

VIEW FROM THE FOOTHILLS

Fall 2006

A publication of Foothills Asset Management, Ltd.

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Slower Growth Favors Financials and Health Care

A funny thing has been happening during the last few years while investors have been worrying about inflation, higher energy prices and terrorism. The U.S. economy has been growing and so have corporate profits. Earnings for the S&P 500 have more than doubled from their nadir in 2001. Stock prices are up too, but not nearly as much as earnings. The net result is that stocks are now in that big grey area called “fairly valued.” By historical standards they aren’t cheap, but they aren’t expensive either.

It is fun to talk about what may or may not happen in the stock market or the economy over the next several months. However, we believe that the serious money is made by focusing on what is likely to happen over the next few years. If we are right, and stocks are fairly valued, then investors should expect appreciation to average 5% to 6% a year for the next several years. Add a dividend of about 2% and investors are looking at a total return from stocks of 7% to 8% a year. That’s not great by the historical standard of 10% to 11% a year, but it’s better than the 4.55% yield on a 10-year treasury bonds.

The near-term outlook is mixed. With the market in the big grey area called “fair value,” there are lots of cross currents. Two topics with

broad agreement are housing and interest rate policy by the Federal Reserve. Housing is slowing (not crashing) and the Fed has probably finished raising short-term rates. The quantitative analysts at Ned Davis Research recently produced two interesting reports. The first examined the performance of the stock market when new home sales declined. The second study analyzed the performance of the stock market from the last Fed rate *increase* to the first Fed rate *decrease*.

The first study found that when new home sales decline, the sectors of the stock market that are sensitive to economic growth tend to struggle. Specifically, technology, consumer discretionary, industrials and materials stocks tend to be the worst performing sectors. The better performing sectors were telecommunications, utilities, health care and energy. The study covered the period from February 1972 to August 2006.

The second study examined the performance of the S&P 500 Index and S&P 500 earnings between the time of the last rate hike and the first rate cut. Conventional wisdom says that once the Fed goes on holiday and stops raising interest rates, stock prices should surge higher. Unfortunately, market history contradicts this common belief.

Based on data going back to 1929, the stock market has experienced a median decline of 4.7% between the time the Fed stopped raising rates and the time it started lowering rates. Not counting the current case, there were 13 prior episodes. The rate of growth in corporate profits decelerated significantly once the Fed paused. Specifically, the year-to-year growth rate in corporate profits fell from 19.1% to just 4.3%. Corporate profits continued to expand, but the rate of growth was probably disappointing relative to investors’ expectations.

During these periods of hiatus by the Fed, the best performing sectors of the stock market were financial services, consumer staples, health care and utilities. The worst performing sectors were industrials, consumer discretionary, materials and technology.

We believe earnings growth will slow over the next few quarters. Companies that generate consistent profit increases during a period of decelerating economic growth will likely do better than companies that are sensitive to the strength of the economy. Our preferred sectors are health care and financial services. We would also concentrate on the larger, higher quality companies. *(Text written 9/27/06).*

Stock Market Performance September 30, 2006

<u>Index</u>	<u>Last Month</u>	<u>Quarter to Date</u>	<u>Year to Date</u>
Dow Jones Industrials	+ 2.62 %	+ 4.74 %	+ 8.97 %
S&P 500	+ 2.46 %	+ 5.17 %	+ 7.01 %
NASDAQ Composite	+ 3.42 %	+ 3.97 %	+ 2.41 %
Russell 2000	+ 0.70 %	+ 0.13 %	+ 8.97 %

Stocks Post Best Quarter Since 2004

During the third quarter, stocks posted their best gains since 2004. Skepticism was thick as investors worried about inflation, energy prices and housing. When opinion is one-sided, the stock market often humbles the majority by going in the opposite direction.

The best performing sector during the third quarter was health care. This downtrodden group has reasonable valuations and very modest expectations. Even mediocre earnings growth was better than the fears of market participants, and the stocks surged more than 9%. At the other extreme, the formerly hard-charging energy stocks were the worst performing sector. As oil prices sagged, investors worried that earnings may not rise as fast or as far as they had hoped.

The interest rate background improved during the third quarter. Long-term interest rates fell during the period from 5.13% to 4.63% as slower economic growth has eased investors' fears about inflation. The Fed will probably not cut rates until sometime in 2007

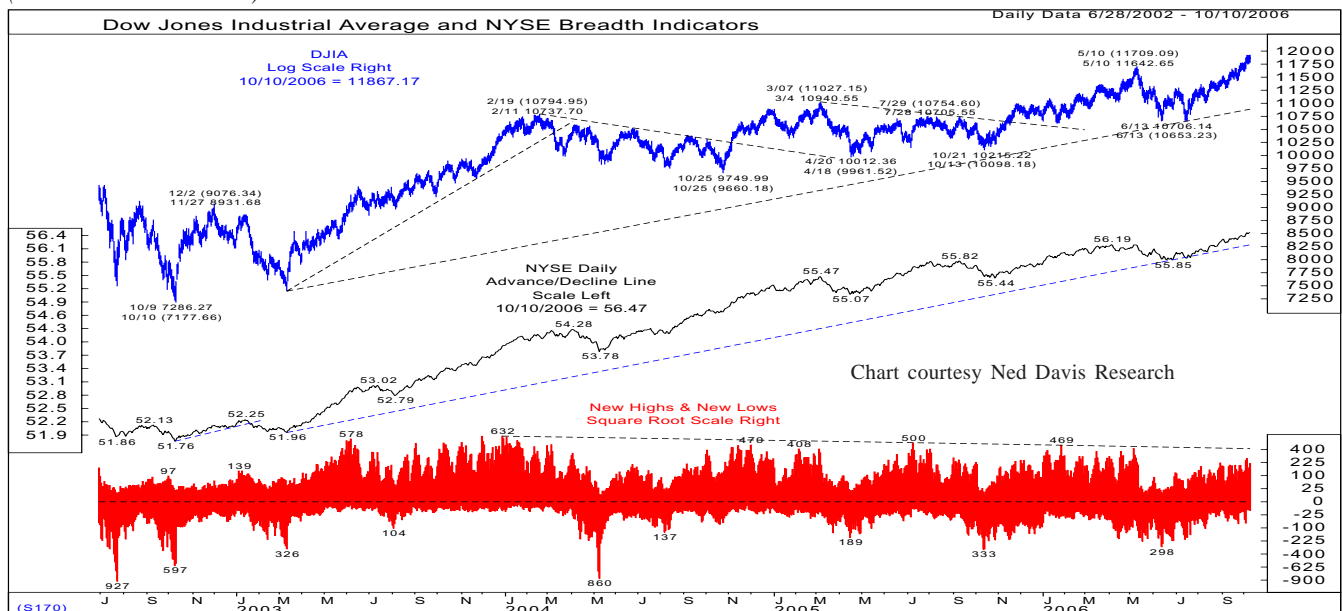
(Text written 10/11/06)

so the market will have to contend with an inverted yield curve (higher short-term rates than long-term rates).

Investors have been skeptical of the advance in stock prices. There is an old Wall Street saying, "The market climbs a wall of worry." As long as investors remain cautious, stock prices are apt to grind higher.

The offset to these positives is that profit growth will slow. Investors and analysts are not very good at gauging how dramatic changes in trend will be. The risk is that profits slow more than the consensus believes. A downward adjustment in expectations could cause weakness in individual stocks or the broad market.

Given the cross currents, we recommend that investors maintain a fairly neutral asset allocation. The evidence is not lopsided either positively or negatively so a middle-of-the-road strategy makes sense. We would also focus on larger, high-quality securities. As a general rule, the blue chips offer better risk-reward prospects than many of the mid- or small-cap stocks during periods of slowing economic and profit growth.



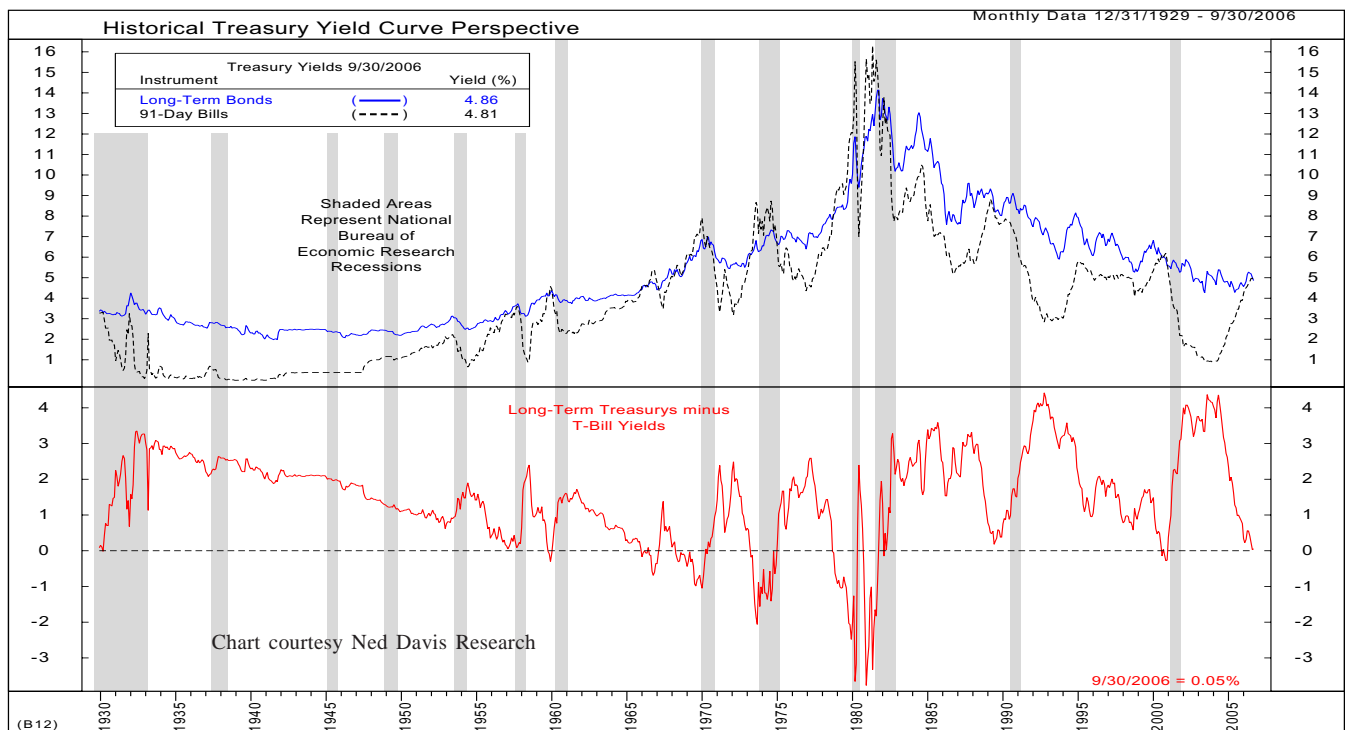
Laddered Maturities Protect Against Reinvestment Risk

During the third quarter of the year concerns about high energy prices and inflation pressures have begun to give way to concerns about economic and profit growth. Consequently, the yield on 10-year government bonds declined from 5.25% to 4.60%. At the same time, the yield on 6-month treasury bills has remained near 5.00%. Many investors do not understand why they should buy a 10-year bond that pays a lower interest rate than a 6-month treasury bill. The simple answer is that interest rates may be lower six months from now. *Reinvestment risk* is an important, but little appreciated, facet of investing in fixed-income securities.

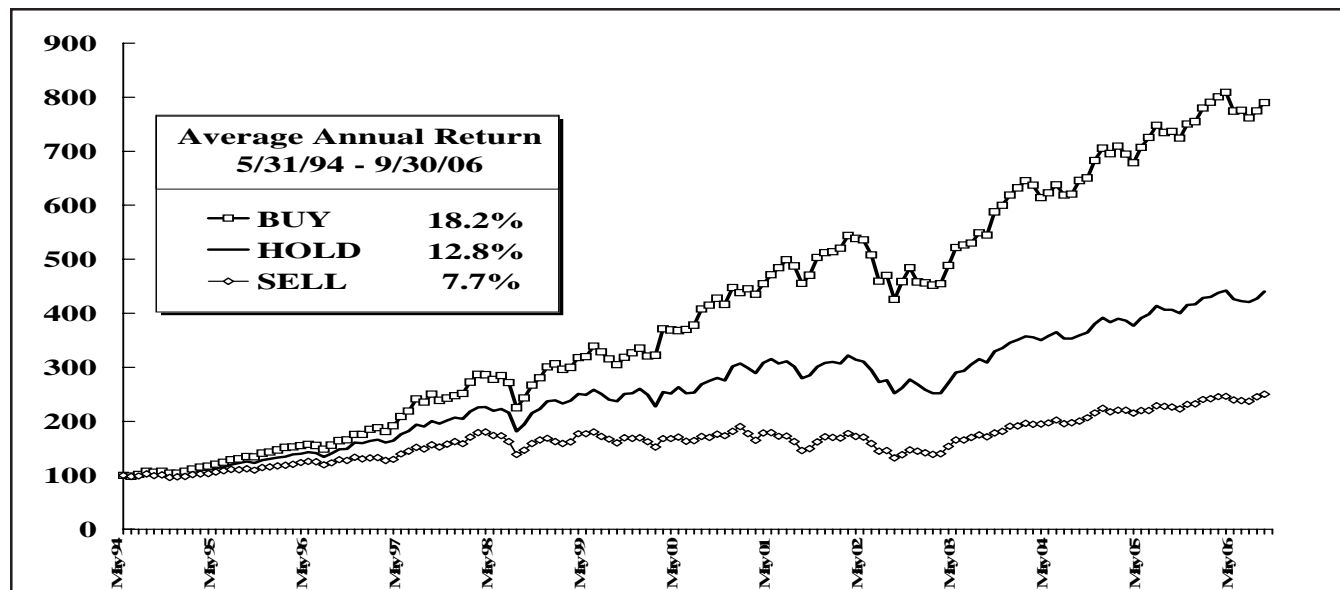
During the 1970s, the yield on treasury bills reached a peak near 16%. The top yield paid by long-term government bonds maturing in 30-years was “only” 14%. The rates were higher, but the same relationship existed – short-term bonds paid more than long-term bonds. Having the benefit of hindsight, we know that the yield on treasury bills gradually declined to their trough near 1% in 2002. Investors who bought 30-year bonds in the late 1970s and early 1980s were politely considered naïve. However, some of those people are still collecting their 14% interest – so who was foolish and who was shrewd?

The 1970s scarred the psyche of bond investors in the same way the Crash of '29 and Great Depression scarred a generation of stock investors. Inflation and interest rates edged ever-higher during the 1970s. Bond investors who “knew” interest rates could not go higher than 8% saw the value of their holdings fall to 60 cents on the dollar or less. Investors who thought the best decision was to buy money market funds, in deference to long-term bonds, were in the majority. Many so-called experts believed that long-term interest rates would rise to 20% or higher. Investors were consumed by fear and ignored a once-in-a-lifetime opportunity in the bond market.

In the early 1980s few investors predicted or believed that interest rates would fall below 10%, let alone approach zero! The point of this missive is that few, if any, of the experts can consistently predict the ups and downs of interest rates. We believe the best strategy is to *diversify* across the continuum of maturities. Just as interest rates rose higher than most believed possible during the 1970s, they fell more than anybody would have believed in the early 2000s. A portfolio of bonds with staggered maturities provides the best protection against either a dramatic loss in market value or a dramatic change in income. *(Text written 10/03/2006)*



We began ranking the relative attractiveness of stocks we follow on May 31, 1994 to illustrate how the principles of valuation, earnings momentum and price momentum could be applied to security selection. Each month we assign a rating of buy, hold or sell to each stock in our research universe and monitor the percentage gain for each category. The chart below shows the cumulative results of this ranking process, it does not represent the performance of an actual portfolio. Results do not include the effects of dividends, commissions or taxes. Past performance is not a guarantee of future results.



The table below shows the largest holdings in our clients' discretionary investment management accounts. This listing should not be construed as a recommendation to buy or sell specific securities. Individuals should consult with their investment advisors prior to making any purchase or sale.

Foothills Asset Management Equity Composite

15 Largest Holdings as of September 30, 2006

Company Name (Ticker)	S&P Quality Rank	Price 09/30/06	Operating EPS Last 4 Quarters	P/E Ratio	Long-Term EPS Growth Est	Div Yield
AFLAC (AFL)	A	45.76	2.40	19.1	13	1.1
Bank of America (BAC)	A-	53.57	4.30	12.5	8	4.2
Chubb Corp (CB)	B+	51.96	4.20	12.4	10	1.9
Constellation Brands (STZ)	B+	28.78	1.30	22.1	12	0.0
Express Scripts (ESRX)	B+	75.45	2.40	31.4	17	0.0
General Dynamics (GD)	A	71.67	3.89	18.4	11	1.3
General Electrec (GE)	A+	35.30	1.85	19.1	10	2.8
iShares EAFE Index (EFA)	N/A	67.75	-	-	-	1.6
Johnson & Johnson (JNJ)	A+	64.94	3.50	18.6	11	2.3
Kinder Morgan Inc (KMI)	B	104.85	4.30	24.4	12	3.3
MBIA Inc (MBI)	A	61.44	5.30	11.6	10	2.0
Sherwin Williams (SHW)	A	55.78	3.76	14.8	10	1.8
United Technologies (UTX)	A	63.35	3.37	18.8	11	1.7
Unitedhealth Group (UNH)	A	49.20	2.62	18.8	16	0.1
Wachovia Bank (WB)	A-	55.80	4.30	13.0	8	4.0

Sources: Standard & Poor's, Ford Investor Services

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