SMS Capital Management, LLC

www.smscap.com

Phoenix Tower • 3200 Southwest Freeway, Suite 3300 • Houston, Texas 77027-7526
Phone 713-402-6116 • Fax 713-840-6005 • Email info@smscap.com

Market Commentary 2007
"U.S. Economy - Irreconcilable Differences?"

January 2007

By Steven M. Sheldon, CFA

About SMS Capital Management

SMS provides investment management services to individual investors desiring to preserve and build long-term wealth. As a fee-based firm, SMS has an independent, objective and sound approach to portfolio management. The firm is a Registered Investment Adviser.

About the Author

Steven Sheldon has more than thirteen years of professional experience analyzing and managing investments. Prior to founding SMS, Mr. Sheldon worked as a senior member of a corporate principal investments group. Mr. Sheldon has an MBA from Tulane University and a BBA from The University of Texas. In addition, he is a CFA charterholder and a member of both the CFA Institute and the Houston Society of Financial Analysts (HSFA).

In June, when I wrote my midyear review entitled, *"Time to Go Shopping?",* I had the right idea by encouraging investors to start getting more aggressive about owning stocks. Since the third quarter, stocks have been on a tear, essentially moving in a straight line up.

However, I must admit that I did not expect the market to turn so quickly and was even a little slow to heed my own advice. At mid year, my 2006 expectations were for a mildly profitable year with a 5% total return for the S&P 500. My bullish enthusiasm was reserved for 2007 which I thought could be a very strong up year. While I got the market's direction right, the S&P 500 has bested my 2006 target by about 10% (as of 12/14). Given this strong run, I have adjusted my outlook for 2007 down, as I think we have simply received a portion of next year's returns early (thanks largely to falling oil prices and robust corporate earnings growth).

Given my expectation for decent growth in corporate earnings and a continuation of a low interest rate environment, I expect the S&P 500 to reach 1550 by the end of 2007. This represents about an 11% total return next year (down from my prior estimate of roughly 25%).

2006 Review

It is easy to sum up 2006 because it was two completely different stories: the first half and the second half. The first half of the year was a challenging investing environment, marked by record high oil prices, rising interest rates, and plenty of investor fear. After a strong start to the year, there was an overdue stock market correction in May/June that saw the S&P 500 lose 8% from its peak logged earlier on in the year. Many investment professionals and market strategists, including myself, expected this correction to be more substantial since we have not had a 10% or greater correction since this bull market began in October 2002 (making this one of the longest bull markets on record).

However, as we moved into the summer months, the stock market found its footing. This was particularly surprisingly since the summer is typically the weakest seasonal period of the year. Despite the pessimistic environment, the

www.smscap.com
Phoenix Tower • 3200 Southwest Freeway, Suite 3300 • Houston, Texas 77027-7526
Phone 713-402-6116 • Fax 713-840-6005 • Email info@smscap.com

stock market continued to "climb the wall of worry" through December. Falling oil prices, strong corporate profits, and improving investor sentiment kept the bull market alive. Not even a transfer of power to Democrats in midterm elections could derail the market's advance.

2006 Total Returns
(Including Dividends)

Index	2006 Total Return (%)*
S&P 500	15.30
Nasdaq	8.76
Russell 2000 (Small Cap)	17.24
MSCI EAFE (International)	24.98
Emerging Markets	25.27
U.S. Bond Aggregate	4.43

*Returns through 12/18/06

Large and small caps had fairly comparable returns during the year, but both were beat out by international stocks once again. Despite getting clobbered by rising interest rates in the first half of the year, bonds managed a respectable gain as interest rates dropped in the back half.

Going their Separate Ways

The U.S. economy can be put into two broad categories: services-providing and goods-producing. The services economy includes healthcare, professional and business services, leisure and hospitality and the goods-providing is comprised of the nation's manufacturing and construction base.

For the last several years, both areas of the economy have been expanding at a decent pace. However, recently, their paths have diverged. The services economy continues to thrive while the good-producing economy has hit the skids. The U.S. auto sector continues to downsize while the construction industry grapples with the meltdown in residential real estate.

According to the Institute for Supply Management ("ISM"), which publishes surveys relied on by economists to give a pretty accurate read on the state of the economy, the manufacturing sector recorded its first indication of a contraction since April 2003. However, the services sector readings continue to

www.smscap.com
Phoenix Tower • 3200 Southwest Freeway, Suite 3300 • Houston, Texas 77027-7526
Phone 713-402-6116 • Fax 713-840-6005 • Email info@smscap.com

indicate solid growth. With no clear signs that the manufacturing sector has bottomed, the big question is whether the two economies - one hot and one cold - can coexist together much longer without further fallout. Or, will they end just like a celebrity marriage - on a piece of paper citing "irreconcilable differences?"

The chart below shows how significant the differences are in these two economies. In the period from September through November; the U.S. economy lost over 100,000 goods-producing jobs while over 300,000 service-producing jobs have been added to corporate payrolls.

Non-Farm U.S. Payrolls (in thousand's)

	Sep '06	Nov '06	Two Month Change
Goods-Producing	22,419	22,317	-102
Service-Providing	113,388	113,701	+313

Source: Bureau of Labor Statistics

The big danger is that prolonged weakness in housing and manufacturing may cause consumer spending (which accounts for 2/3 of the economy) to meaningfully decline. In time, that could push the entire U.S. economy, and quite possibly the global economy, into a full fledged recession.

For now, I am optimistic that the strong services economy, the wealth effect of the rising stock market, and the potential for some interest rate cuts by the Fed will be enough to keep the economy expanding, albeit at a lukewarm pace, through 2007.

Earnings

Generally, earnings should follow the economy. Is it possible that the current economic slowdown could lead to plunging earnings? In this current expansion, earnings growth and profitability has been stronger and more resilient than most pundits thought possible.

Since 2001, U.S. corporations have grown their earnings by double-digits every year with 2006 being no exception. Earnings for 2006 are expected to show 14% year over year growth. Over the long term, earnings should grow around the nominal rate of GDP growth (approximately 6%). So you can see that we have been in a serious above trend environment for some time.

www.smscap.com
Phoenix Tower • 3200 Southwest Freeway, Suite 3300 • Houston, Texas 77027-7526
Phone 713-402-6116 • Fax 713-840-6005 • Email info@smscap.com

While some of that growth has been artificially manufactured by stock buybacks (buybacks reduce the number of shares outstanding, thereby increasing earnings per share), the growth in corporate earnings over the last four years has been nothing short of spectacular.

While earnings may inevitably slow in 2007, and may even decline in certain sectors, they are unlikely to go negative for the companies comprising the S&P 500. In particular, large multinational corporations selling into global developing markets have strong momentum and more predictable earnings going into next year. **I believe that the S&P 500 should grow operating earnings by 7% to 9% in 2007. Assuming multiples can hold around 16.5x earnings, the S&P should climb to about 1550 by this time next year.**

Third Year's a Charm

Another reason to be optimistic for another up year in 2007 is that third years of the four year presidential election cycle are usually positive. In fact, there has not been a down year for the S&P 500 in the 3rd year of the cycle since FDR in 1937.

The theory behind this is that the administration starts to prime the economy to maintain a favorable economic environment so as to not lose control of the White House in the following year's election.

Portfolio Positioning

In this environment, investors should maintain their equity exposure at or slightly above their target levels. However, large cap stocks should comprise a significant portion of the equity allocation. The risk/return profile that U.S. large cap stocks offer at this stage of the business cycle is still more appealing than mid and small caps. That does not mean investors should completely abandon mid and small caps funds because they deserve a place in a well diversified portfolio. Investors may continue to trim gains and/or redeploy distributions from mid and small cap funds and reinvest them in larger cap funds. It would not be surprising to see the U.S. stock market have a pullback given the strength of the current run. Investors can use that as a buying opportunity. International funds should also perform well again in 2007 and we may see the Japanese market resume its bull market run after largely stalling out in 2006.

With regard to fixed income investments, sticking with high quality short-term investment grade bonds and U.S. treasury funds makes sense. The high yield

www.smscap.com

Phoenix Tower • 3200 Southwest Freeway, Suite 3300 • Houston, Texas 77027-7526
Phone 713-402-6116 • Fax 713-840-6005 • Email info@smscap.com

and REIT markets appear overheated. If the stock market hits a trouble patch in 2007 on news of further economic weakness, high quality bond funds should hold up well as investors move to safer investments. On the other hand, high yield bonds and REITs already at stretched valuations will likely decline in value. In addition, if the Fed decides to lower short term interest rates in the coming year, high quality, short-term bond funds stand to produce decent capital gains.

*None of the information or data presented herein constitutes a recommendation by SMS Capital Management, LLC or a solicitation of any offer to buy or sell any securities. Information presented is general information that does not take into account your individual circumstances, financial situation or needs, nor does it present a personalized recommendation to you.

Although information has been obtained from and is based upon sources SMS Capital believes to be reliable, we do not guarantee its accuracy and the information may be incomplete or condensed. This report is for informational purposes only and is not intended as an offer or solicitation for the purchase or sale of a security. Past performance is no indication of future results.