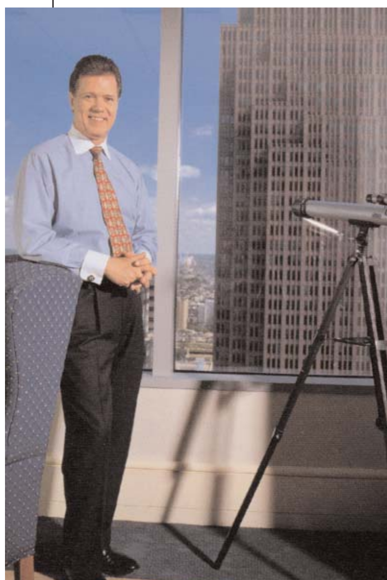
FOURTH QUARTER 2006

2006...A Contrarian's Dream 2007...A Repeat?

If contrarians dream, the past year was one they would dream about. Conventional wisdom, historical trends, time honored methods, and market cycles all went out the window. Turns out that the Wall Street adage "When everyone is looking one way, look the other" was the way to go last year. Let's look at the year past and try to discern if the trends, or in this case counter trends, established will continue into the new year. **This is the third year, or pre-election year, in the important Presidential Election Cycle and as such has had an outstanding record of stock market gains.** Will this year also produce the unexpected?

As the massive liquidity sloshing around the world returns to the U.S., the 3.0% reduction in the float of U.S. stocks will be very bullish.

Last year was one where two market cycles intersected: the four-year stock market cycle and the Presidential Election Cycle. Each called for various market actions and each tracked exceedingly well over many decades – until last year. The four-year cycle as well as the Presidential Election Cycle called for a distinct market bottom around the mid-term elections. In fact, the equity market has experienced a top in prices in late August or early September in 16 of the



HARRY J. CLARK, CFP PRESIDENT / CHIEF EXECUTIVE OFFICER

CCMG In The News

December 21, 2006

CNBC "Morning Call"

Harry Clark, chief executive officer of Clark Capital Management Group, explains to CNBC's audience that he expects there to be a 10% correction by February. Industries such as technology and health care are poised for growth, per Mr. Clark.

January 2, 2007

Bloomberg TV "After the Bell"

Sean Clark, CIO of Clark Capital Management Group, talks about three positives for the US Economy. They are liquidity, relative valuations and the fact that the country is currently in the third year of the Presidential term.

Money Management Executive

November 27, 2006

Money Management Executive

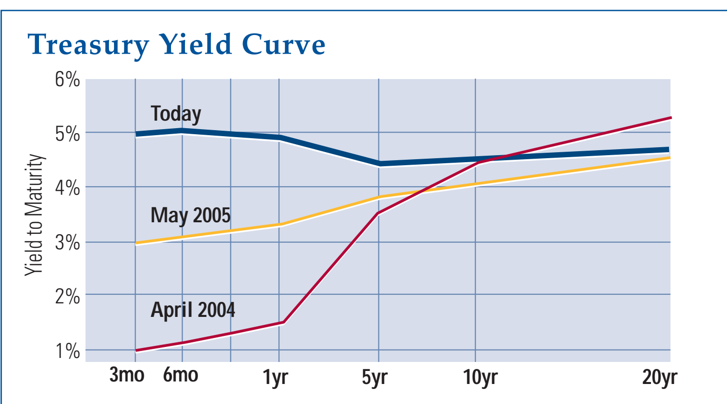
Chief Executive Officer Harry Clark shares with the readers of Money Management Executive the availability of Clark Capital Management Group's new product the Navigator 401(k).

past 20 years, which would have produced the expected bottom near the mid-term elections. Yes, the market had a minor correction in May and June but that correction, as it turned out, was to be the only one of the year. Over the past 80 years the four-year market cycle has produced an average decline of 27% intra-year. The smallest decline over that time frame was 10.2% in 1994. The decline in 2006 (based on the S&P 500) was 8.5%. There is a chart of these declines in the fourth quarter 2005 Navigator Report where I said, *"there will be a correction of some sort to set the stage for the best buying opportunity of the next several years."* Will the small correction we had last year set the stage?

A November correction was one thing that failed to materialize last year but there were several others. The Discount Rate moved to 6%, as it has seven times over the years. In every case the equity markets had either just begun, or would begin, a bear market within a month. The average decline was 41%. The decline this time was 8.5% and, fortunately, no bear market is anywhere in sight.

The Federal Reserve had raised interest rates multiple times on 14 prior occasions causing 12 recessions and 11 bear markets over their history. This time we had one of the largest tightening cycles in history and, to date, no recession or bear market (thank goodness).

The yield curve, the difference between short-term and long-term interest rates, remains inverted (short rates higher than long rates) and that traditionally has meant that a recession was imminent.



The graph above is from InvesTech Research, by James Stack, and shows how the yield curve has become inverted with the 3-month T-bill yielding more than the 10-year T-Note. When the yield on the 3-month T-bill rises to within 0.50%, or above, the 10 year T-note, a recession has only been avoided once. That was in 1998. This indicator has an accuracy of 88%. The Fed avoided a recession in 1998 by cutting rates twice quickly and providing excess liquidity to the banking system. Their actions were precipitated by the collapse of a very large hedge fund. In addition, Mr. Stack reveals that the Federal Reserve Bank of New York has its own Treasury spread model which shows one of the highest probabilities of recession in the last 20 years over the next 12 months.

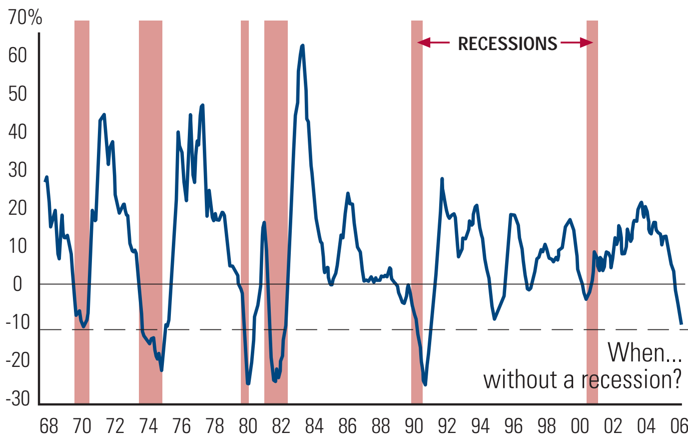
The above notwithstanding, so far it appears as if the Federal Reserve has engineered a soft landing in the economy for only the third time in its history. But I believe that the difference between a hard and soft landing for the economy will rest with the housing market. The housing market remains the one fly in the ointment. As you can see from the chart below, every recession of the past 40 years has been preceded by a major decline in residential construction. Of course the question is, will this time be different? While the chart is compiled by the U.S. Census Bureau the Index compiled by the National Association of Home Builders (NAHB) is more accurate because it takes into account cancelled sales which have been running at record rates. That Index stands at the lowest reading since the fourth quarter of 1991 and is down 55% from the early 2005 peak. *So housing will be the wild card in the economy for 2007.*

Every historic indicator has predicted a recession and/or demise of this bull market but it just keeps on charging. I cannot find any instance of a recession without a bear market, although there have been bear markets without an accompanying recession. (A 20% decline is classified as a bear market.) *This current bull market is now the longest since 1926 without at least a 10% correction.* The current rally began on March 11, 2003 and, as of this writing, is now 1402 days long. The next five longest rallies lasted between 955 and 1208 days. While the present one is by far the longest, it is the smallest in terms of gain with a gain of 66.43%. The other gains averaged 92.2% with the biggest gainer of 150.55% ending in the crash of 1987!

There are several other major factors that affected 2006, such as $78/barrel oil prices and rising commodity prices, but as I said in the 3rd quarter Report, "The market had every reason to fall apart earlier this year and instead held together." Let's look at 2007 and see what lies ahead. Will the pre-election year live up to its billing or will history again be ignored for other reasons?

The Lack of Growth

Another anomaly during the past year was the lack of performance in the growth sector of the market. While the major averages show good performance for 2006, growth indices trailed by a large amount. The Lipper Index of Multi-Cap Growth Funds was up 6.40% and the Large-Cap Growth Funds Index was up 3.78%. During 2006, 81% of active equity managers underperformed their respective indices. **In our case, since we emphasize growth in our offerings, we also underperformed in most cases.** Our one bright spot was the Style Preferred Portfolios where our models point to the top performing sectors such as Large-Cap Value and Small/Mid-Cap value. In our Master Program, which utilizes outside



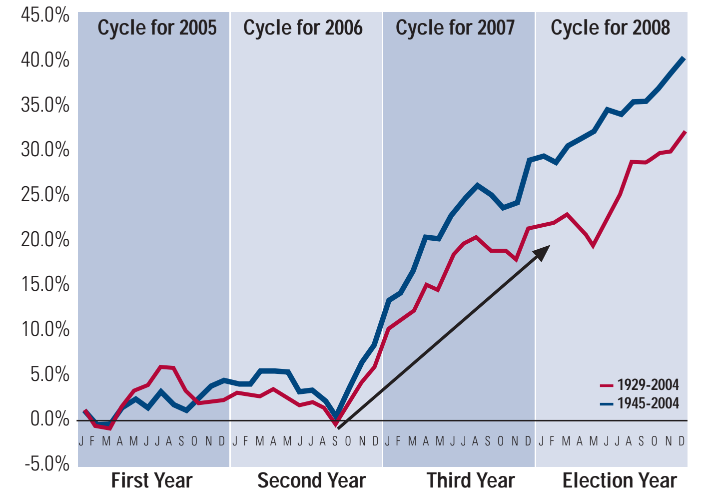
Master money managers, all growth-oriented managers missed except for our Growth of Income manager. The only class of Large-Cap stocks to keep pace during 2006 were the Ultra Large-Cap stocks. We believe that Growth will again come to the fore during 2007. Since the last big up year in equities during 2003, corporate earnings have increased 40%. During this time equities have also appreciated but have remained almost 30% undervalued based on the Federal Reserve valuation model. Managers that have been true to their disciplines will again show superior relative performance as the equity markets begin to reward those companies with superior earnings potential. During 2006 U.S. retail investors sank $140 billion, or 90% of all new mutual fund money, into offshore funds. That money should flow to U.S. funds this year as retail investors usually don't stay in one area for very long. Most investors don't realize that 40% of S&P 500 company earnings come from outside the U.S. Corporate repurchase of stock and Private Equity buyouts soaked up fully 3% of all U.S. equities during 2006. *As the massive liquidity sloshing around the world returns to the U.S., the 3.0% reduction in the float of U.S. stocks will be very bullish.*

The Best in Years?

The coming year could be the most rewarding since the recovery year of 2003 if the economy manages to hold together. So far Mr. Bernanke has been able to win the praise of his critics by keeping interest rates steady since the last increase in June. The economy has been slowing from the unsustainable pace of over 5.6% in the first quarter of 2006 to 2% in the third quarter of 2006. A poll of 60 economists (whatever that is worth) predicts that inflation-adjusted GDP will increase at an annual rate of 2.3% during the first half and 2.8% during the second half of 2007. Personally, I believe that we could very well see a quarter of very low, possibly 1% or so, GDP growth before the economy gets going again. But a slowing economy, and a further decline in residential construction will be the reason the Fed lowers interest rates this year from 5.25% to 4.50%. The Fed has already shown signs of worry over the economy by beginning to expand the M2 and MZM money supplies after over two years of contraction. This is a very good sign that they are worried and this will begin to accelerate the U.S. economy.

The chart below shows the typical market action for the pre-election year. This is the most predictable year of the cycle and has not seen a decline since 1939. The average gain since then has been 17% for the year. As shown in a prior newsletter, the gain from the low in the mid-term election year to the high in the third, or pre-election year, has averaged 51% since 1934. The last four occurrences from the low to the high were:

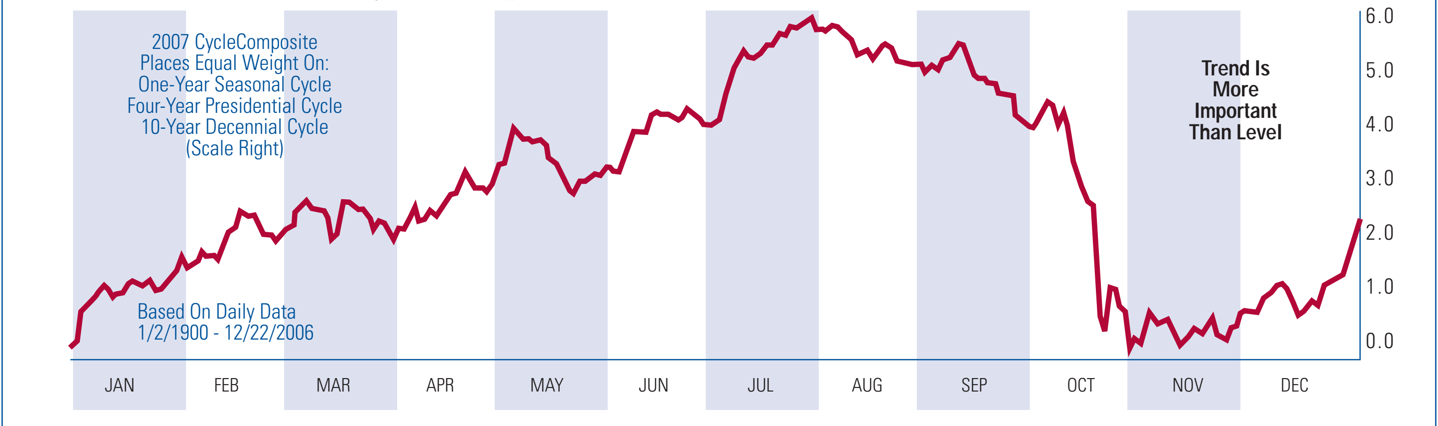
10/11/1990 to 12/31/1991 = 41.2%
4/4/1994 to 12/13/1995 = 41.6%
1/9/1998 to 12/31/1999 = 58.4%
10/9/2002 to 12/31/2003 = 43.1%



But let's not get carried away with enthusiasm. The 1938 to 1939 spread was deceiving. The low of 1938 was on 3/31 and the high was on 1/4/1939. That gain was 55.6% but the market still had a loss for the 1939 year. We cannot throw caution to the wind as evidenced in the chart on the next page from Ned Davis Research. It shows his combined cycle chart for the year. While we believe that we could see a correction at anytime, and most likely in the first quarter, we should be aware of his predictions.

We could see a good run to a high later in the year and then the correction he shows could occur. The market could still meet the average gain of 17% even after a nasty correction. Remember 1987. The market peaked on 8/25 after a gain of 65.5% from the low the prior year and then the devastating crash occurred.

As always, nothing is guaranteed and we cannot just stick our heads in the sand and hope. There are several things that



could go wrong. A surprise acceleration of the economy could cause the Fed to resume hiking interest rates. That would not be well received by the equity markets. Any increase in wage pressures, with a tightening labor force, could also prompt action by the Fed. The price of oil has fallen from $78/barrel to $52/barrel over the past several months and other commodities have also seen steep declines. Oil declined, due to warm temperatures in the Northeast and the resulting oversupply, and commodities declined due to a softening U.S. economy. While we expect these trends to continue, a resurgence would be troublesome for the Fed. And (take another look at the chart of Private Residential Construction on page 3) if the housing market continues to slide, can we avoid a recession? If a recession appears imminent, the equity markets will most likely have a quick and severe decline before recovering later in the year.

In summary, we expect a very good upcoming year. Many are predicting 10 to 12% gains but Don Hays, a very prolific and fine market technician, is predicting a 27.5% gain for the year. We expect the economy to slow and then recover as the year progresses. Corporate earning should slow to single digit gains before beginning to recover. This year is usually the strongest of the four-year Presidential Election Cycle so we will give it the benefit of the doubt and we will give Don Hayes' prediction a haircut to 22% for the year.

CCMG In The News

November 8, 2006
AdvisorMax.com
"The Financial Advisor's Advisor"
Clark Capital Management Group President and CEO, Harry Clark, talks about how his firm is always advising its investors to strive for stability by employing a unique approach to separately-managed accounts that stresses protection from market downturns over chasing the latest hot sector.

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All CCMG performance figures in this Report are net of fees and expenses. Past performance is not a guarantee of comparable results in the future. The sited data have been prepared utilizing a methodology consistent with industry standards.

The cited performance data assumes the reinvestment of all dividends and capital gains distributions, and reflects the deduction of the maximum management fee changed by CCMG for the referenced program. Historical performance is available upon request.