

J.J. BURNS & COMPANY, LLC

FINANCIAL PLANNING • WEALTH MANAGEMENT

Market Review: 2006 Revisited; 2007 What Lies Ahead

It's that time of year again where we revisit 2006 and dust off the crystal ball for 2007. Most equity (stock) asset classes did well this past year, with smaller caps leading large caps, however, with a greater degree of volatility throughout 2006. The one standout of 2006 was that value indexes vastly outperformed their growth counterparts across all market capitalizations. The S&P 500 returned 13.6%, and the Russell 1000 Growth Index posted a gain of 7.78% compared to the Russell 1000 Value Index gaining an eye popping 19.22%. The Russell 1000 Index and the S&P 500 provide a much broader and more accurate measurement of the larger cap stocks.

Our mantra has always been to be well diversified in multiple asset classes, thus having a risk adjusted asset allocated portfolio. The market's surprising run left stock-pickers badly trailing major indices. Fewer than 20% of U.S. fund managers running diversified stock funds were able to top the S&P 500 this year. Growth oriented investors lagged their respective indices, while value managers were rewarded. For the last six years, value managers have performed better than growth. Currently, there is evidence that a leadership shift may be taking shape, and market momentum is building in growth stocks. We are asset allocators and, as such, have value and growth representation within our portfolios. We do see that valuations are beginning to favor growth investing going into 2007 and feel we are positioned to benefit from this trend.

On the fixed income side, the yield on the 10-year Treasury note (a benchmark for mortgages, loans and corporate bonds) ended the year at 4.708%, compared with 4.393% at the end of 2005. Overall, bonds earned a modest return in 2006. The Lehman Brothers US Aggregate Bond Index rose 4.3% versus a gain of 2.6% in 2005. High-yield bonds had another good year, returning 11.6% in 2006, according to a Merrill High Yield index.

Continued on Page 2

JJBCO IN THE NEWS

October 25, 2006
SmartMoney.com

Anthony LaGiglia, Managing Director of J.J. Burns & Company, makes his debut on SmartMoney.com in the article "Managers With Skin In The Game" where he discusses the criteria that JJ Burns & Company utilizes when selecting Mutual Funds. Anthony shares that one approach for choosing a Mutual Fund is to look at those funds who have large percentages of insider ownership.



October 31, 2006
NY 1 News

With housing, and the economy in general, simply "slowing down", a soft landing is expected and JJ Burns believes consumers have a second chance due to the fact that the Fed has not raised rates recently and mortgage rates have gone down to the six percent range.



November 29, 2006
CNBC "Morning Call"

Following the most recent speech from Federal Reserve Chairman Ben Bernanke, JJ Burns joins CNBC's Morning Call to provide his reaction and analysis of Bernanke's comments and the effects it makes on the markets.



To view these and other appearances, visit our website at www.jjburns.com and select the JJBCo In The News tab!

Long-term yields have been hovering below yields on short-term Treasury securities since mid-July, an unusual phenomenon (known as inverted yield curve) because investors commonly require higher returns to compensate them for holding assets over a longer period.

Internationally, the overseas markets have been stellar performers. The MSCI – EAFE index which is a measure of international markets, was + 23% for 2006. Across the globe however, these returns did not come easily due to geopolitical risk in many parts of the world. There was much volatility especially in Thailand as there was a political coup and a revaluation of the currency. In addition, India went through a deep but quick correction and recovered. Of noteworthy comment, the Bombay - India index ended the year gaining 42%, Japan posted a modest 9% return, Korea increased 23%, and finally Asia (x-Japan) posted a gain of 28%.

Recap 2006: Where we have been

It was an eventful and, at times, tumultuous 2006. The ongoing difficulties in Iraq and the related shift in power in Washington D.C. were just two of the big headlines that almost everyone watched with rapt attention. We too were interested in those events from a human interest standpoint, although neither of them was especially significant from an investment standpoint.

Oil and Energy Prices: We saw record oil prices in 2006. Oil started off the year at around \$60 per barrel, about \$10 below its peak of the year prior, but still higher than what the markets had become accustomed to. As the months moved on, so too did oil prices, ultimately peaking near \$80 per barrel, amid a widespread belief that this would either ignite inflation or cause the Fed to raise interest rates to a recession inducing level. As is often the case, many assumed that this trend of higher oil prices would continue indefinitely (pundits were talking about the inevitability of \$100 a barrel oil), although many of the managers and strategists we follow believed that oil prices would come down. The latter turned out to be true, and oil is back to roughly the same place at which it began 2006.

“While the risk of a housing decline was very high, the magnitude and spill-over into the broader economy was not sufficient enough to warrant a defensively oriented portfolio move”



Housing Prices/Loans: This has been the single biggest topic discussed about the economy for all of 2006. Would the inevitable crash in housing be deep enough to cause a crippling recession, or even worse? In the beginning of 2006, we saw rising interest/mortgage rates and falling house prices. Our firm was called on numerous times by CNBC, Bloomberg and other media outlets to weigh in on how we saw this affecting the markets. Focusing on the broader picture, our analysis suggested that while the risk of a housing decline was very high, the magnitude and spill-over into the broader economy was not sufficient enough to warrant a defensively oriented portfolio move. We are glad we stuck to our guns on that, since a defensive posture would have caused us to miss out on a portion of the good stock market returns for the year. Lately, the housing market is showing signs that perhaps the worst of the storm has passed.

Federal Reserve Policy: By the first trading day of 2006, the Federal Reserve had been on an interest rate increase campaign for eighteen months, having already increased the overnight lending rate by 325 basis points (3.25%). Consequently, at the beginning of the year, investors were growing concerned about the possibility of an interest-rate overshoot causing a recession. By the time summer rolled around, the Fed had added another 125 basis points to the Fed Funds rate, raising fears even more, and the stock market started to feel the pinch. However, once the Fed finally announced that it was on hold for future rate hikes, the market spent the rest of the year bouncing higher.

Big Picture in 2007

Our perspective on what will shape the year ahead is based on many factors. Through some of the TV media attention that our firm has received we have been able to align ourselves with some of the best Wall Street minds. In the end, this is of great value because we are able to access comprehensive data and speak to the analysts, portfolio managers, and market commentators on issues which ultimately help guide us to make a positive impact on our clients' portfolios. Therefore, our big picture is a composite of many smaller pictures. In speaking to our managers, analysts and economists, we find there are good companies generating returns and executing brilliantly in otherwise challenging industries and difficult economic climates.

GDP: Gross Domestic Product (GDP) is a measure of economic activity. GDP is measured domestically and globally. As you can imagine, a lot of work goes into calculating our nations GDP. Therefore, understanding this important indicator of the level of economic activity domestically as well as globally is paramount to making investment decisions. We believe that GDP growth will remain on the current trajectory and even improve slightly going into 2007. There are risks to GDP as the housing market remains challenging. Construction spending, consumer goods and services are all measured by GDP. Global economies are doing better than expected because of robust activity in Asia and other areas of the world that produce oil and raw materials. Going into 2007, we see the economy slowing to perhaps a 3.0% GDP down from 3.4% in 2006, however, still considered expansionary but a bit slower supporting the "soft-landing" or "Goldilocks Economy."

Inflation: The big bad "inflation wolf" has been the 2006 topic of the year. Inflation erodes purchasing power and can ultimately ruin the expansionary progress of the US economy. The Federal Reserve's main focus is to keep inflation in check by altering the flow of short term Federal Funds. Thus far, it is fair to say that Mr. Bernanke has done a superb job in keeping inflation in check. We do not think that either inflation or wage pressures will increase. In truth, those are two sides of the same coin. Without wages and labor costs going up, there cannot be sustained inflation in the economy, because spending and wages represent the lion's share of the US economy and of corporate costs, respectively. Unless wages rise, cost increases cannot be sustained, ergo no inflation other than energy prices and food. We continue to look at all the economic indicators which measure inflation. Payrolls, wages, unemployment, initial jobless claims, and rents are just a sampling of some of the indicators the Fed looks at to measure inflation. The question we look to answer is how much of the increased costs of producing consumer goods and services are passed on through increased prices to you the consumer. Commodities, oil and gas are major factors to produce goods and services and can be a risk to inflationary pressures.

US Housing Market: Will the slumping housing market throw the entire U.S. economy into a severe recession? Many investors made this argument in the beginning of 2006. Following this "wave of housing contagion" caused many investors to break prudent disciplines of portfolio management and miss some of the increases in the markets. Most consumers don't stop spending when their house value falls. The result of this past year show the US consumer is simply resilient. The unemployment rate is near a record low level, employers are paying up for skilled labor, and skilled labor is consuming goods and services to keep the economy moving in a positive direction.

Interest Rates: Interest rates are not going up either on the short-end or the long end by any measure barring any unforeseen event. The benchmark 10-year Treasury will more likely yield 3% than 6%, for the same reasons we think that there will be little inflation and few wage pressures. In a world where companies can increasingly go anywhere for capital and labor, there is no shortage of either and that means there are no reasons for the cost of capital or the cost of workers to increase.

Corporate Profits: Corporate profits will remain high, and profit margins will improve. This may not be true for every company, of course, but we believe this to be true for the companies our managers and analysts follow. We believe that reinvestment into those companies which have a large global footprint and are expanding in this area will prosper domestically and globally.

Major Themes For 2007

Internet Commerce: Last year we noted that internet commerce was beginning to represent a more meaningful portion of overall retail sales and advertising. This year, that trend has continued. Online retailing has gone from 2.3% of total sales to 2.8% and is growing more than 25% a year. For the final quarter of 2006, total e-commerce sales are estimated to be almost \$30 billion, as millions of us decided not to wait in line to do our holiday shopping and instead surfed the web at midnight with credit cards in hand. I tracked the gifts that family members and our firm's employees purchased and discovered e-commerce usage was up over 50% from last year. We think this trend will continue. Advertising budgets continue to shift evermore toward the web and away from traditional print and broadcast media (online advertising grew even faster than online sales, at a 30% clip), with winners such as Google standing in stark contrast to "old media" stalwarts such as the Tribune Company. In a similar vein, music and video are finding a burgeoning home online, at the expense of the retailers of yesterday such as Tower Records, the neighborhood video store, and even the local movie theater.

The Entertainment Experience: As housing softens, spending for entertainment experiences should grow even more, at the expense of spending purely for objects. Of course, some of those experiences require hardware such as gaming consoles, flat panel TV's and computers for home entertainment, or next generation (3G) cell phones that transform the phone into a multimedia device. While these trends are noticeable in the United States, they are tectonic in emerging markets such as China, where one company (China Mobile) has more subscribers (around 300 million) than the entire population of the United States. The spending on next generation hardware and software to upgrade cell phone service will continue for years.

Technology and Software: The rollout of Microsoft's Vista platform (new operating system) looks to trigger a new round of hardware sales, as consumers and companies shift from the old Windows platform over the course of the next two years. Software companies will launch new versions of old products; semiconductor companies will ramp up production to meet the demand for hardware to support the massive Vista operating system; and computer manufacturers

will try to use the rollout to generate demand for new laptops and desktops.

International Investment: We believe that Industrial companies and consumer companies pegged to growth outside the US will continue to reap rewards in terms of revenue growth. Some may find it challenging to maintain margins but, on the whole, those companies involved in the basics of creating a modern economy – moving earth, constructing buildings, generating power, paving roads and entertaining a burgeoning middle-class consumer – are likely to thrive. China/Greater Asia will continue to have significant infrastructure development. The rise in the middle class in China shows that over the coming years they could be a large consumer. However, currently most of China has a GDP per person of under \$3,000, compared to \$44,000 GDP per person in America. We do think however, the declining dollar has helped foster this growth and feel the volatility of the dollar could be a risk going forward. We constantly review our international managers to be certain their analysis has defined valuations and sell strategies that are clear and understandable based on a refined process. Maintaining broad diversification and sticking to larger cap companies will be important while investing internationally in 2007.

The U.S. Dollar: It is important to understand what implication the US dollar has on world economies since a weaker dollar creates plenty of global hardships. Not only do European vacations get more expensive for Americans, but so also do Chinese-made television sets and other imported goods. For foreigners, a weaker dollar means their investments in the US lose value. But in the eyes of economists, the more the dollar weakens, the more it helps alleviate one of the great worries of our time, the gaping US current-account deficit. The current account, which includes trade flows and other international payments, measures exactly how much Americans' spending is outpacing their income and how much they are borrowing from abroad to fill the gap. The US is estimated to have rung up a deficit of about \$900 billion in its current account last year. That is equivalent to nearly 7% of the US economy, a level that, if sustained, would cause the nation's foreign debts to pile up to dangerous levels. A weaker dollar is welcome from this perspective; however, too much volatility in any direction could trigger risks within our economy.

Summary For 2007

A few themes have already emerged in the first weeks of 2007:

- The US economy appears in shape to achieve the “soft landing” which the Fed has engineered.
- The US stock market appears it will have a positive year.
- As inflation fears subside, energy and commodity prices are likely to continue moderate.
- Foreign stocks and emerging markets remain attractive.
- The dollar will likely continue to fall, enhancing returns in foreign currencies.
- It likely will not matter whether the Fed has to raise or lower rates in 2007.
- There will more than likely be some event in 2007 to rethink conventional wisdom and affect global markets. However, this will likely be a buying opportunity. For example, the sharp pull back in emerging markets last year was triggered by interest rate hikes. This potential event may cause global world equity market investors to realize highs have been met and may bring money back the US stock markets. In a risky, world the U.S. is the better bet!
- The valuations for growth stocks is compelling and this part of the market could surprise to the upside and perhaps leave value stocks in the rear view mirror.
- Diversification will be the secret ingredient to portfolios.

The World is Flat

This past November, our firm was invited to attend a wealth management conference. One of the speakers was Tom Friedman who wrote “The World Is Flat,” a book I would highly recommend. Without going into too much detail, what you can learn from his book is that we are at the very beginning of a technological revolution which is “flattening” the world we live in. Our lives are increasingly being shaped by technology and thus will create increased global efficiencies which will play a significant role in how companies, people and products are managed and distributed. Even now, we are literally only a mouse click away from getting almost anything we need. Furthermore, the most powerful item at our fingertips is information. We will all be witness to the synergies created as the world flattens, and with this we stand ready to protect and create wealth for your portfolios.

All of us at J.J. Burns & Company wish you and your loved ones a healthy, happy and prosperous New Year.

Sincerely,

J.J. Burns

