

AKT WEALTH ADVISORS - Quarterly Market Commentary

January 17, 2007

COMMENTARY

Third quarter GDP growth came in at 2.0%, below the second quarter's 2.6% and well below the first quarter's 5.6%. Despite slowing economic growth, the answer to the soft landing or recession question seemed increasingly biased toward a soft landing. This was in stark contrast to the beginning of the fourth quarter when opinions were evenly split. So what caused the change in outlook? Several important factors either improved or stabilized during the fourth quarter. The price of oil ended the quarter about where it started, reducing the prospect of higher oil-related inflation. Residential housing's downslide may have bottomed in the quarter as existing home sales surprised to the upside in October and November. Corporations continued to report double-digit profit growth with a majority of S&P 500 companies beating third quarter estimates. But arguably the most important factor was strength in employment. Jobless claims and the unemployment rate remained at historically low levels throughout the quarter. Historically, the U.S. economy has avoided recession during periods of strong employment.

There were really only two weak areas in the U.S. economy during the fourth quarter: housing and autos. Despite some positive news regarding existing home sales, the housing market weakened during the quarter. The effects of seventeen interest rate hikes by the Fed and an oversupply of new homes in many of the nation's cities combined to put the brakes on the residential real estate market. New home sales slowed during the quarter as cancellations increased and builders were forced to offer incentives to move inventory. New home sales were about 15.0% lower at year end versus 2005. Despite the bad news for the housing market, the median home price ended the year about where it started. The domestic auto industry appeared to be in the midst of a considerable downturn. The Big Three's reliance on its once highly profitable truck and SUV lines backfired as gasoline prices remained elevated. Bankruptcies by a couple of auto part suppliers and multiple downgrades on auto and related company debt highlighted the industry's woes.

EQUITIES

For the first time during the year, equity indices posted positive results in each month during the quarter. Consequently, indices posted high single digit returns and in some cases more than half of 2006's returns occurred in the fourth quarter. Stocks rose impressively during October, with domestic stock indices up between 3.0% and 7.0%. Outstanding third quarter profits and lower interest rates combined to fuel strong returns among stocks. Returns moderated slightly in November as some investors locked in gains. Oil prices rose over the month and contributed to the Energy sector's solid return and the recently lagging Technology sector posted a strong return. Indices generally held onto or extended gains in the year's final month. The only sector that struggled was Energy. Oil prices declined in December and dragged down returns among energy and related companies. Returns were fairly similar across asset classes and styles. There was only about a 3.0% spread between the quarter's poorest performer, large cap growth stocks, and the best performer, small cap value stocks. This was in sharp contrast to the third quarter when large cap stocks outperformed smaller cap stocks and value handily outperformed growth. Just when it appeared that large cap stocks were poised to take a leadership role, small and mid cap stock returns rebounded.

The only theme that seemed consistent in the quarter and throughout 2006 was a clear dominance by value stocks. Three primary value sectors, Energy, Utilities, and Financials all performed extremely well in the quarter and year and helped generate the performance advantage for value stocks.

International equities were the darlings of the quarter and the year. Every country in the EAFE index posted positive returns, showing the strength of the global economy. The weaker dollar was also beneficial, contributing about 3.5% return in the quarter and 10.0% for the year. However, the majority of positive performance in the quarter and year was associated with strength in Europe. The MSCI Europe index was up 11.5% in the quarter and 33.7% in 2006. Virtually every country in the Euro zone posted strong returns as the economic climate in the region continued to improve. The only obvious weakness internationally was Japan. The country continued to struggle with economic reform issues and deflationary growth throughout 2006. However, Japanese stocks ended the year on a good note, experiencing nearly all of their 2006 returns in the fourth quarter.

FIXED INCOME

The Federal Reserve remained on hold during the fourth quarter and left the Fed Funds rate at 5.25%. At the beginning of the quarter, it appeared that the Fed was likely to reduce the overnight rate in early 2007. Interest rates dropped significantly in October and November as fixed income investors became increasingly comfortable that the Fed's next move was an ease. Economic data was surprisingly strong in December and fixed income investors became more bearish. Expectations for a rate cut dropped in December and interest rates increased, wiping out declines in the prior two months and ending the quarter just above where they started.

After two previously volatile quarters, the LB Aggregate Bond index posted a gain of 1.2% in the quarter, roughly in line with the index's 5.0% annual yield. Yields remained fairly consistent between the beginning and end of the quarter and investors were provided with similar returns regardless of whether they held short or long term bonds. Floating rate funds outperformed fixed rate funds because their returns are pegged to short term rates, which remained elevated versus longer rates. Fixed income investors were rewarded for taking risk as high yield bonds posted the highest returns among fixed income options. With yields near historically low levels, investors were willing to take on additional risk in search of higher returns. Despite credit spreads near historical lows, high yield bonds were the recipient of substantial cash inflows.

2007 MARKET OUTLOOK

Entering 2007, we again believe that equities will outperform fixed income instruments. Domestic stocks appear to be fairly priced as price-earnings ratios stopped dropping last quarter and interest rates are expected to remain fairly constant. Therefore, equity returns will likely come from earnings growth rather than expansion in price-earnings multiples. Although we expect earnings growth to slow from the double-digit levels seen over the last few years, we anticipate a modest decline to somewhere in the high single digit zone. Under these assumptions, we anticipate high single-digit equity returns.

Although economic growth in the U.S. slowed over the last two quarters, growth generally increased internationally. During 2006, the Euro zone posted its fastest growth since 2000 and currently it looks like growth will continue unabated in 2007. The Japanese economy showed signs of strength in the fourth quarter, and the economy seems poised for positive growth in 2007. Emerging market countries continue to benefit from strong global growth and burgeoning local consumer markets. Although a trend of lower commodity prices may hurt some resource focused countries, we don't anticipate a significant decline.

With economic growth slowing modestly and inflation starting to trend downward, we anticipate the Fed will be on hold for some time. Consequently, interest rates will likely trade in a fairly narrow range. It is feasible that the weak housing market will negatively impact economic growth and force the Fed to cut rates to fuel growth. However, strong corporate profitability and

low unemployment provide a solid backstop that should keep the economy from falling too far below its growth potential. Inflation remains above the Fed's stated comfort zone and there is also some risk that the Fed may actually raise rates if inflation doesn't drop to within their comfort zone fairly soon. However, we don't think either of the aforementioned scenarios is likely and therefore we believe interest rates will remain fairly stable.

We continue to work diligently to help you achieve your investment goals. Please call us if you have any questions about your investment portfolio.

Very truly yours,

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