# Notes on the Quarter
# Looking Ahead at the New Year

## Overview of the Quarter:

1) The year finished strongly, the indexes all showing strong growth. In fact, the U.S. had amongst the weakest returns worldwide, save for Japan and South Korea. Only one sector did not provide a positive return. Inflation was under control, and by the end of the year, commodity prices began to show weakness. Energy prices were down from their highs, as were many of the hard commodities (copper, gold, etc). So this is going to be a superlative year – right? Let's look closer.

## Portfolio Specifics:

1) Large Caps finished the year just barely behind the Small Caps; it was the Mid Caps that underperformed the most. While we have been expecting large caps to perform well, the Small Caps strength was a surprise.
2) The top sectors last year were 1) Real Estate; 2) Utilities; and 3) telecom. The worst sectors were 1) Home Construction (-20.41%); 2) Semiconductors (+0.7%); and 3) Biotech (+1.0%).

## Looking Ahead:

**Information is very mixed, so let's look at the pieces.**

1) Housing is continuing to show weakness although the media is trying to convince people that it is beginning to stabilize. Why don't I buy it? Three reasons; first, because default rates are rising and now a number of sub-prime lenders are either blowing up or giving up and getting out of the business; second, a number of banks have started reporting increased loan losses; and third, because housing, like interest rates, take a while before the full impact is felt. For housing, the lag is typically one year. Note that copper prices are down – and one of the primary uses of copper is…say it with me…housing.

1) Holiday sales were weaker than hoped. Yes electronics sold well – because of lower prices and lower prices mean lower margins for the retailers. Producers of flat screen glass are reporting rising inventories, and Motorola just announced weak Q4 cell phone sales.

2) The Democrats are in control (more or less) of Congress and they plan to raise the minimum wage and want the government to become more involved in healthcare so that they can better control drug prices. Price controls have a history of failing miserably. Higher business expenses, of which wages are typically the biggest component, rarely leads to deflation…..

3) The economy has been on a roll for four years – much longer than normal. Economic cycles exist. Yes, they are not rigid, sometimes lasting longer or shorter than expected, but they exist never-the-less.

4) Almost every pundit I can find, hear or read about is positive about 2007 and most investors are sanguine.

**On the plus side…**

5) Most companies are in good economic shape; lots of cash and record profits. Inflation has been fairly well contained, although not as good as the government numbers imply. Foreign countries continue to grow well, especially China and India, and many are seeing interest rates and inflation dropping – Brazil being a prime example. Certainly the demand for goods and services in these countries will continue to grow as people have more money to spend.

6) Interest rates are low. The ten year treasure is yielding about 4.6% and the 30 year is yielding about 4.8%. Recent economic numbers, growth rates and consumer confidence numbers, have been good, albeit lower than they were during the year.

**There is no obvious sign of a recession**. The economic information is certainly contradictory. And there is the crux of it. During a direction change one gets confusing and often, contradictory information. This is not illogical as data from different parts of the economy react to changes at different rates of time. The change in direction only becomes obvious once all the data is reporting the change, which can take many months.

So what to do? We believe that it is time to start getting more defensive. When will a recession or soft landing occur? We do not know; we are not market timers, we are investors. As investors we can determine if it is time to buy or sell, but we do not try and predict the timing as much as the direction.

HARMONY
ASSET MANAGEMENT

On any energy rallies, we will continue to reduce positions. We believe in the long term viability in energy and in most commodities, but believe that there will be a better entry point later on. As of this writing oil prices are down to $53/barrel (we suggested this would happen last quarter). The time to add will be when stock prices adjust further to the reality of lower margins.

Defensive play should continue to do well as can be seen by the first two weeks of this year. Our favorites at this point are healthcare and large cap dividend plays.

It is possible the markets will move up for a little while still – but when the market turns, it will turn fast.

We expect many investors to flock to foreign investments because they did much better than the U.S. last year. But this is driving forward while looking in the rear-view mirror. It tells you about the crash you missed, not the one you are heading into. The fact is, worldwide markets are more closely correlated than ever before. Commodity prices drive the Latin American and Russian markets (and Canada and Australia too). Technology and infrastructure drive India, and both India and China benefit from lower commodity prices. So while different economies react differently to the same external factor, an economic slowdown in one major economy will tend to have supply/demand impact on the others even if to differing degrees.

Long term we like India, China (Asia in general) and Brazil along with Eastern Europe. Short term, China is expensive, and most emerging market will b negatively impacted by lower commodity prices, as will Canada and Australia.

We think that fixed income can offer returns that could be as high as 5%-8%, especially if there is a slowdown and the Fed lowers rates. By focusing on the intermediate maturity range we should be able to balance the interest rate risks and opportunities.

In summary, we think that those that keep their powder dry this year will be glad they did so. We are not planning mass liquidations, but rather to lighten up - taking profits where opportunities present themselves. We will see more exciting options at a later date.

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