Courier Capital Corporation

Market Review & Update

WINTER 2007

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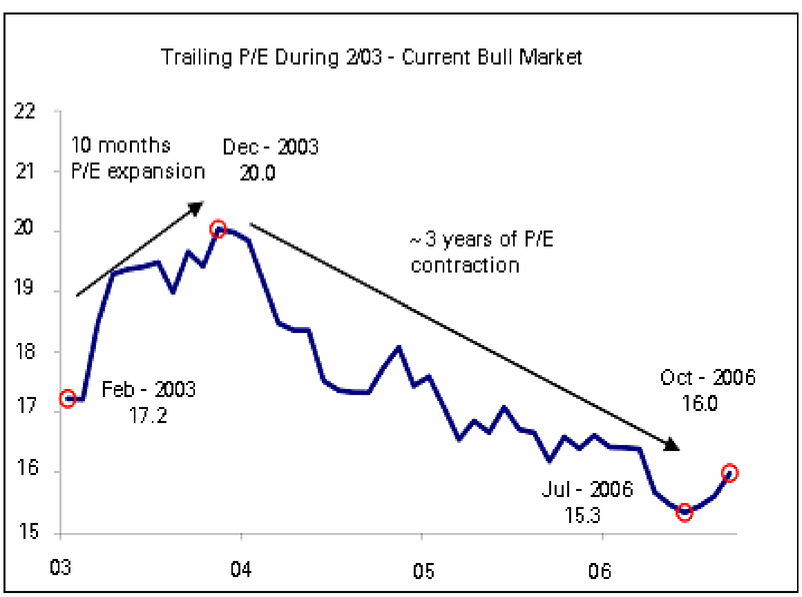
2006 finished on a strong note, as we predicted. The drivers? As we previously described, there is a continued momentum in broad-based global growth. No longer a China and India phenomenon, strong growth from Russia and Eastern Europe to Brazil is stimulating business in volumes unseen heretofore. This, coupled with declining oil and commodity prices, and benign inflation trends, were largely unanticipated by the markets. In fact, oil is currently trading at an 18 month low (Figure 1). On the domestic front, participants were likewise surprised by the resilient employment trends, solid exports, and 4 more solid quarters of double- digit earnings growth from corporations possessing historically strong financials. Their hefty cash hoard is propelling merger and acquisition activity, share buybacks and dividend hikes. Rarely do we get blessed by every prediction falling into place, but blessed we were. The result? Solid double-digit returns by nearly every market segment.

Figure 1. Oil prices retreating

Rumor has it that a little blonde girl bears some responsibility for all this good fortune. The media has frequently referred to this “Goldilocks” environment. Just what makes it so? Stability in the aforementioned trends, most notably the drivers of inflation and corporate earnings that proved so resilient in 2006.

Where does 2007 head? Throughout 2006 we preached that valuations, especially for large cap stocks, were at historically low levels in terms of Price to Earnings comparisons. And the surprise was that this low valuation was coupled with historically high cash levels, not to mention double-digit earnings growth. Guess what happens when the markets rise 15% and earnings rise 16%? The market gets CHEAPER! We are beginning 2007 with even slightly better valuation characteristics than we witnessed at the start of 2006. (Figure 2)

Figure 2. The market got cheaper in 2006



Source: Haver, Thomson Financial, S&P, Robert Schiller, Standard & Poor's, Morgan Stanley Research.

Before we turn to the corporate sector, let's not overlook the consumer—helped a bit by falling oil prices, wage growth and low unemployment, and hurt a bit by housing. But housing has not deteriorated as much as the bears anticipated due to a friendly rate environment. The speculators left, as Greenspan planned, but for homeowners the market is constructive. On balance, we have a consumer that's in pretty fair shape.

Figure 3. P/E contraction ending?

P/E Rarely Contracts Four Years in a Row

Consecutive Periods of Multiple Contraction

Year 1	Year 2	Year 3	Year 4	Year 1	Year 2	Year 3	Year 4
1905	1906	1907	1908	-15%	-9%	-23%	56%
1915	1916	1917	1918	-24%	-41%	-17%	50%
1934	1935	1936	1937	-16%	-9%	-5%	-45%
1939	1940	1941	1942	-33%	-27%	-26%	27%
1946	1947	1948	1949	-20%	-34%	-30%	9%
1964	1965	1966	1967	-0.2%	-4%	-19%	25%
1976	1977	1978	1979	-4%	-20%	-11%	-6%
1992	1993	1994	1995	-3%	-17%	-17%	13%
2004	2005	2006td		-10%	-9%	-3%	???
			Average	-14.0%	-19.0%	-18.3%	16.1%
			Median	-15.4%	-16.9%	-17.9%	19.0%

Thesis does not work in Deflation

or in high Inflation

Source: Morgan Stanley Research Group

The solid corporate fundamentals, coupled with stable domestic economics, most notably inflation, provides the components of something we have not witnessed in years, P/E expansion. P/E ratios have in the past actually contracted for 3 years. 4 years would be a rare event and one we doubt will occur as it is normally coupled with a more drastic environment. Bonds may actually be the curiosity du jour that has had an impact on this trend. Investors pay a lot of attention to the yield curve, which is now slightly inverted (long yields below short yields). Normally this would signal some economic weakness on the horizon. However, the strong global growth trends have generated substantial cash worldwide. This excess global liquidity must find a home and typically, the most popular home is U.S. Treasuries. Some estimate that this cash glut may have created a demand imbalance which may be reducing long–term rates by as much as 1%. This would mask the true nature of the economy that would otherwise drive the yield curve. And so, with stable financial conditions, investors eventually become willing to pay a bit more for reliable growth. Previously, as we noted in past issues, poor investor sentiment has kept a lid on valuation. And, if history repeats itself, investors love to buy into the successes they see in their rear-view mirror. So, having experienced a strong '06 will manifest itself in more confidence that a strong '07 is possible. Continuation of the benign "Goldilocks" trends will add credence to this hypothesis. And hence, the opportunity for P/E expansion.

The Fed should induce a bit more psychic and quantitative positivism as it will likely begin to reduce short-term interest rates by mid-year. Strategists' consensus now point to the probability for an 8-12% return for the S&P 500 for 2007. We should view this in light of the fact that analysts' estimates for earnings have been too pessimistic, as we have witnessed in the previous few quarters. If that is also resident in their 2007 metrics, we may have a bit of room for upside surprise. The typical caveats exist to turn this outlook more negative or more positive, including any material changes in the aforementioned trends and the ever-present exogenous event. Trends seem stable as of this writing and we look forward to another year of positive results. One notable quote this year from Bill Gross, the director of Pimco " investment management is part science, part art and part B.S." we'll leave it to the reader to divine our path…

We'll talk to you soon.

Figure 4. 2007 Scenario probabilities for S&P 500 Index

S&P 500 Bull/Base/Bear Case Scenarios for 2007

	Price Target	Scenario EPS	Scenario Estimated Probability
Bull Scenario *"Goldilocks"*	1,625	95.00	30%
Base Scenario	1,525	91.00	50%
Bear Scenario *"Recession"*	1,275	80.00	20%

Source: Morgan Stanley Research Group