




Looking Ahead: 2007 Economic and Investment Outlook

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Once again, the U.S. economy was resilient in 2006 as it grappled with a housing slump, higher energy prices, a mid-term election, the continuing war on terror, weakness in the automotive sector, a change in Federal Reserve leadership, a large budget deficit, and growing trade imbalances. Based on those events, you may have surmised that the U.S. economy and financial markets performed poorly in 2006. Quite to the contrary.

The U.S. economy enjoyed its fifth consecutive year of economic expansion, posting growth of approximately 3.4%. Stock markets, both domestic and international, recorded solid double-digit gains. Market returns actually exceeded their long-term historical averages. Both the Dow Jones Industrial Average and S&P 500 Index reached new highs and recovered all the painful losses experienced during the 2001–2003 market correction.

Similarly, though not as strong, fixed income returns, both domestic and international, posted positive results. Investors enjoyed another year of healthy investment returns with the majority of fixed-income securities providing a total return equivalent to -- or exceeding -- their indicated yield.

As we strive to maximize portfolio returns while managing risk for our clients, we must understand current

economic conditions and market fundamentals and anticipate changes in 2007 that will either positively or negatively impact our clients' portfolios and investment returns. Our 2007 Economic and Investment Outlook will guide NextTier Wealth Management's decisions and recommendations for the coming year.

U.S. Economy

The U.S. economy will continue to expand in 2007 at a decelerating rate. After posting economic growth of approximately 3.4% in 2006, the U.S. economy is poised to grow at a modest 2-2.5% rate in 2007 as the effects of the housing correction work their way through the economy. While "soft landings" are difficult to engineer, we believe the Federal Reserve has done an exemplary job managing short-term rates thus far and has positioned the U.S. for such a landing. A successful "soft landing" will result from the U.S. economy avoiding high inflation and interest rates and a recession while the growth rate slows. As measured by Gross Domestic Product (GDP), economic growth of 2-3% should keep inflation from accelerating. We believe the Fed will successfully create a Goldilocks scenario in which the economy is not too hot and not too cold. Economic growth in the first half of 2007 will be slower than the second half as the housing

correction impacts the economy. Economic growth during the second half will be driven by a strong export market resulting from a weakening U.S. dollar.

We anticipate inflation, as measured by the Consumer Price Index, to ease in 2007 to 2-2.5% from approximately 3.5% in 2006, primarily due to lower energy costs and continued improvement in productivity. The risk to our inflation outlook centers on wage pressures, a slowdown in productivity gains, and energy prices. The current low unemployment rate suggests the possibility of continued wage pressure. Businesses that are able to generate greater output per man-hour can tolerate increased costs without raising prices. Slowing productivity decreases the rate at which the economy can comfortably grow without higher inflation.

Housing and Labor Implications

The majority of economists believe that the worst of the housing market correction is behind us. We agree. Softness in the 2006 housing market was primarily the result of an excessive inventory build. Housing inventories became excessive due to low interest rates, a strong economy, and speculative buyers entering the market. We are now in the early stages of restoring fundamental

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balance to supply and demand in the housing sector. The pace of new home construction should bottom out in early 2007 as builders reduce supply to better match demand. The average selling price of a home will decline in 2007 in the “bubble” markets such as Florida, California, and cities in Arizona and Nevada. Median home prices in markets that did not participate in the housing bubble will experience a modest price increase in 2007. Attractive mortgage rates, declining inventories, and a healthy job market will prevent the overall housing market from further deterioration.

Recent activity in the labor market also supports our prediction of a “soft landing” scenario developing for the U.S. economy. The unemployment rate remains low. Job growth in the service sector is offsetting weakness experienced in the manufacturing sector (housing and automotive). Government, leisure, and hospitality hires lead employment growth in the service sector. We estimate 1.2 million jobs will be added in 2007 vs. 1.8 million in 2006. Stable consumer spending, an increase in exports, and steady business investment spending are all contributing factors to job growth.

Reflecting slower economic growth, average energy prices will be lower in 2007 than in 2006.

While consumers would welcome falling energy prices, it cannot be assumed with certainty. Geopolitical instabilities and tensions, combined with OPEC’s desire to restrict oil output, could easily push energy prices to higher levels. Without a significant disruption, we expect oil prices to average \$63-\$65 a barrel throughout 2007.

As previously forecasted, the U.S. dollar weakened against other major currencies in 2006. We expect the dollar’s modest weakness to continue in 2007 as investors seek higher interest rates elsewhere and remain concerned about the large U.S. twin deficits (budget and trade). A large and rising trade deficit often triggers a declining currency. The benefits of a weaker dollar include a higher level of exports (improving our trade deficit) and a greater value on foreign income when it is converted back into U.S. dollars.

The bond market ended 2006 with an inverted yield curve. Despite a yield curve inversion preceding the past six recessions, there is no guarantee that the current inversion will lead to a 2007 recession. The combination of increased global savings, reinvestment of petrodollars, lower inflation volatility, and, most importantly, greater transparency in monetary policy are helping to keep longer-term interest rates lower than

short-term rates. The current level of interest rates and the availability of credit on reasonable terms is a healthy recipe for sound economic activity.

Throughout 2006, the Federal Reserve continued its effort to bring the fed funds rate to a neutral level. The goal was to slow economic growth and cool inflationary pressures. Meanwhile, the savvy bond market bid yields lower on longer maturities betting that the Fed had succeeded in slowing growth, perhaps even leading the economy into a recession. Additionally, weaker economic reports, excessive global liquidity, and investors’ search for yield have led to lower long-term yields. We anticipate rates on longer-term treasuries to rise slightly throughout 2007 based predominantly on a weaker U.S. dollar, budget deficit concerns, and the possibility of rising wage inflation. The bond market will finish 2007 with a more historically normal yield curve. As previously stated, we believe the Fed has successfully engineered a “soft landing.” Therefore, they will be in the position to hold current short-term rates steady and then lower the fed fund rate in the second half of 2007.

Stocks and Bonds

Our outlook for the equity markets is eerily similar to 2006. The

economic and financial conditions that led to strong 2006 performance have not dramatically changed and are still in place to drive 2007 performance. We expect equities to outperform fixed income securities in 2007.

The year 2007 marks the third year of the presidential cycle, which historically results in double-digit growth for the stock market. Specifically, we have an economy growing at a below-normal rate, which will allow for economic stimulus as 2007 progresses. Stock market performance will be driven by strong corporate profitability, improving balance sheets, share repurchases, increased dividends, and continued strength in the merger and acquisition area. The global financial markets are awash in liquidity. Private equity firms continue to search for viable acquisition targets. Merger and acquisition activity in 2006 was one of the strongest on record. We expect 2007 activity to exceed the robust level achieved last year.

January 2007 will mark the 46th month of the bull market that began in March 2003. Since WWII, the average duration of a complete bull market cycle has been 38 months. While this bull may be tiring, we anticipate overall market returns between 7-9% in 2007.

In 2006, we projected Large Cap growth stocks would outperform Large Cap value stocks due to an anticipated economic slowdown. Growth stocks were also selling at a significant discount to value stocks. This did not happen. The economy slowed as forecasted, but value stocks registered their sixth consecutive year of outperforming and dominating growth stocks. On a valuation basis, Large Cap growth stocks remain relatively cheap compared to value stocks. We are not altering our stance in 2007. We maintain our slight overweight position in growth stocks relative to value in our tactical asset allocation strategy. Growth stocks will be the beneficiary of a slowing economy. Small and Mid Cap stocks continue to perform well. Despite their continuing to sell at a premium to Large Cap stocks, we recommend exposure to these asset classes.

International stocks, both developed and emerging markets, will provide ample upside potential and diversification to all equity portfolios. This is consistent with a weakening U.S. dollar and continued economic growth in global markets.

We continue to recommend portfolio exposure to the metals and mining sector. Driving positive performance will be favorable

supply/demand fundamentals, growth in emerging markets, and industry consolidation. While this sector has performed extremely well over the past several years, we believe further upside potential exists.

Our tactical asset allocation strategy recommends a shorter maturity in our fixed income portfolios. The risk vs. reward scenario is not conducive to extend portfolio maturities based on the relatively low longer-term interest rate environment. As longer-term interest rates rise throughout 2007, we will revisit our tactical stance and reexamine the potential benefits of lengthening the maturity in our fixed income portfolios to a more neutral stance.

International bonds, which benefit from the weakening U.S. dollar, provide investors with a steady income stream, and offer diversification, remain an appropriate investment in our fixed income portfolios.

In summary, we anticipate 2007 will unfold much like 2006. It will be a good year for investors. However, at NexTier Wealth Management, we believe it is prudent to position our portfolios in 2007 for a potential slowdown in the U.S. economy.