

Repolishing the Crystal Ball 2007's Fearless Forecasts

Due to the popularity of last year's newsletter *2006, Inside the Crystal Ball*, we are again opening the year with a look at the issues that will drive the performance of the equity markets in '07. We will examine the rationales for both the market optimists and pessimists and also provide a rundown of fearless forecasts from the pros. While it is impossible to know which prognostications will prove to be accurate and which will merely add to global warming, a thorough knowledge of the issues and their potential impact will help provide guidance as we navigate the next 12 months.

Revisiting 2006

Before we begin, however, let's take a very brief look back at the 2006 scorecard. Last year's predictions from 16 market gurus covered a broad range of expected returns from Steve Leutold, Marc Faber and John Mauldin's predictions for a double-digit loss in the S&P 500 to Jordan Netburn's stargazing forecast of a Dow 14,000 (30% advance). **Interestingly, the actual 15.8% total return from the benchmark S&P 500 outpaced the expectations of 14 of our 16 experts.**

Despite a precarious beginning caused by a housing slowdown, a hemorrhaging auto industry, continuing Federal Reserve interest rate hikes, a deteriorating dollar, and soaring energy costs, a second half rally launched by accelerating corporate profits and a wave of mergers and acquisitions propelled the stock market to its best year since 2003 with both the Dow industrials and S&P 500 notching all-time highs.

Big Mo for '07?

Looking at three separate surveys of investment managers concerning predictions for 2007, the consensus is overwhelmingly optimistic. The recently released **Russell survey shows one-third of managers expecting the overall stock market to rise by 10% or more with 80% of managers expecting a positive return for '07. A similar Business Week survey found that 85% of managers expect a positive return for the S&P 500 while 20% of managers predicted gains of at least 10%. Similarly, a Bloomberg News survey of investment strategists at 14 major brokerages reported a predicted average price gain for the S&P 500 of 9%.**

Ever an optimist, Abby Joseph Cohen, chief investment strategist for Goldman Sachs makes the case for continuing market momentum. While acknowledging that corporate profit growth is in the process of deceleration, Ms. Cohen reported that her team's research indicates that the S&P is still underpriced; thus their 12-month price target of 1550. While the Goldman team also sees a continuing slowdown in housing, they believe the economy will rotate toward discretionary consumer services such as travel and entertainment. Overall, **Ms. Cohen sees a positive market driven by stabilized or declining interest rates accompanied by continued merger activity.**

Joining the bull camp are Ethan S. Harris, chief U.S. economist for Lehman Brothers and Richard Bernstein, Chief Investment Strategist at Merrill Lynch, both of whom have set S&P targets of 1570 for year-end '07. **Harris believes "There's still room for the market to rally," thanks in large part to the economy shrugging off the housing slump. And while Bernstein is equally optimistic with his year-end target, he also warns of a "choppier market, as the uncertainty about the Fed easing has gone up."**

Also on the plus side of the ledger is CNBC's James J. Cramer, co-founder of TheStreet.com. While Mr. Cramer sees the S&P 500 rising as much as 15% this year, his reasoning is slightly different. As set forth in his New York Magazine article, *Lucky 2007*, Cramer sees "an equity supply shortage of mammoth proportions." Citing the statistic that 29 of the 30 Dow Industrials are buying back billions of dollars worth of shares instead of floating more equity to take advantage of higher prices, Cramer sees this equity buyback creating a scarcity, causing the remaining stocks to be bid up in value.

He also cites the impact of private equity funds, pools of capital put together to buy companies, as drivers of higher prices. **Private equity buyout firms such as Silver Lake, Bain, Texas Pacific, Kohlberg Kravis Roberts, and Blackstone, are focusing on the "unloved," old-line "cash cows" that can no longer generate the 15% growth required by hedge funds. As these companies are taken private, the equity supply shortage is exacerbated.**

Third, Cramer views the weakening dollar as a boon to the acquisition market as companies are acquired at bargain prices by corporations in countries with stronger currencies. Cramer senses that companies are also "getting a sense of urgency as the clock is ticking on many mergers now blessed by a Republican-controlled government."

Finally, Cramer expects the ongoing decline in housing and the worries about car manufacturers to trigger Federal Reserve interest rate cuts to as low as 4%, bringing investment back into the stock market as "risk-free" money market returns drop to paltry levels.

Wrapping up the bull side of the forecasts is Dr. Mark Skousen, Editor of the Investment U e-letter. To arrive at his prediction for higher prices for stocks in '07, Dr. Skousen quotes Yale Hearst of the Almanac Investor, "The four-year Presidential Election/Stock Market Cycle is the 'Old Faithful' of indicators for us." As evidence, Skousen looks back at the last 43 administrations, starting with Andrew Jackson's in 1833. **In aggregate, the last two years of each**

administration (pre-election year and election year) produced a total net market gain of 746%, more than twice the gains of the first two years of these administrations.

As a rationale, Dr. Skousen explains that, "Presidents tend to make the most painful decisions in the first two years of their administration, such as a fighting inflation, cutting back on wasteful spending and starting wars. The second half is a different story. Presidents need to be reelected and they 'prime the pump,' encouraging a period of economic prosperity and bull markets." While an interesting concept, we leave the arguments over any connection between politics and stock market performance to our readers.

The Bear Side of Goldilocks

Leading the loyal opposition is MarketWatch commentator Irwin Kellner, who states, **"If you believe the conventional wisdom, 2007 is either the year of the soft landing, a Goldilocks economy or will mark the return of Rosy Scenario."** Kellner methodically challenges the assumptions underlying each view as not seeming to make sense, concluding that '07 is "The year of the conundrum." In presenting his argument, Kellner examines the interrelationships among housing, interest rates, corporate profits and economic growth.

Over the past two years, the average household has spent more than it has earned, the longest period of negative savings since the Great Depression. Consumers were able to do this because housing values were surging, allowing homeowners to extract a portion of this increased equity buildup to fund any shortfall between their net income and their consumption. **With housing prices now falling, Kellner argues that the days of using homes as "piggy banks" are over, stifling consumer spending as a source of strength for both the economy and the equity markets.** Supporting this viewpoint are statistics provided by Barry Ritzholtz of Ritholtz Research & Analytics, demonstrating that without the positive contribution from mortgage equity withdrawals (MEWs), GDP (Gross Domestic Product) over the past three years would have

been reduced from the reported 3 1/2%-4 1/4% range to less than 1% for 2004-2005 and only fractionally above 1% for 2006. Further, it is argued that the negative impact from defaults and foreclosures on sub prime and adjustable rate mortgage loans is just beginning to surface. However the housing market turns out, there is no question that it will be a primary determinant of economic health and equity market performance.

Next, Kellner questions the assumption that the Fed will be able to cut interest rates in order to keep the economy from stalling. **Although the Fed has stopped the chain of 17 consecutive rate hikes dating back to the middle of '04, the money supply (Remember how economists use to monitor M1 and M2 money supply numbers so carefully?) is growing faster today than it was when rates were at their lowest and the economy theoretically needed the greatest boost.** In order to consider reducing rates, the Fed must also believe that inflation is under control. This combination of a moderate growth economy coupled with restrained enough inflation to justify the Fed's lowering of interest rates is truly a Goldilocks (not too hot, not too cold) scenario.

With little or no support from MEWs (mortgage equity withdrawals) and stimulus from declining interest rates questionable, how are the record corporate profits that fueled stock performance in '06 expected to be sustained? The conventional wisdom argues for the emergence of greater corporate spending to upgrade facilities and enhance productivity. However, **Kellner points out that last year was the first year ever that the blue chip firms spent more money on buying back their stock (providing price support) than on capital expenditures.**

Addressing this same issue of corporate profits, William Hester of the Hussman funds points out that corporate profit margins are at a historical extreme near 8.5%, as are corporate earnings. Looking at history since 1975, Hester analyzed different periods of corporate profit margins, stock P/E (price/earnings) ratios and subsequent 3-year and 5-year annualized stock returns.

Not surprisingly, Hester found that during periods of high corporate margins and profits, investors bid stock prices up to their highest levels, a P/E of +/-25 at the peak. He also found that the subsequent 3-year median return was -1.02% and the subsequent 5-year median return was only 3.45%. **As concluded by Hester, "While it's possible that profit growth will continue to surprise, investors should recognize that they are paying high P/E multiples on high profit margins, and should be prepared for some possible headwinds."**

As we stated at the opening, it is impossible to tell whose crystal ball will prove most prescient for the 2007 markets. To keep the game interesting (and to provide fodder for next year's "failure of the famous" recap), we have expanded our list of fearless forecasts to 26 participants, all selected from the BusinessWeek survey. As you have seen above, the arguments presented by the most optimistic are as credible as those offered by the most guarded. And, as we have just witnessed in 2006, the markets may choose to merely go their own way with no regard for either camp's reasoning.

We can find no better way to close than we did last year, "Predictions are for show, while this year's ongoing portfolio strategies are for dough." The measure of success is not one's expertise in forecasting but rather the ability to capture the unexpected opportunities and to minimize the unanticipated risks in order to reach each client's financial objectives. We look forward to working with you in meeting the challenges of 2007.

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