NexTier Wealth Management

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Looking Ahead: 2006 Economic and Investment Outlook

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The U.S. economy was resilient in 2005. In the face of rising short-term interest rates, higher energy prices, natural disasters, a War on Terror, a large budget deficit with growing trade imbalances, the weakening of the U.S. auto industry, and other challenges, the U.S. economy experienced its fourth consecutive year of economic expansion. Since November 2001, real Gross Domestic Product (GDP) has expanded at a relatively moderate and healthy annualized rate of 3.3%.

Domestic and international stock markets absorbed the challenges of 2005 with the majority of stock indices posting positive returns. Bond returns were flat to modestly higher for the year, the result of rising short-term interest rates. In retrospect and despite obstacles presented to the 2005 financial markets, a well-diversified and balanced portfolio of stocks and bonds provided investors with favorable returns.

Now that 2005 is behind us, where are we headed in 2006?

- Will the U.S. economy show continued strength? Are we in for a "soft landing" or a recession?
- What impact will higher or lower interest rates and energy prices have on consumer spending?
- How will the stock market and the housing market perform?

As we strive to maximize portfolio returns while managing risk for our clients, the answers to these questions and others will guide NexTier's investment decisions and recommendations for the coming year.

The U.S. Economy

The current expansion characterized by moderate GDP growth, job creation, and low inflation leads us to believe that a "soft landing" scenario will unfold in the second half of 2006. Historically, economic expansions have grown at an average annual rate of 6%. The current economic expansion of 3.3% annualized GDP is not as strong as previous recoveries. We anticipate a slowdown with real GDP for 2006 falling between 3.25% and 3.50% versus 3.6% for 2005. The consumer currently accounts for approximately 70% of GDP. Higher interest rates and energy costs, a softening in the housing market, and moderate job creation and wage increases will likely cause consumer spending to ease.

We believe that business spending and inventory rebuilding could be the primary economic drivers for 2006.

We expect inflation, as measured by the Consumer Price Index (CPI), to decelerate in 2006. In 2006, we anticipate that the overall CPI will average 3.5% with core CPI (excluding food and energy prices) hovering at, or near, 2.5% due to lower energy prices and continued productivity gains.

Energy prices are driven by supply and demand fundamentals such as seasonal factors, global growth (specifically China) as well as supply constraints and disruptions.

As speculation in energy markets diminishes and supply disruptions dissipate, we expect oil prices to average $55 per barrel in 2006.

Productivity gains have been strong and will continue to increase in 2006 at a rate of 3% to 3.5%. Given these production gains, businesses will be able to meet demand without significant labor cost additions.

Recent job growth has been sluggish due, in part, to weakness in the manufacturing sector. Growth may also be constrained by the low unemployment rate. We anticipate unemployment to remain low in 2006, in the 5%-5.2% range. Job creation will continue at a steady rate.

Low interest rates and excess liquidity led to a strong housing market over the past several years. However, the housing market may have peaked in the third quarter of 2005 as existing home sales are down from the highs reached in June. The housing market strength has the attention of the Federal Reserve since a significant drop in the housing market would be detrimental to the economy.

To avoid a negative housing scenario, the Federal Reserve will engineer a gentle "cooling off" of the housing market in 2006 through higher short-term interest rates. Therefore, we expect 2006 sales of new and existing homes to decrease moderately from 2005 levels, but remain healthy throughout the year.

Additionally, the national median price for new and existing homes should increase in the mid single digits over 2005 median prices.

To the surprise of many, the U.S. dollar strengthened throughout 2005 relative to the Euro and Japanese Yen. It was widely anticipated in 2005 that the dollar would weaken against other major currencies because of the large U.S. twin (budget and trade) deficits. This did not happen.

The dollar's strength can be attributed to:

- Capital surpluses and large exchange reserves with foreign trading partners, including $800 billion with China
- Perception of U.S. dollar as a "safe" currency
- Investments in the U.S. by oil producing nations
- Higher U.S. interest rates versus other international markets

In our view, it is a question of "when" not "if" the U.S. dollar will weaken against other major currencies.

The twin deficits will eventually become a major concern for foreign investors. The impact that the U.S. entitlement programs—Social Security and Medicare—will have on the budget deficit is expected to grow significantly.

At NexTier Wealth Management, we believe it is prudent to position our portfolios in 2006 for a potential slowdown in the U.S. economy.

Our forecast for the U.S. dollar in 2006 calls for a gradual weakening throughout the year. The catalysts for the weakening dollar will be the end of rising interest rates in the U.S. markets and the revaluation of the Chinese Yuan. It is in China's best interest to fight domestic inflation by allowing its currency to appreciate against the U.S. dollar.

Fixed Income

The secular bull market in bonds has likely ended and a bear market is emerging. Rates are headed higher in 2006 because of continued economic growth, inflation, and growing budget deficit concerns.

Monetary tightening will continue given the Federal Reserve Bank's preoccupation with inflation risks in both the labor and product markets.

During the first half of 2006, we expect that the Federal Reserve will raise the Fed Funds Rate twice, in 25 basis points increments to reach 4.75%. The Fed Funds rate will finish the year at this level.

The yield curve will remain flat through the year with the 10-year Treasury Yield approaching 4.75% by mid-year and finishing 2006 between 4.90%–5%.
We continue to recommend a shorter maturity or duration for bond portfolios. The risk/reward ratio does not favor longer-term bonds. This outlook may change during the year as the economy slows and the Fed completes the tightening cycle. It may then be appropriate to lengthen the maturity or duration of the bond portfolio.

International Bonds serve as a hedge against a weakening U.S. dollar and provide investors with a steady income stream. We recommend slight exposure to this asset class.

Equities, The Bottom Line

Financial conditions will remain comparatively benign and will continue to favor equity investments.

Corporate profitability remains strong. Increased dividends, share repurchases, and mergers and acquisitions will provide a solid base from which stock prices can appreciate.

While the stock market recovery is mature, there is still upside potential. January 2006 will mark the 34th month of the bull market that began in March 2003. Since WWII, the average duration of a complete bull market cycle is 38 months.

We expect high single digit returns for the US equity markets in 2006 driven by a slower yet healthy year over year earnings gain in the S&P 500. A reasonable valuation for the overall market is a 10% gain from current levels.

An economic slowdown favors Large Cap stocks that possess defensive characteristics such as strong balance sheets, stable business environments, diversification, and international exposure. Large Cap quality stocks
should perform well as economic and earnings growth moderates.

For these reasons, our current tactical asset allocation strategy favors Large Cap stocks.

In particular, we favor Large Cap Growth stocks versus Value stocks because they tend to perform better during an economic slowdown and are less sensitive to the economic environment.

In addition, growth stocks look attractive relative to value stocks on a valuation basis. Growth stocks are presently valued 1% above their historical average whereas value stocks are priced 12% above theirs.

Small and Mid Cap stocks have performed extremely well over the past five years. Several years ago, Small Cap stocks were selling at a 40% discount relative to Large Cap stocks making them an attractive investment choice. Now, Small Cap stocks sell at a premium and they are not expected to outperform Large Cap stocks in 2006.

Overall, international economic growth in specific markets may exceed U.S. growth in 2006. International stocks will benefit from a weakening U.S. dollar. Therefore, international stocks remain an attractive investment. NexTier recommends a 10% investment allocation in these asset classes. NexTier recommends exposure to this asset class.

Emerging Market Stocks are recommended for the same reasons as mentioned above for international stocks. Valuations, while not as compelling as several years ago, remain attractive. There was a substantial inflow of capital into the emerging markets in 2005, resulting in strong performance and diminishing investment opportunities.

Industrial Metal Equities and Commodities will continue to perform well in 2006. This asset class is attractive because of favorable supply/demand fundamentals and continued strength in global markets, specifically China and India.

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