



EARL M. FOSTER ASSOCIATES

I N V E S T M E N T M A N A G E M E N T

NEWSLETTER

January 2007

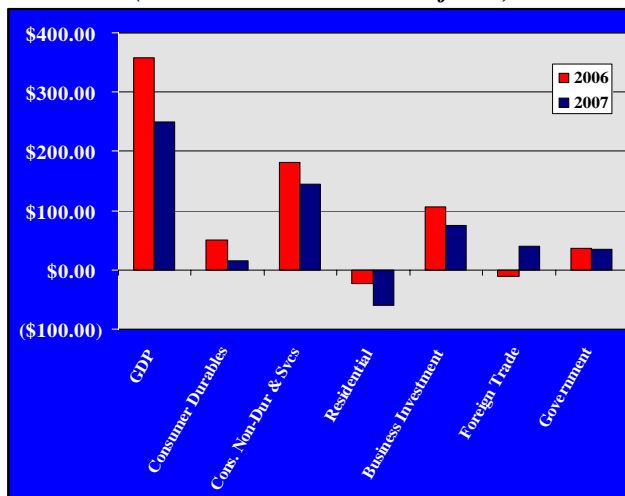
OUTLOOK FOR 2007

Economy Decelerates, But Further Stock Market Gains Likely

Last year's estimated 3.2% economic growth maintained the same pace as in 2005 in spite of a substantial downturn in residential construction. Fortunately, home construction represents only 5% of the total economy, and weakness in that sector was offset by a general rise in employment, a retreat in energy costs, and a robust industrial sector. As a result, consumer spending, which comprises more than 70% of the economy, showed only minor deceleration. It was also the fifth successive year of double digit profit growth (the fourth for the Standard & Poor's Index).

imports increased faster than our exports, causing our trade balance with other countries to deteriorate. This had a detrimental impact on overall economic growth. Last year's weakness in the dollar will help make our products and services in 2007 more price competitive in the world market. The resulting impact could be two-fold. First and most directly is a narrowing of our trade deficit, which will occur for the first time in five years. Secondly, a weaker dollar assists the industrial sector of our economy, a major source of our exports.

Chart I
Economic Growth by Sector (Billions of \$)
(2006 Estimated vs. 2007 Projected)



The economy has enough momentum to carry the expansion throughout 2007 with rising wages and expanding employment that should support continued growth in consumer spending, even if that growth is not as robust as in 2006. The consumer non-durables and services sectors will be quite resilient and experience only minor deceleration. Those two sectors alone are likely to account for 60% of this year's \$260 billion expansion in the economy (Chart I).

The 2007 economy will also be assisted by a decline in the value of the US dollar. Over the last several years,

With that said, growth in 2007 is unlikely to be as robust as last year. First, last year's 4% decline in residential construction is likely to be deeper in 2007 based on year-end 2006 construction trends. Second, the strength in consumer spending over the last several years is projected to moderate in 2007. Consumers have spent more than their income over the last several years, and the normal saving rate of 2% - 4% of disposable income has dipped into negative territory, obviously an unsustainable condition. A restoration of consumer savings is inevitable and would require some tempering in the pace of consumer spending growth.

On balance, 2007's growth is expected to decelerate into the 2.0% - 2.5% range. Deceleration should be concentrated in the residential construction and consumer durables sectors, particularly during the first half of the year. By year-end, however, the pace could re-accelerate to 3.0% or more as the housing sector starts to recover.

The economic outlook is not without risk. First and foremost is the Middle East. Any deterioration in the political and military conditions in that part of the world could interrupt the supply of crude oil, thereby jeopardizing the re-acceleration expected for the second half of the year. Additional factors that might impact the economy later in the year include whether the world economy will be strong enough to support a significant rise in our exports, whether inflation rates will be

impacted by tightening labor markets, and whether the Federal Reserve is able to maintain interest rates at low levels.

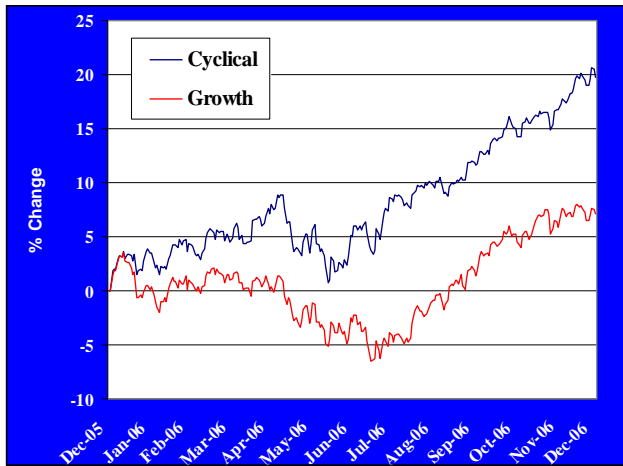
Absent those risks, corporate profits are expected to increase 5% - 10% this year.

INVESTMENT STRATEGY

Stock market gains were surprisingly strong during the second half of 2006 with 84% of the increase in the Standard & Poor's Index occurring during the second half of the year, 46% in the fourth quarter alone. Those gains were prompted by a combination of strong earnings growth and a decline in interest rates for most fixed income securities with a maturity of a year or more.

CHART II

2006 Price Change - Cyclical Vs. Growth



The disparity in price performance between cyclical companies and secular growth companies was particularly dramatic. Cyclical companies, which had little deterioration during the first half of the year, rose sharply during the second half. Their price advance was supported by a sharp rise in profits, and seemed to ignore warnings that profit growth in 2007 could become more challenging.

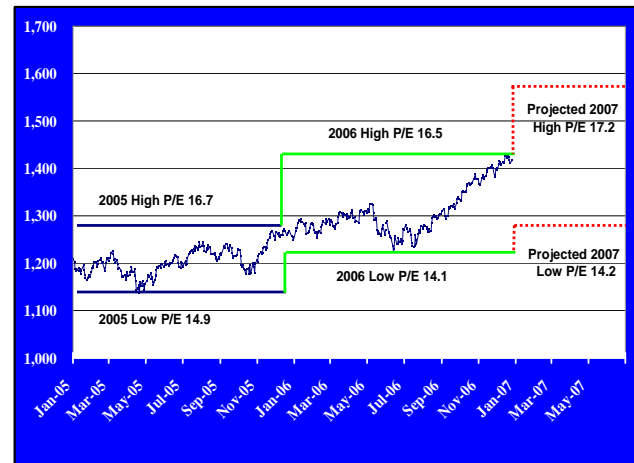
Growth companies, on the other hand, had negative returns during the first half of the year and also lagged during the second half. As a result, their return was less than half their cyclical counterparts (Chart II).

The outlook for the stock market remains positive for 2007. Last year's price gains were "in-line" with earnings growth, and the Standard & Poor's Index ended 2006 with the same 16.4 price-earnings ratio as at the

end of 2005. From a valuation point of view, therefore, stock market risk has not increased.

CHART III

The Standard & Poor's Index



The projected trading range for this year is 1,275 – 1,575 (Standard & Poor's Index), and assumes marginally higher price-earnings ratios than actually occurred for 2006. The projected range for 2007 is consistent with the expected rise in profits and assumes continued moderation in interest rates. It is interesting to note that the top end of the range extends beyond the 2000 peak of 1,553, even if only marginally so.

Based on a 2006 close of 1,418, the projected investment return from stocks (including dividends) ranges from a negative 8% to a positive 13%; i.e., a return potential that exceeds the risk by better than 50%.

However, the relative performance between growth companies and those that are cyclical is expected to reverse the 2006 experience. While cyclical companies appear to be reasonably valued relative to earnings expectations, those expectations are subject to considerable risk during a period of slowing economic growth. The earnings of growth companies, on the other hand, are less vulnerable to an economic slowdown, have more stability, and are more likely to achieve expectations. Moreover, growth company profits are expected to accelerate in 2007 from their mid single-digit performance last year. As a result, growth stocks now have a better return risk trade-off than their cyclical counterparts.