corporate profitability had risen back into the upper part of its historic normalcy range, and
2. Interest rates had fallen sharply (long-term Government bonds from 15% to 5%).

Buffett also commented on stock market psychology. In his words: "Once a [sustained] bull market gets under way...a crowd is attracted into the game that is responding not to interest rates and profits but simply to the fact that it seems a mistake to be out of stocks."

That is how investors were thinking in late 1999, as the Dow Jones Industrial Average approached its all-time high. A Paine Webber/Gallup survey conducted that summer showed new equity investors (those with fewer than 5 years experience) expecting *annual* returns of 22% over the next 10 years. And those with 20+ years experience were looking for nearly 13%.

Buffett, in effect, said, "No way!"

To come close to even 13%, he argued, interest rates had to fall further – possibly drop in half, and/or corporate profitability had to rise even higher, above what was already a high level historically. He emphatically

thought that these were not reasonable assumptions.

Today, seven years later, we find that, indeed:

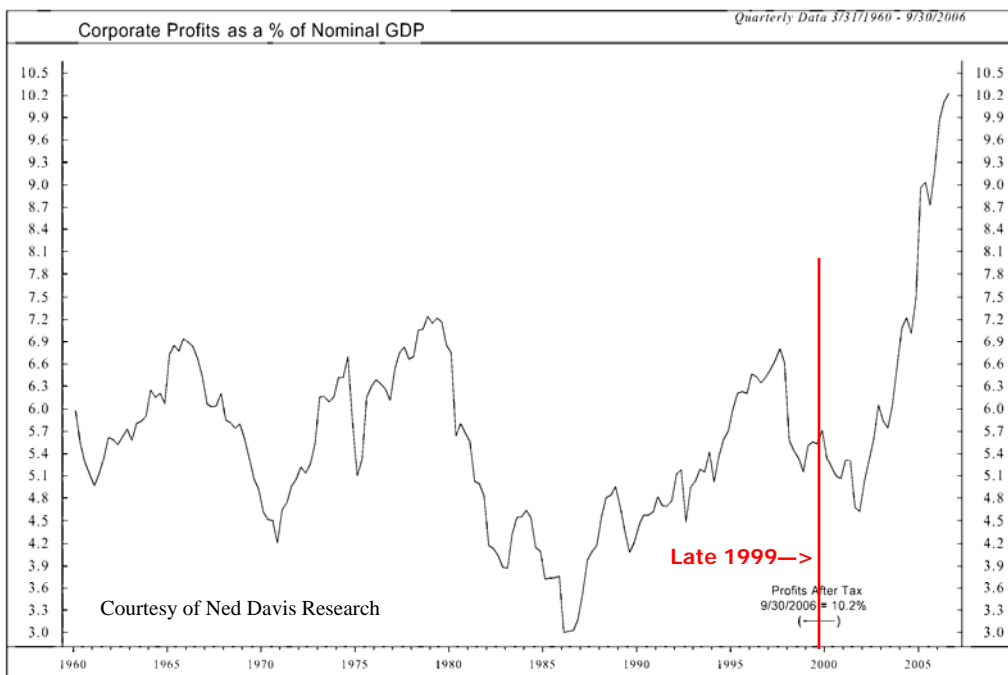
1. Corporate profitability has risen well above its historic high range, and
2. Interest rates did drop in half, although they have since reversed direction and recovered some of the decline.

The accompanying charts bring us up to date. The chart below at left shows the surge in corporate profits from 2001 to the present. The chart on page 3 illustrates the sharp drop in interest rates from 2000 to a low in 2003. They are higher now but not at all close to where they were.

At the very least, this may explain why stock prices have done so well during the past 4 years. Of course, as Buffett stated in the Fortune article, his perspective was 15-20 years, not 4. Also, we know that after a major market peak and sharp decline like the 2000 to 2002 period, multi-year cyclical rallies against the long-term trend are not uncommon.

In the same 1999 article Buffett warned against thinking that somehow 'this time it's different' because of the information technology revolution. He singled out two earlier industries, automobile manufacturing and commercial airlines, as having had profound impact on our society but also having proved to be very poor investments. "The key to investing," he said, "is not assessing how much an industry is going to affect society, or how

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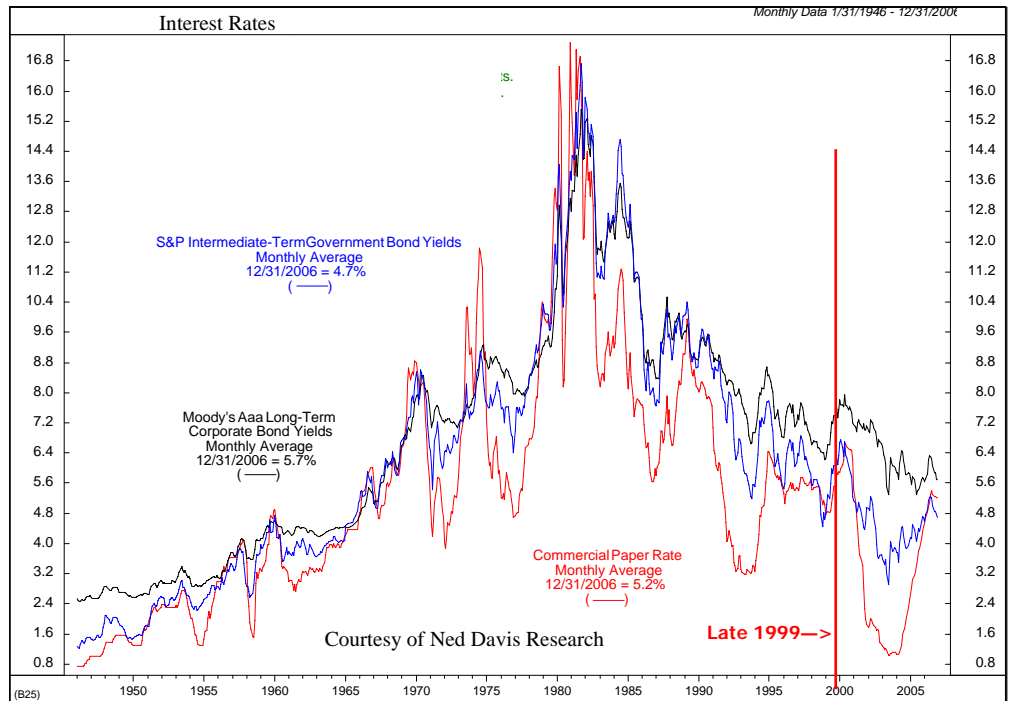


Warren Buffett Revisited (continued)

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much it will grow, but rather determining the competitive advantage of any given company and, above all, the durability of that advantage.”

Buffett wound up his comments by saying that although in 2016 investors may be feeling disappointment, they will probably be enjoying far higher standards of living than they were currently (in 1999). He also opined that, “the rewards from this creation of wealth will have flowed through to Americans in general... That wouldn't be a bad world at all – even if it doesn't measure up to what investors got used to in the 17 years just passed.”



Tax Considerations for 2007

by Ted Feinour



Since 2001, when the Economic Growth and Tax Relief Reconciliation Act was adopted, there has been a phased increase of estate and gift tax exemptions. For 2007 the estate tax exemption will remain at a level which shelters \$2 million of assets, the same as 2006.

The exemption will also stay at this level for 2008, but will jump to \$3.5 million in 2009. With a Democratic-controlled congress, it does not appear that the estate tax will be eliminated in the near future.

For annual gifts this year, the amount one individual may give another is \$12,000, also remaining at the 2006 level. Furthermore, spouses who consent to combine their gifts may transfer \$24,000 to any individual free of the gift and generation-skipping transfer tax. This annual exclusion is allowed for gifts of present interests, but not for gifts of future interests in property. Present interests include any interests that

are available for the recipient's immediate use, possession, or enjoyment. An unlimited amount of property can be transferred between spouses.

In addition to the annual \$12,000 exclusion, an unlimited gift tax exclusion is permitted for amounts paid on behalf of a recipient directly to an educational organization, provided this is for tuition. Amounts paid for books, dormitory fees or board are not eligible to be excluded.

For traditional individual retirement accounts or Roth IRAs, the permitted contributions remain at \$4,000 for 2007. There is, however, a \$1,000 additional "catch up contribution" that may be made if one is over the age of 50. Individuals have until the due date of their tax returns to make contributions to their IRAs for the return year, this date being April 15, 2007 for the 2006 tax year.

We recommend, when planning your gifts and/or changes to your will, that you consult your attorney or accountant to ensure adherence to the tax regulations.

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Commodities prices, especially for metals and other natural resources, also remain at high levels. Strong demand on a global basis, especially Asia, is the primary factor. In addition, during previous years of low commodity prices, producers failed to invest in exploration and development and are now being forced to play catch up with demand. Such development takes years, and supply should eventually rise to meet demand but not in the near future.

Outlook - Trying to conjure future market performance from current economic and market conditions is usually an exercise in humility, but at this point the weight of the evidence gives the advantage to the bulls. By some measures the stock market is one of the better values among asset classes right now. Commodities have run up considerably in price. Credit spreads on bonds are very tight meaning there is little reward for taking risk in corporate bonds, lower credit quality issues or longer maturities. In addition, commercial real estate has experienced huge price inflation.

Corporate profits and finances are in excellent shape. Though starting to slow, the strength in corporate profits has been a great positive factor countering the breakdown in the housing market. With earnings growing faster than stock prices for at least the past two years, P/E ratios have continued to contract even though the market has been rising.

On the interest rate front, the slowing U.S. economy will help to keep a lid on interest rates. Although some foreign economies are still in a tightening mode, there is considerable

conjecture that the Fed may need to cut rates sometime in 2007 to prevent the slowdown from tipping into recession.

As always, there are some risks to the outlook. Complacency is perhaps the greatest risk of all. Investors have shown a voracious appetite for risk. The proliferation of exotic derivative investments, explosive growth of hedge funds, low market volatility and the contraction of credit spreads in the bond market are all evidence of a casual attitude toward risk. Unexpected weakness in the global economy, a sudden surge in interest rates or an unanticipated drop in the dollar could throw the markets off balance and return a more appropriate level of risk to the equation.

Also, while stocks are not currently considered overvalued by most measures, the excess valuations from the pre-2000 bubble have not been fully corrected. Historically, stocks usually become significantly undervalued before the stage is set for the next long-term advance. Too, while the Dow has recovered and gone on to all time highs, the S&P 500 and the NASDAQ remain well below the 2000 bubble highs reminding us that this advance has been a cyclical one within a long-term trend that is less than favorable.

We believe that the best indicator of what the market is going to do is what it actually is doing. For that reason we will remain flexible and alert to the shifting of investor sentiment and asset preferences while monitoring the overall health of the market. A balanced and carefully diversified portfolio should continue to allow investors to take advantage of what the market has to offer while limiting risk. Best wishes for a healthy and prosperous 2007.