



MEMO

Date: 1/22/07
From: Jonathan D. Weir, JD*
To: WFR Clients and Friends
Subject: Fourth Quarter Economic Trends

During the first half of the year the equity and fixed-income markets were buffeted by worries of rising inflation and surging oil prices. Since mid-2004 the Fed has steadily raised rates from 1% to 5.25% to combat inflation. Worries abounded about the consumer's ability to continue spending in the face of these challenges. A fall in consumer and investor confidence was a prevalent concern among market participants. By July, the market, once strong earlier in the year, had given up its gains and the Dow Jones Industrial Average slumped to a modest loss.

It has been said that "the markets advance by climbing a wall of worry." There was certainly enough to worry about. For patient investors this set the stage for solid gains. As the second half of the year progressed the concerns began to moderate. Energy prices began to retreat, making consumers more willing to open their wallets. Falling fuel bills also helped reduce manufacturing and transportation costs for companies and most earnings met or exceeded expectations.

A number of high-profile buy-outs and merger transactions gave investors further confidence. This translated into the strong rally that sustained itself throughout the year. This strength further reinforces our view that short-term movements in the markets are notoriously hard to predict. It is discipline and patience, not emotional reaction that are most often rewarded in investing.

Domestic Equities: This quarter's performance was both powerful and broad. Domestic equities of every stripe participated. The S&P 500, an index of the largest 500 stocks in the U.S. increased 6.7% for the quarter and finished the year up 15.8%. Smaller stocks represented by the Russell 2500 Index jumped 8.7% during the quarter and 16.2% for the calendar year.

International Equities: International stocks were certainly not left out of the party. The "wall of worry" was also being scaled in the overseas markets. As it became apparent that the Fed was, at least temporarily, prepared to halt the rise in short-term interest rates, foreign currencies rose against the dollar. That tailwind, together with good earnings, resulted in very strong gains. The MSCI EAFE index, which measures developed markets in Europe, Asia and the Far East, surged 10.4% for the fourth quarter. For the year, aided by favorable currency movements, it surged 26.9%.

<i>% Returns as of 12/2006</i>			
<u>Equity Indexes</u>	<u>Q4</u>	<u>YTD</u>	<u>3 Yrs</u>
S&P 500	6.7	15.8	10.4
Russell 2500	8.7	16.2	14.1
MSCI EAFE	10.4	26.9	20.4
Emerging Markets	17.6	32.6	31.0
NAREIT (equity)	9.5	35.0	25.9
<u>Bond Indexes</u>			
TIPS	(1.3)	0.4	3.9
Aggregate	1.2	4.3	3.7
Governments	0.8	3.5	3.2
Mortgages	1.6	5.2	4.2
Intermediate Credits	1.3	4.5	3.3
Long-Term Credits	1.6	3.5	5.5
High Yield	4.2	11.9	8.5
Municipals	1.1	4.8	4.3
<u>Cash Equivalents</u>			
3-Month T-bill	1.3	5.1	3.3

Emerging markets, those stocks of companies located in smaller less developed countries, can be quite volatile. As concerns grew at mid-year, these markets were hard hit. They also revived from their mid-year slump. Emerging markets jumped to a 17.6% gain for the quarter and a 32.6% advance for the year.

Real Estate: Concerns also swirled around real estate investments. Fears of slackening demand and higher interest rates were popular stories in the media. As interest rates rose, demand for residential homes slackened. Many believed that commercial real estate would reverse multi-year gains and retreat. Showing that the market often moves in a way to embarrass short-term predictions, the NAREIT Index of real estate investment trusts shot up 17.6% for the quarter and 31% for the year.

Fixed Income: Recently appointed head of the Federal Reserve, Ben Bernanke had his work cut out for him. The two year campaign of rising interest rates was beginning to have an effect. The difficult part was how to balance a tough inflationary stance with economic growth. So far, the markets seem to approve although bond returns were muted.

The Lehman Aggregate, an index consisting of a broad spectrum of bond investments, produced a gain of 1.2% for the quarter and 4.3% for the year. High yield bonds did better posting a gain of 4.2% for the quarter and 11.9% for the year. Government bonds even eked out a modest return of 0.8% for the quarter and a respectable 3.2% for the year.

Conclusions

In my 2006 mid-year letter, when things did not seem so rosy, I stated: "It is important to maintain perspective, discipline and diversification." As always, we are standing by that approach. The markets have had a solid run over the past six months. Vigilance, perspective and good planning are important in both up and down markets.

I look forward to speaking with you soon. Until then, I appreciate the confidence you have placed in me. Please call with any questions you may have.

Source of data – Wall Street Journal, Econometrics.com, Conference Board, US Department of Labor, Bureau of Economic Analysis, Lehman, NAREIT, Bloomberg, The Economist, MPI Stylus, Oppenheimer Funds, Strategic Times. The performance of an unmanaged index is not indicative of the performance of any particular investment. It is not possible to invest directly in any index. Past performance is no guarantee of future results. This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. Treasury Inflation Protected Securities (TIPS) have principal values that grow with inflation if held to maturity. Traditional bonds have fixed principal value and yield if held to maturity. TIPS and traditional bond prices can fluctuate before maturity. Stocks can have fluctuating principal and returns based on changing market conditions. The prices of small company stocks generally are more volatile than those of large company stocks. International investing involves special risks not found in domestic investing; including political and social differences and currency fluctuations due to economic decisions. Investing in emerging markets can be riskier than investing in well-established foreign markets.

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