

January 2007

### **Barnyard Forecast: 2007**

2006 was a good year for both the stock market and the economy. The headlines, of course, gave us reasons to think otherwise with stories of oil spikes, saber rattling in Iran, GM's and Ford's sales troubles, and Fed rate hikes. These issues scared away many speculators but allowed long-term investors to reap the rewards of sharply higher earnings and dividends, which produced mid-double digit rates of return.

It was a very good year for Donaldson Capital Management's high-quality dividend-oriented investment styles and investment models:

1. All of our Rising Dividend styles of investment management produced rates of return in the mid-to-high teens.
2. Each of our model portfolios' total return was about what we would have expected based on our dividend valuation models.
3. The economy tracked remarkably close to what we had expected and described in our 2006 Barnyard Forecast.

The importance of this last point should not be missed. John Maynard Keynes once said,

*"It is dangerous...to apply to the future inductive arguments based on past experience, unless one can distinguish the broad reasons why past experience was what it was."*

That John Maynard had a way with words, didn't he? In simple terms, he was saying that investors should not place too much confidence in extending the lessons of the past into the future, unless they know what forces caused the past to be the past.

At Donaldson Capital Management, we have financial models for everything from the stock market to the economy and interest rates, and they are all based on historical relationships. We use these models to "drive" our investment decisions. If John Maynard Keynes is correct, it could be disastrous to use these models if we don't understand why the historical relationships worked in the first place.

It is for this reason that we start each year with The Barnyard Forecast. The Forecast is simple, but its simple construction belies its purpose – to open the eyes and minds of DCM’s Investment Policy Committee to a view of the economic landscape from 30,000 feet and re-think where we are, how we got here, and what the Federal Reserve is likely to do next.

At its heart, the Barnyard Forecast is a checklist of the elements of the economy as seen from the perspective of the Federal Reserve, because the Fed has the power and the responsibility to manage the economy in a prudent manner.

**E + I + E + I = O 2006: How’d we do?**

E + I + E + I = O, of old McDonald’s Farm fame, is the acronym that we work through to see how things look to the Fed and compare it to what we believe they are trying to accomplish.

E + I + E + I = O stands for—

- E*conomy plus
- I*nflation plus
- E*arnings plus
- I*nterest Rates equals
- O*pportunity for the stock market.

E + I + E + I = O is not sequential, it is circular in that everything affects everything, and this circularity is what makes predicting the future course of the economy and the stock market so difficult.

Table I shows the predictions we made in the 2006 Barnyard Forecast compared with the actual results.

**Table I**

	<b>2006 Prediction</b>	<b>2006 Actual</b>
<b>Economy</b>	Trending toward 3%	Ended year with 3% year over year GDP
<b>Inflation</b>	Will end 2006 near 2.5% on Nominal CPI	Nominal CPI ended year near 2%
<b>Earnings</b>	Earnings and dividend growth of 10%	Preliminary figures show earnings and dividends grew near 13%
<b>Interest Rates</b>	10 year Treasury bond yield will rise but stay below 5%	Closed year at 4.75%
<b>Opportunity for stocks</b>	Dow Jones 30 will end the year between 12,000 and 13,000	Closed year at 12,463

We published our first E + I + E + I = O forecast in January of 1994. In checking back, our combined predictions have never come so close to the actual results as they did in 2006. We are happy about the accuracy of our predictions for 2006, but as Mr. Keynes said, if we don’t know how we arrived at them, then, in a way, they are just dumb luck and should give us little confidence in our predictions for the coming year.

With all due respect to Mr. Keynes, we do know how we arrived at every prediction we made last year, and we detailed them in our Barnyard Forecast of a year ago. We will follow the same format as last year for our 2007 Barnyard Forecast.

## Economy:

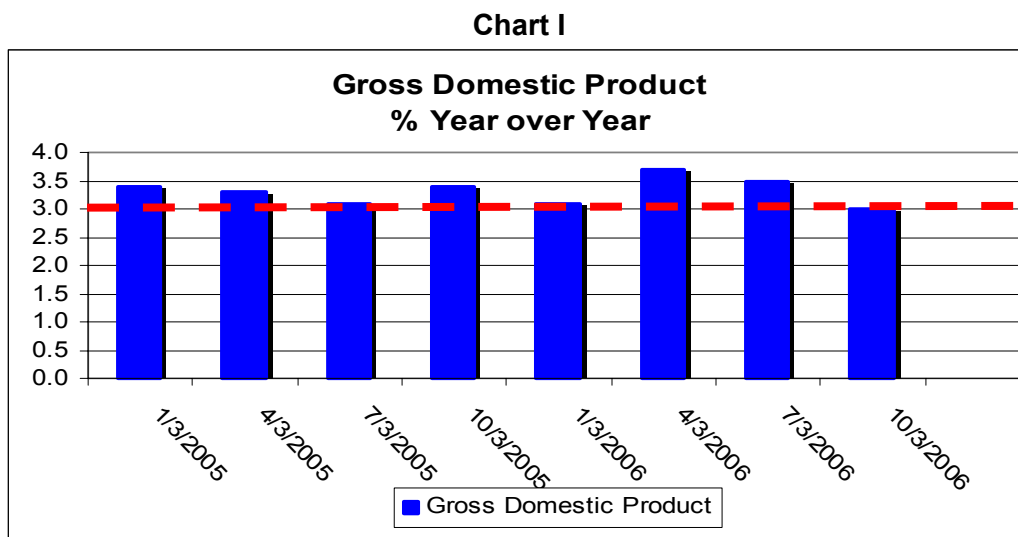


Chart I shows that the economy has been slowing on a year-over-year basis for the last three quarters, with the last reading for the third quarter of this year falling to 3%. We believe that the Federal Reserve would like to see the economy move between 2.5% and 3.0%, with an occasional reading of 3.5%. Chart I shows that the economy's growth has been consistently above the 3% level for most of the last 7 quarters. That is one reason the Fed continued to raise rates, and the recent fall to 3% growth on a year over year basis is a big reason that the Fed stopped their long string of rate hikes.

Until the Fed starts cutting rates, however, GDP growth is likely to continue its downward trend. In addition, as we have discussed in previous letters, we are concerned that the real estate bubble will take longer to unwind than the market currently believes. This will contribute to sub-par growth for the economy in 2007.

We estimate that 2007 GDP growth will average 2.5%, slightly less than the Wall Street consensus. We believe this slower growth, however, will be positive for stocks. This is counterintuitive, but if you think about it, Blue Chip stocks were flat during 2005, a time when the economy was flying high. Stocks started moving sharply higher in 2006 when the Fed stopped their rate hikes.

The next move by the Fed will likely be to cut rates; when that happens, we believe stocks will start another leg higher. We will have more on this in the Opportunity discussion.

**Inflation:**

**Chart II**

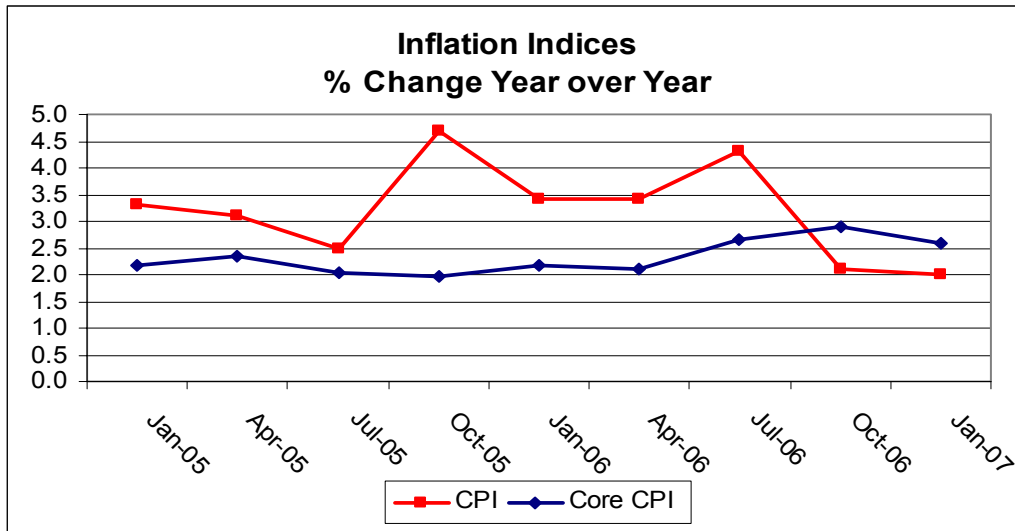


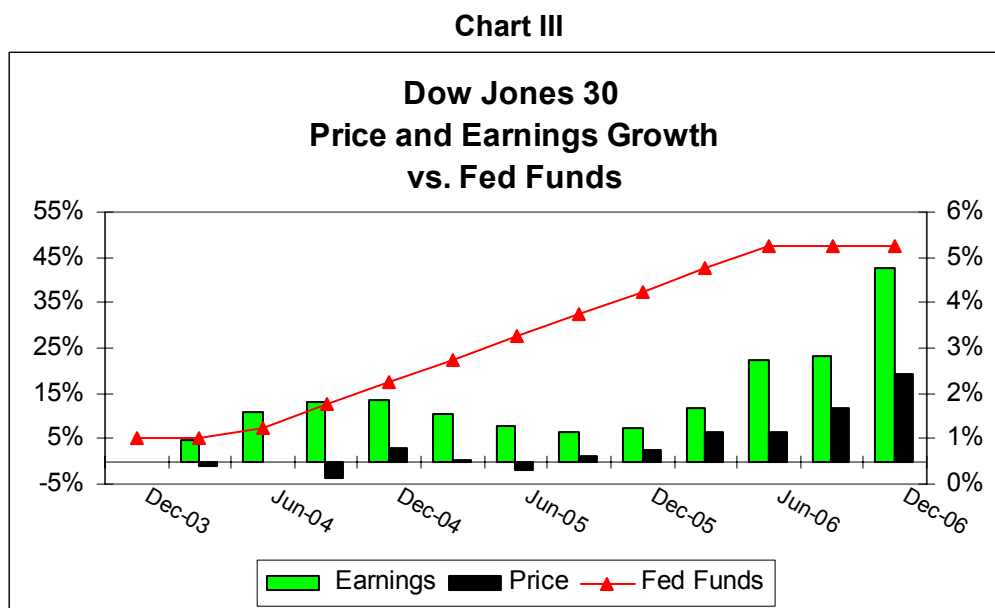
Chart II shows the nominal Consumer Price Index (CPI) and the Consumer Price Index excluding food and energy, the so-called Core CPI. The Core CPI rate (blue line) is the inflation gauge that the Fed watches most closely because it excludes food and energy, which are very volatile. The nominal CPI (red line), as we showed in Table I, has recently fallen to 2% from as high as 4.7% in the aftermath of Hurricane Katrina and the run-up in oil prices. The recent fall in the CPI is good news and has been a contributor to the strong showing in stocks, but we believe an inflation problem still looms.

The problem lies with the Core CPI. The chart shows that Core CPI is less volatile than nominal CPI, but it has stayed stubbornly above 2.5%. We believe the Fed's target for Core CPI is between 1.5% and 2.0%. A fall to that level will not be easy because, as the name implies, Core CPI will get no help from falling oil prices.

An improvement in Core CPI will take time, but we are convinced that it will fall under 2%, possibly as low as 1.75% by year's end. The main reason for our optimism is that Housing is 40% of Core CPI's weightings. A continuation in the recent weak Housing data, which we believe is a near certainty, will help bring down this measure of inflation.

The fall in Core CPI will prompt the Federal Reserve to begin a series of rate cuts by mid-year that will be positive for stocks.

## Earnings:



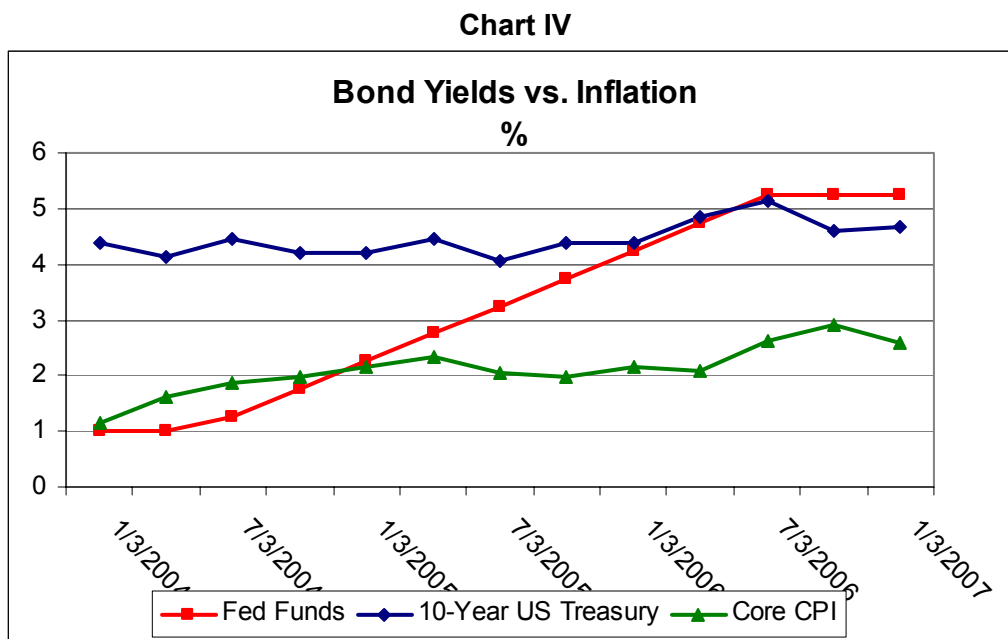
The big money on Wall Street believes in the saying, “**Don’t Fight the Fed.**” Chart III, while a little complicated, shows this in spades.

- The Federal Funds rate, shown in red with its values on the right axis, stood at 1% before the Fed started hiking interest rates in June of 2004. The Fed raised rates a quarter of one percent about every six weeks until stopping in June of 2006 at 5.25%.
- During the same time, earnings for the Dow Jones 30 companies continued to grow, quarter after quarter. Just as the Fed was about to stop raising rates, the Dow’s earnings growth (green bars and left axis) exploded. For the three years ending December of 2006, Dow Jones 30 earnings (and dividends) grew by over 40%.
- Even though earnings and dividends were growing, the Fed’s rate hikes proved to be a strong headwind to the Dow Jones 30’s price growth, shown in black bars (left axis). The Dow was essentially flat from the beginning of 2004 until the beginning of 2006.
- Chart III shows that the Dow did not begin its recent move in earnest until the first quarter of 2006 when it was clear the Fed would soon stop its rate hikes. Another way of thinking about this is that almost all of the Dow price gains of the last three years have come in the last twelve months.

This has left us with an untenable position: Over the past three years, Dow Jones earnings have grown by over 40%, while prices have grown by only 20%. Over the last 45 years, the Dow’s price growth and earnings growth have over a 90% correlation. If this historical relationship is to hold, stock prices have a lot of catching up to do especially when considering that we believe earnings will grow at double-digits again in 2007. In our judgment, either earnings growth must slow significantly, which we believe is very doubtful, or the Dow’s price must grow faster than earnings. We believe the latter is more likely to happen.

We predict that the Dow Jones 30's earnings will rise 10% in the coming year. This is higher than the consensus estimates, but we are confident that the worldwide economy will continue growing at a solid pace, and the Dow Jones 30 companies produce nearly 50% of their earnings outside the US. Thus, while we project that the US economy will be slowing, the global economy will continue to spur double-digit earnings for US blue chip stocks.

## Interest Rates:



While the Federal Reserve's long string of rate hikes held back stocks in 2004 and 2005, Chart IV shows that the Fed's actions were successful in keeping inflation under control. This is reflected in the relatively flat trend of the rates for 10-year Treasury bonds and Core CPI over the last three years. The up-tick in Core CPI in early 2006 has rolled over, and we are confident that the worst of inflation news is behind us, particularly with the weak conditions in Housing.

The best indicator of this is the graph of the 10-year Treasury bond yield (blue line). In short, it has been flat for the last 3 years. It is the one indicator of inflation that is set by the market. Buyers and sellers of 10-year bonds determine its yield. Contrast this to Fed Funds, which are manually set by the Federal Reserve and Core CPI, which is a calculation performed by the government.

We have long said that the best indicator of inflation is the trend for the yield of 10-year Treasury bonds. Savvy professional bond traders with, in some cases, analytics rivaling that of the Fed determine these yields in the open markets. With yields on 10-year T-bonds staying reasonably flat over the last 3 years, we believe the professional buyers are signaling that the Fed has done its job in keeping inflation under control.

In essence, the Fed has broken the back of inflation with their rate hikes, and in time, they will start lowering the Fed Funds rate to a more neutral status. We believe that will happen after they have seen at least two more quarters of falling Core CPI.

We forecast that Fed Funds will end the year under 5% and that 10-year Treasury bond yields will remain in a narrow range but stay below 5%.

## Opportunities for Stocks:

The **Economy** will weaken in the coming year, but that will not harm stocks because the weakening economy will allow the Fed to cut rates, which will be a positive for stocks. We rate the economy **positive** for stocks.

**Inflation** is improving, but the Core CPI rate is still a bit too high. We believe this means the Fed will not be cutting rates as soon as many investors hope. We do not view this as a problem in the long run, but it may create some headwinds for stocks in the short run. We believe inflation is **neutral** for stocks.

**Earnings** are very strong, and we see few signs that they will slow by much in the coming year. We rate earnings as **positive** for stocks.

We rate **Interest Rates** as **neutral** for stocks. Even though the Fed has stopped raising rates, as we have previously said, we don't think they are going to start cutting them as soon as many analysts are predicting.

That gives a total of two positive scores and two neutral scores. On a balance, that produces a positive rating for stocks in the year to come. Earlier, we said the stock market had some catching up to do and that price growth would likely exceed earnings growth. With our estimate for earnings growth in the 10% range, we believe price growth will likely be closer to 12%. One of our most reliable stock market valuation models has a fair market estimate for the Dow Jones of close to 14,000. That sounds like a pretty good number from all that we see.

Please watch our blogsite [www.risingdividendinvesting.blogspot.com](http://www.risingdividendinvesting.blogspot.com) for weekly comments about individual companies, the markets, and the economy. Also take a look at our new website at [www.dcmol.com](http://www.dcmol.com). You will see some familiar faces as well as learn all that is going on at Donaldson Capital Management.

Blessings,

Greg Donaldson

Mike Hull