

## Capital Markets Outlook

IN HIS BRILLIANT and challenging book, *Fooled by Randomness*, Nassim Nicholas Taleb warns us about the perils of watching the markets too closely. We are not psychologically equipped to handle their variability. Losses far outweigh gains in their emotional impact. As a consequence, we often take market positions that insulate us from frequent bad news but are sub-optimal or, even worse, expose us to infrequent but catastrophic loss events. We maximize good feelings instead of our chances for economic success. Taleb's book is a must-read for investors.

Hopefully, looking at the markets on a quarterly basis, as we do here, will not expose us to the perils of frequent market-watching. We look at the markets periodically in order to track their underlying economics and valuation trends. From an asset allocation perspective, our interest is not in taking advantage of market trends by adjusting asset allocations (market timing) but in keeping ourselves well informed so that we can avoid over-exposure to irrationally priced markets and make better judgments about long-term expectations.

A review of changes in the capital markets since last October shows little reason to change our three-to-five-year return outlooks. If anything, we may be inclined to assign a higher degree of confidence to our projected returns since they have proven to be largely in line with the near-term outlooks voiced by many prominent Wall Street analysts, as reported in *Barron's* in December 2006. We should take caution, however, when our views are congruent with the majority opinion. Although being in the majority may be comforting, it does not necessarily keep us from being mistaken, and—as Taleb warns us—we should be cautious about seeking the comfort of crowds.

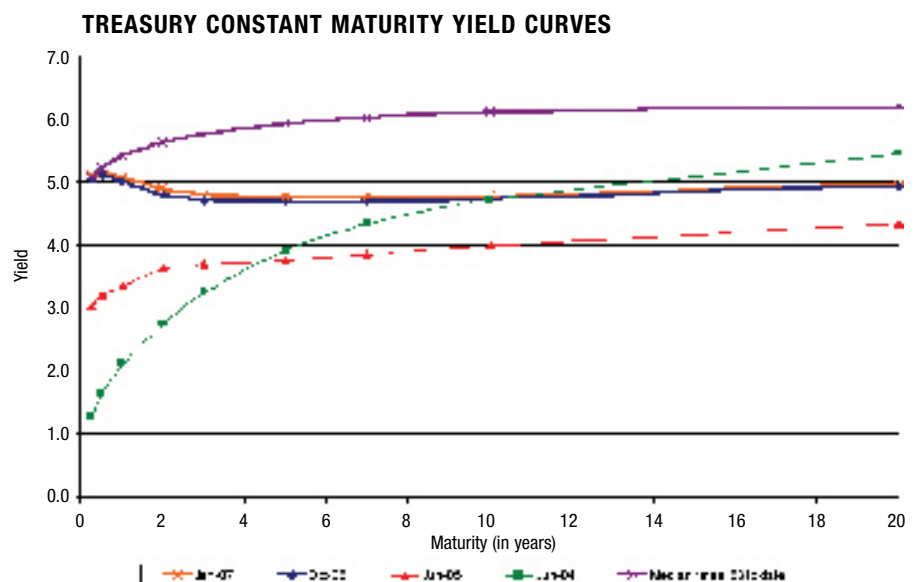
### U.S. BOND MARKET

We begin this review with the bond market rather than the stock market. Much space has been devoted recently in the popular and the financial press to trying to guess where U.S. interest rates and the economy are headed, especially now that the Fed has left the target federal funds rates unchanged since late June of 2006.

Figure CMO.1 shows the mid-January Treasury yield curve. It is almost identical to the late October yield curve—two or three basis points higher on the short end, several basis points lower on the long end—and inverted. As most investors know, every recession since 1970 has been preceded by an inverted yield curve, although not every inverted yield curve has presaged a recession. (The joke among economists is that inverted yield curves have predicted eight of the last five recessions.) Nevertheless, the inverted yield curve has many commentators talking about the possibility of a recession or, alternatively, a soft-landing—a measured slowdown in economic growth.

Forward rates in the bond market would indicate that fixed-income investors have implicitly accepted the soft-landing scenario. Figure CMO.2 compares the implied forward rates in the mid-January yield curve

Watching the markets too closely is perilous to our health. As Taleb warns us, we are not equipped psychologically to handle their variability.



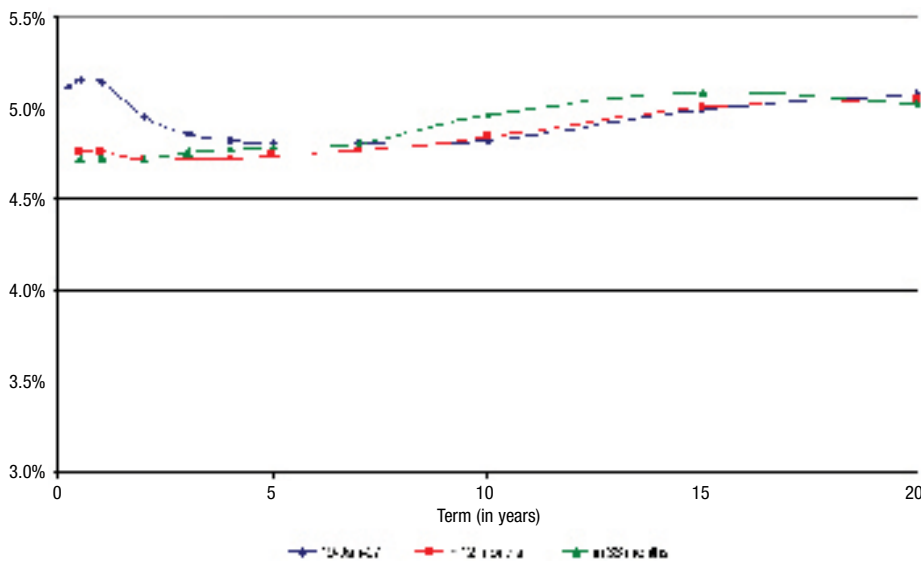
**Figure CMO.1:** Treasury Constant Maturity Yield Curves  
**Source:** Federal Reserve Board and *Advisor* calculations

with current rates. As in late October, the market still sees short-term rates declining within the next year by 0.25% to 0.50% and little movement in long-term rates. Why else would investors be buying three-year Treasuries to yield 4.86% in January when they could buy six-month or one year Treasuries to yield 5.15%? Although one can make arguments for the yield curve returning to normal through an increase in long-term rates, the market thinks that short-term rates will be the ones to change. This implicit view may reflect confidence in the central bank's ability to keep inflation under control, or it may reflect a concern about slower growth, or both.

In any case, inflation expectations are clearly moderate. The difference between the nominal five-year Treasury rate and the rate on five year Treasury inflation-protected securities (TIPS) has not changed appreciably since October. The mid-January differential of 2.23% is 0.06%

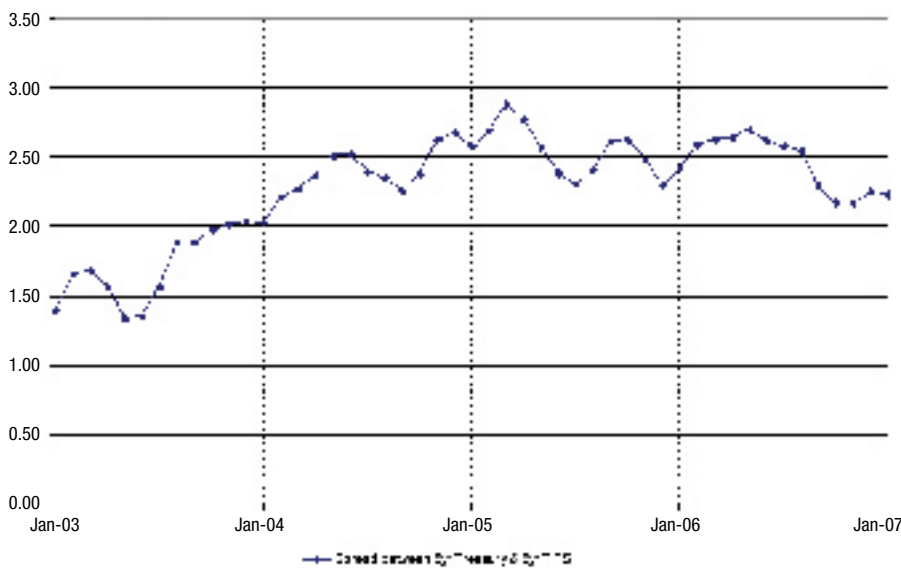


**ACTUAL AND FORWARD SPOT TREASURY RATE CURVES**



**Figure CMO.2:** Actual and Forward Spot Treasury Rate Curves  
**Source:** Advisor calculations

**INFLATION EXPECTATIONS**

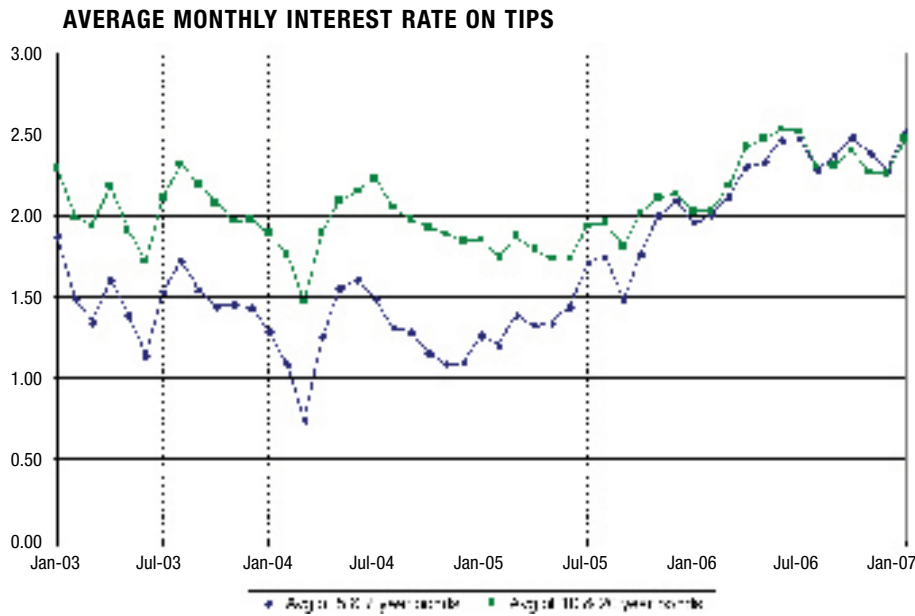


**Figure CMO.3:** Inflation Expectations  
**Source:** Federal Reserve Board and Advisor calculations

higher than the October average of 2.17%. This differential is a measure of expected inflation since bond investors would not accept a nominal Treasury yield that did not offer a sufficient premium over the TIPS rate to compensate for inflation over the life of the Treasury note. Figure CMO.3 shows the history of this differential since 2003.

Real interest rates have not changed appreciably since late October. The rates on TIPS have varied in a range of approximately 20 basis points since July of 2006. Rates in late January were within five basis points of October levels, with the five-year TIPS nearly unchanged at 2.50% for the week ended January 26. Figure CMO.4 reports average monthly rates through December 2006 and the average weekly rate for the week ended January 19.

In the corporate bond market, credit spreads (the premiums over Treasury rates paid by corporate borrowers for their credit risk) on U.S. corporate bonds have gotten slimmer by five to ten basis points since last October—in both the investment grade and the non-investment or high-yield sectors. Credit spreads on both AAA and Baa bonds are now both below the median spread since 1993, as are credit spreads on high-yield bonds. Figure CMO.5 and CMO.6 report the history of credit spreads for the investment grade and high-yield sectors, respectively.



**Figure CMO.4:** Average Monthly Interest Rate on TIPS  
**Source:** Federal Reserve Board and *Advisor* calculations

### INTERNATIONAL BOND MARKET

In the international bond market, despite rate increases by several central banks, including the European Central Bank and the Bank of England, yields on ten-year government bonds in developed nations are generally at or below their mid-year 2006 levels and relatively unchanged from late fall. See Figure CMO.7 for a comparison of U.S., UK, German, and Japan bond yields.

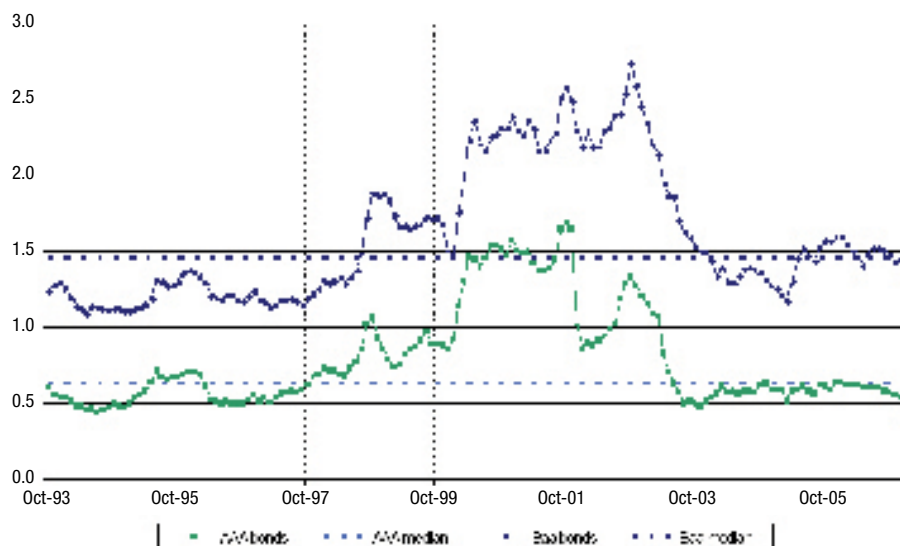
Yields on emerging market sovereign debt continue at or near their recent minimum levels. Spreads relative to U.S. Treasuries on Asian emerging-market sovereign debt have continued to shrink while spreads on the sovereign debt of emerging market nations in Europe and Latin

Forward rates indicate that the bond market expects a soft landing and a decrease in short-term rates of 0.25% to 0.50% within 12 months.



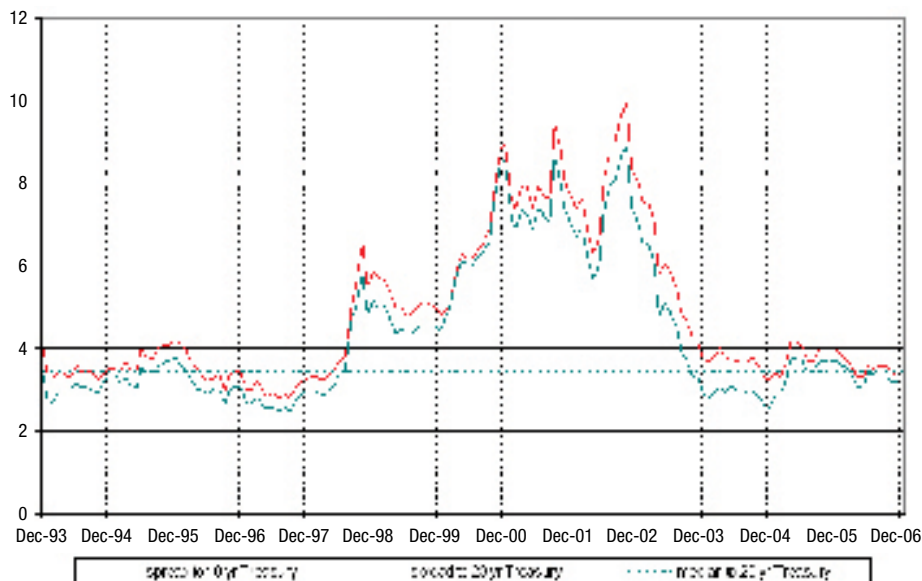


**U.S. INVESTMENT-GRADE CORPORATE BOND CREDIT SPREADS, MONTHLY AVERAGES**



**Figure CMO.5:** U.S. Investment-grade Corporate Bond Credit Spreads, Monthly Averages  
**Source:** Federal Reserve Board and *Advisor* calculations

**U.S. HIGH-YIELD CORPORATE BOND SPREADS**



**Figure CMO.6:** U.S. High-yield Corporate Bond Spreads  
**Source:** Merrill Lynch, Federal Reserve Board, and *Advisor* calculations

America have remained relatively unchanged since late fall. The yields on all of the sovereign issues tracked in Figure CMO.8 declined from July of last year. Figure CMO.8 reports yields on selected emerging market sovereign debt.

The editor is obliged to note that the rates reported for Brazil long-term government bonds in the previous issue of the *Advisor* were incorrect. The rate reported was an administered rate offered by the Central Bank of Brazil and labeled by the bank as “long-term” and not a market-derived rate from secondary market trading. The administered rate is not indicative of long-term market rates, as can be judged by the difference between the secondary market yield for three-year government bonds, which is more than 12%, and the “long-term” central bank rate of 6.85%.

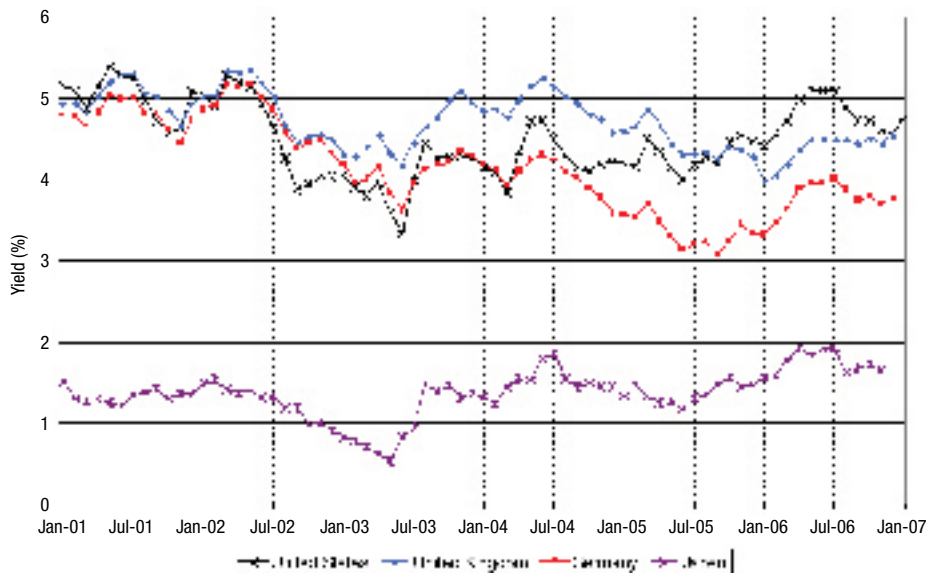
**U.S. STOCK MARKET**

The nine analysts surveyed by *Barron's* in its Outlook 2007 issue last December projected a range of earnings growth from 3% to 9% for the S&P 500 for the year. Their median projection of just 5% is decidedly more pessimistic than the eight thousand plus analysts' projections for the companies that make up the index, which, in aggregate, average to 10%. For comparison, the *Advisor's* October projection was 7% over the next three to five years.

We continue to believe 7% is a reasonable three-to-five-year earnings growth rate for the S&P 500. Although analysts have been surprised by stronger than expected earnings for 2006, with earnings for 2006 now estimated at more than \$80 per share compared to an estimate of \$74 per share in October, we continue to be concerned about the level of corporate profits as a share of national income. At the end of the third quarter of 2006, it stood at 14.1%, the highest level ever for the data set that starts in 1929. Until we have a good understanding of the fundamental economic changes, if any, that account for this record level of profits, the prudent investor must assume that earnings growth will slow over the next several years. Otherwise, corporate profits will comprise an ever-increasing and unprecedented portion of national income.

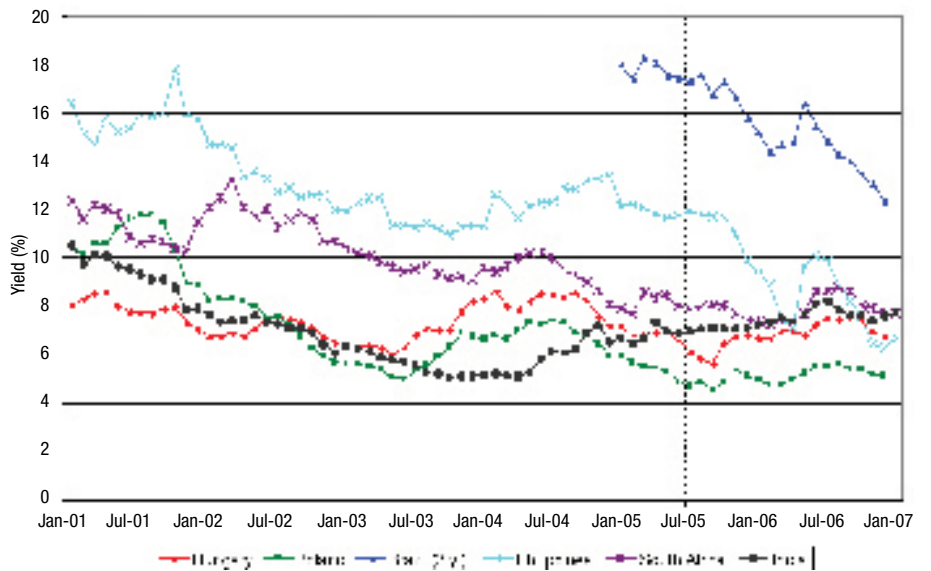
As we noted in the last issue, the recovery of stock prices since 2003 has been driven by the increase in corporate earnings and not by increases in valuations or earnings multiples. Figure CMO.9 shows the index price, earnings per share, and price/earnings ratios for the S&P 500.

**TEN-YEAR GOVERNMENT BOND RATES**



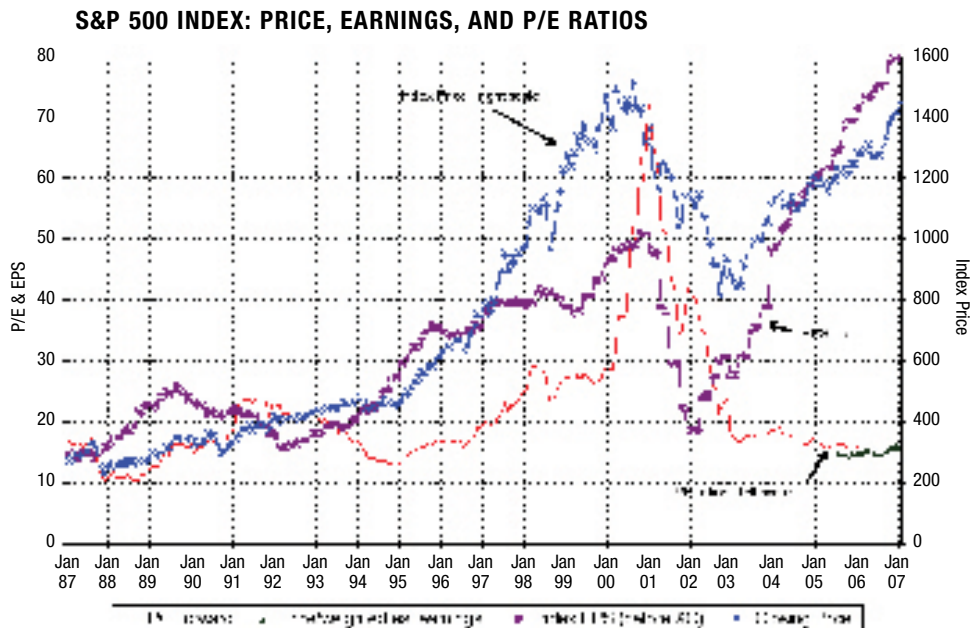
**Figure CMO.7:** Yields on the Ten-year Government Bonds of Selected OECD Countries  
**Source:** Federal Reserve Board, European Central Bank, Bank of Japan

**EMERGING MARKET SELECTED LONG-TERM (TEN-YEAR) BOND YIELDS**



**Figure CMO.8:** Yields on the Ten-year Government Bonds of Selected Emerging Market Nations  
**Source:** European Central Bank, Bloomberg





**Figure CMO.9:** S&P 500 Index: Price, Earnings, and P/E Ratios  
**Source:** Bloomberg and Advisor calculations

Valuations have increased moderately, however, since October. The P/E ratio for the S&P 500 increased from 15.8 to 15.9 from October to February. Multiples for the mid-cap and small-cap index also increased. The table in figure CMO.10 reports current P/E multiples and compares them to those at the end of October 2006 and the longer-term medians. In all cases, the P/E ratios are to forward or estimated future earnings. The modest increases in valuation multiples since the third quarter of 2006 now leave them nearer the long-term medians.

Our expectations for returns on U.S. equities remain unchanged from the fall 2006 issue. Further increases in multiples, if sustained, would increase our return expectations. However, we don't believe further increases would be sustained long term. The fundamental factors that could increase P/E multiples—increased earnings growth, a reduction in the real interest rate, a reduction in inflation

expectations, or a reduction in the equity risk premium—all seem remote. Figure CMO.11 compares our current total return projections for large- and small-cap U.S. stocks with our last projections. Some minor adjustments to dividend rates have been incorporated in the current projections but are lost in the rounding when compared with the previous outlook.

Finally, we note that short interest in the S&P 500 index remains relatively unchanged from levels last October, indicating no significant change in investor market sentiment.

**CURRENT VS. HISTORICAL MONTH-END PRICE/EARNINGS RATIOS**

	Current vs. Historical Month-end Price/Earnings Ratios (based on 12-month forward operating earnings, actual and/or estimated)			
	Current (2/2)	10/27/2006	10-year Median	20-year Median
S&P 500 large-cap	15.9	15.8	23.2	17.8
S&P 400 mid-cap	18.5	17.6	20.4	n/a
S&P 600 small-cap	19.9	18.8	21.7	n/a

**Figure CMO.10:** P/E Ratios, Price to Forward-Year Operating Earnings, Estimated or Actual for U.S. Large-, Mid-, and Small-Cap Stocks  
**Source:** Bloomberg and Advisor calculations

**INTERNATIONAL STOCK MARKET**

Returns for 2006 from most international stock markets were higher than the 15.8% total return for the S&P 500, with Japan being a major exception. Nearly all of the major euro area market indices had total returns in excess of 20%. Taking into account the 10% price appreciation of the euro, returns to U.S. investors were more than 30%. The UK market had a more modest return of 14.8%, but compounded with a nearly 14% increase in the value of the pound relative to the dollar, it still produced returns on a dollar basis comparable to the euro area markets. Emerging market returns were even stronger, with total returns of 33% for Brazil, 51% for Mexico, 39% for Hong Kong, 48% for India, and more than 100% for China, all on a local currency basis. The 8% return in Japan on the NIKKEI 225 index was modest by comparison.



**U.S. STOCK MARKET RETURN ASSUMPTIONS AND PROJECTIONS**

	Large-cap stocks (S&P 500)		Small-cap stocks (S&P 600)	
	Oct '06	Feb '07	Oct '06	Feb '07
Earnings growth per year	7.0%	7.0%	10.0%	10.0%
Current P/E <i>(to estimated forward earnings)</i>	15.0	16.0	17.5	19.9
Future P/E multiple	15.0	16.0	17.5	19.9
6/09 and 12/09 Index	1,556	1,775	500	550
Price appreciation per year	7.0%	7.0%	10.0%	10.0%
Dividend return per year	1.8%	1.8%	1.0%	1.0%
<b>Total return per year</b>	<b>8.9%</b>	<b>8.9%</b>	<b>11.1%</b>	<b>11.1%</b>
Nominal GDP growth per year	5.4%	5.4%	5.4%	5.4%

**Figure CMO.11:** U.S. Stock Market Return Assumptions and Projections  
**Source:** *Asset Allocation Advisor*

Foreign stock markets had a banner year in 2006, returning more than 30% to U.S. investors in many cases.

Equity analysts on average have made modest reductions in their long-term earnings growth estimates for the UK and the euro area. A survey of the more than six thousand earnings estimates for companies in the equity indices shows changes in the projections for long-term earnings growth from 9.3% to 8.5% for the UK and 8.4% to 7.2% for the euro area. This reduction in longer term earnings has been offset by increases in the P/E ratio to forward earnings for the UK and euro area markets. As of early February, the weighted average P/E ratio to estimated future earnings was 14.3 for the major euro area indices, up from 13.2 last September and 13.3 for the FTSE-100, up from 12.0 in mid-September. Figure CMO.12 shows the increase in P/E ratios from last fall for the major euro area stock market indices.

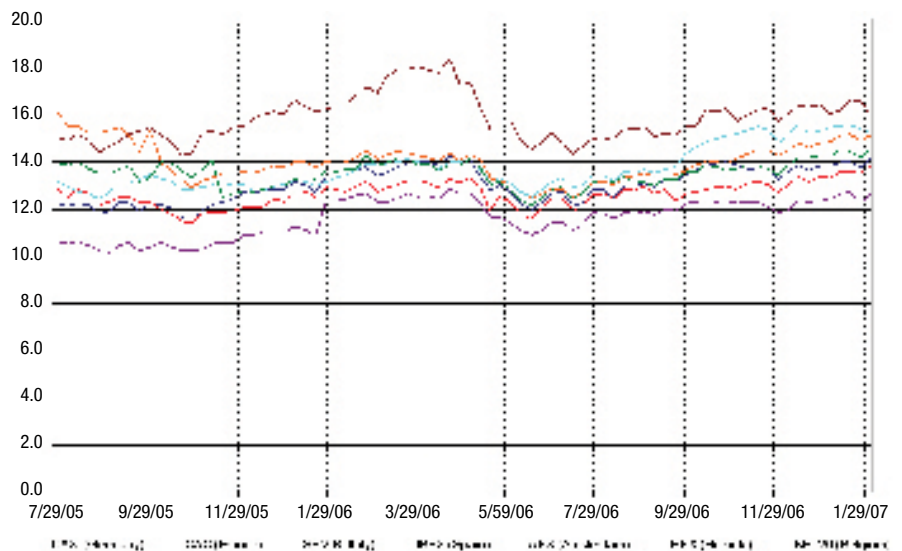
At 14.3 on average, the P/E ratio for the euro area is above the median of 13.2 for valuations over the past five to thirteen years. The only major euro area indices trading below their medians are the DAX 30 in Germany and the Helsinki index. The FTSE-100 also continues to trade below its thirteen year median. We need to exercise some caution in making comparisons with median valuations, however, since in no case is the data as long historically as it is for the U.S. market.

Regarding Japan, analysts' estimates for long-term earnings growth have increased marginally from 11.1% last fall to 11.3% in early February. The price/earnings multiple on estimated earnings has edged up from 40 in mid-September to 43 in February. It remains above the trend line multiple of 38 to 40, but appreciably below the median multiple since 1993 of 58.5. Figure CMO.13 shows the history of estimated earnings and earnings valuations for the NIKKEI 225 index.

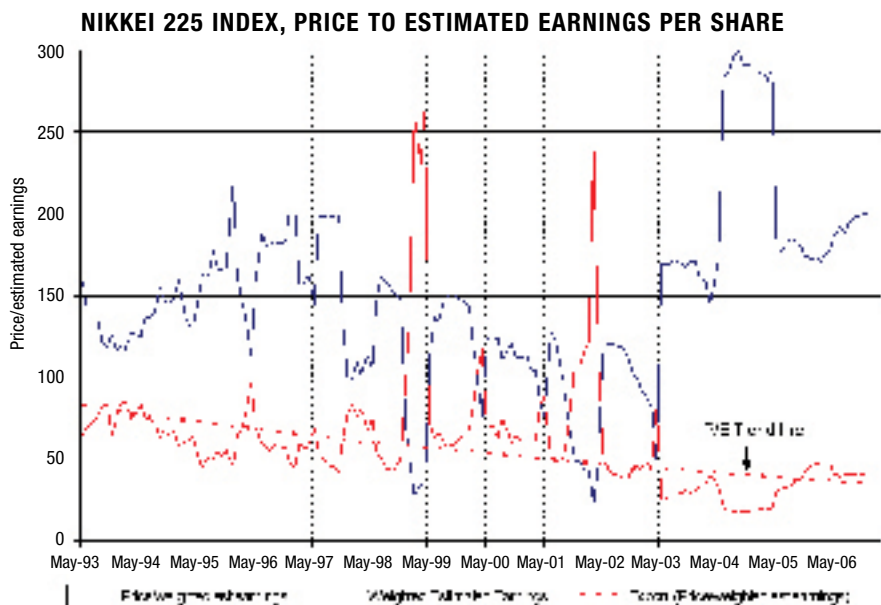
Overall, despite the changes in earnings growth estimates, market valuations, and forward exchange rates, we see no reason to make any material adjustments to the expected international equity returns in the last issue of the *Advisor*. The following list reprises the return expectations (including the effects of currency changes) over the next three to five years from



**EURO AREA STOCK MARKET P/E RATIOS TO ESTIMATED EARNINGS**



**Figure CMO.12:** Euro Area Stock Market P/E Ratios to Estimated Earnings  
**Source:** Bloomberg and *Advisor* calculations



**Figure CMO.13:** NIKKEI 225 Index, Price to Estimated Earnings Per Share  
**Source:** Bloomberg and Advisor calculations

the four international equity categories included among the seventeen asset categories for portfolio optimization.

- UK stocks: 13.3%**
- Euro area stocks: 12.5%**
- Japan stocks: 13.0%**
- Emerging-market stocks: 15.0%**

(The full text of the last issue, including the detailed analysis behind the return expectations, can be found at [www.aametrics.com](http://www.aametrics.com).)

**REAL ESTATE, VENTURE CAPITAL, AND COMMODITIES**

Equity investments in real estate generated a total return just in excess of 35% for 2006 according to the National Association of Real Estate Investment Trusts total return index. This strong performance was largely the result of higher valuations rather



Market valuations of U.S. corporate earnings have increased modestly since last fall, with the S&P 500 trading in early February at 15.9 times estimated earnings.

than higher expectations about future financial performance. Although the median projection for long-term earnings growth increased modestly from 6.1% to 6.4% between October and February, valuations increased much more dramatically. The table in figure CMO.14 shows early February valuation levels on a price-to-forward earnings and price-to-cash-flow basis.

**EQUITY REIT VALUATION COMPARISONS**

Equity REIT Category	Price/Year-Forward Earnings			Price/Cash Flow			Time Period
	Feb '07	Oct '06	Median	Feb '07	Oct '06	Median	
Office & Industrial	17.3	14.8	11.1	14.7	11.1	8.7	1990 to date
Residential	21.6	20.5	12.0	13.9	13.0	8.3	1990 to date
Shopping Centers	19.1	15.9	11.9	13.4	10.8	8.0	1987 to date
Diversified	18.1	15.8	12.2	13.1	10.9	8.6	1986 to date

**Figure CMO.14:** Equity REIT Valuation Comparisons  
**Source:** Reuters StockVal

Our three-to-five-year projected total return for real estate, as developed in the last issue of the Advisor, is 7.5%. With projected earnings growth of 6.4% and projected cash flow per share growth of just under 4.0%, valuations will have to stay at current levels to meet our 7.5% projected total return. Any substantial reduction in valuation multiples will reduce total returns. Accordingly, endowments whose real estate allocations have increased above 5% should consider reducing their allocations to this class.

Venture capital returns through the first three quarters of 2006 produced returns in sharp contrast to real estate. The venture capital index of Sand Hill Econometrics showed a total return of only 2.6% for the nine months ended 30 September 2006. Our three-to-five-year projected return of 16% from this asset class may prove to be overly optimistic if returns continue to be so poor. The performance of individual venture capital funds, of course, can diverge widely from this index of all funds.

Commodity returns are reviewed in the following article.