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Investment Managers
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Mark D. Foster, CFA · *Mickey Kim, CFA* · *David M. Kirr, CFA*
Darrell H. "Kip" Wright, CFA · *Richard H. Hummel, CFA*

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THIS ISSUE

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Interest Rates and the Bond Market

Summary

"Nothing in life is so exhilarating as to be shot at without result."
- Winston Churchill

DEAR CLIENTS:

Our overall market outlook at the beginning of 2006 was for better returns than 2005's mid-single digit performance (S&P 500 total return of +4.91% for 2005). We thought the economy would slow, but corporate earnings would continue to grow, albeit at a slower rate. Further, if inflation remained contained, the Federal Reserve (the "Fed") would have the opportunity to stop increasing or even reverse course on rates. If this happened, the compression of the market's price-to-earnings ratio would likely halt. On a micro level, we expected merger and acquisition activity to continue unabated, also leading to higher stock prices.

Comparing the starting point of the year with the ending point yielded the type of result we had expected for 2006, but performance over the course of the year was anything but a straight line. Investors became unnerved by the Fed's abrupt about-face from stating "inflation is reasonably well contained" and signaling at least a pause in the tightening campaign to stating "inflation is uncomfortably high" and further tightening was likely needed. The "saber-rattling" from the Fed combined with crude oil soaring to $77/barrel cast a pall over the market, with the S&P 500 spending mid-June to mid-July in negative territory for the year. Fortunately, the Fed decided to leave its target for federal funds unchanged at 5.25% at its meeting on August 8, 2006 (and continued to do so at its three subsequent meetings). Recent inflation readings have been benign and crude oil retreated to $61/barrel at the end of the year due to a relatively mild hurricane season in the Gulf, a warm start to the winter and possibly speculative money exiting a weakening sector. Note that oil has continued to plunge in the beginning of 2007, to the mid-$50s as we write this. Corporate earnings were significantly stronger than expected at the beginning of the year, with ISI Group estimating operating earnings for the S&P 500 gained 14.1% in 2006. These positives combined to overcome the fears prevalent at mid-year and led to strong performance in the second half of 2006.

Periods ending December 31, 2006
(Total Returns-Cumulative-Bloomberg)

	Russell 3000 Index	S&P 500 Index	NASDAQ
3-months	7.13%	6.70%	7.15%
One-year	15.72%	15.80%	10.39%
Two-years	22.80%	21.46%	12.73%
Three-years	37.47%	34.66%	23.04%
Five-years	41.35%	34.98%	27.57%

P.O. Box 1729 • 621 Washington Street • Columbus, Indiana 47202-1729 • 812-376-9444 • Fax 812-376-3889

The Stock Market

The environment remains favorable for U.S. stocks. Client portfolios are essentially fully invested and we like what we own.

1) **Valuations are reasonable and have room to move higher.** The S&P 500 Index finished 2006 at 1418.30, 13.6% higher than its 1248.29 starting point. However, recall from the section above that S&P 500 operating earnings are estimated to have increased 14.1% in 2006, meaning the price-to-earnings ratio actually *contracted* slightly. We continue to think short-term interest rates will fall over the intermediate term as economic growth and inflation slow. Lower rates and slowing inflation are consistent with an expanding earnings multiple for the market. Combining a higher multiple with even modest growth in corporate earnings will lead to higher stock prices. Goldman Sachs Portfolio Strategy recently published a simple table that presents a powerful historical perspective:

	1999	2006	% Change
S&P 500 Operating Earnings Per Share	$ 50.96	$ 87.00	+70.7%
S&P 500 Cash Balance Per Share	$152.76	$309.85	+102.8%
S&P 500 Index (@ 12/31)	1469.25	1418.30	-3.5%

Thus, over the past seven years companies comprising the S&P 500 have posted strong growth in operating earnings and cash on their balance sheets has more than doubled, yet the S&P 500 Index has gone nowhere. In hindsight, the S&P 500 was clearly overvalued at the end of 1999. Seven years later the excessive valuation has been wrung out, leaving the market poised to move higher.

2) **Mergers & Acquisitions and stock buybacks will continue at a torrid pace.** The Wall Street Journal reported data, compiled by Thomson Financial, which indicated there were $3.79 *trillion* worth of deals worldwide last year, an increase of 38% over 2005 (and above the previous record of $3.4 trillion set in 2000). A whopping 55 transactions were valued at more than $10 billion each and "private equity" firms were involved with 20% of the deals. These buyout firms and U.S. corporations are flush with cash and also have the ability to leverage those huge sums multiple times in the credit markets, which are currently offering financing at rates not much higher than what Uncle Sam pays to borrow. On the stock buyback side, Standard & Poor's reported U.S. corporations spent a record $325 billion repurchasing their own shares through the first nine months of 2006, up 33% and 150% over the same periods in 2005 and 2004, respectively.

3) **Contrary to continued tough talk from the Fed, monetary conditions have become favorable for financial assets.** In a case of "watch what I do, not what I say," the Fed has been steadily pumping *up* the money supply, while still talking tough on inflation. One of the Fed's primary charges is to keep inflation in check and their public statements are meant to reassure that they remain vigilant. However, their *actions* seem to indicate they believe their 17 rate increases from June 30, 2004 to June 29, 2006 have slowed the economy sufficiently and it's now time to accelerate the growth rate of the money supply.

Interest Rates And The The Bond Market

The yield on the benchmark 10-year U.S. Treasury Bond ended the fourth quarter of 2006 at 4.71%, up from 4.63% at the beginning of the quarter and 4.40% at the beginning of the year. The Lehman Brothers Intermediate U.S. Government/Credit Index produced a modest total return of 4.08% for 2006. Yield-hungry investors piled into the riskier segments of the fixed income market, with the Lehman Brothers U.S. Corporate High Yield Index posting a 2006 return of 11.85%.

The "inverted yield curve" has been getting a fair amount of news coverage. We discussed this phenomenon in some depth in our letter dated January 9, 2006 (past quarterly letters can be accessed on KM's recently updated and we think vastly improved **www.kirrmar.com** website). Briefly, the yield curve is a snapshot of the yields on various maturities of U.S. Treasury notes/bonds. If you plot the yield on the vertical axis and the maturity on the horizontal, the result is a graph of the term structure of interest rates, or the "yield curve" at that point in time. Typically, the yield curve slopes up, as investors demand a higher yield for taking on the risk of a longer maturity. An "inverted yield curve" is when the yield on longer-maturity securities is lower than the yield on shorter-maturity securities. The current yield on the 3-month U.S. Treasury note is about 5.07% and the 10-year U.S. Treasury bond is about 4.66%, so the curve is inverted. Yield curve inversions have been associated with subsequent economic recessions and when the curve tilted from "flat" to "inverted" in mid-2006, investors were spooked. Our take is a little different. Past Fed tightening cycles were aggressive responses to surging inflation. The Fed typically overshot the mark and ended up dragging the economy into recession. By contrast, the recent tightening cycle was more proactive and saw a gradual lifting of short-rates from an artificially low level (i.e. 1% federal funds) while inflation expectations remain low. Further, the inverted yield curve indicates the Fed has moved its monetary policy stance from "accommodative" to "neutral" to "restrictive," meaning short-term rates have risen to the point where both economic growth and inflation will slow. This leads to our expectation that the Fed's next move will be to reduce its target rate for federal funds, not increase.

Client fixed income portfolios continue to be committed primarily to intermediate maturity U.S. Government and higher quality corporate securities. We mentioned in the opening paragraph of this section that the best 2006 performance had been in the riskier sectors of the market. Lehman Brothers calculated that the interest rate spread vs. comparable maturity U.S. Treasury bonds (measure of how much an investor is being compensated for taking on additional risk) on "Ba"-rated securities (i.e. the upper tier of non-investment grade) had declined from 313 basis points at the beginning of 2006 to 200 basis at year-end, a premium we view as wholly unattractive. We'd also note the "Ba" spread was 530 basis points as recently as the end of 2002.

Investing is a long-term, probabilistic endeavor and the best practitioners emphasize process over outcome. While anything can happen in the short-term, we think our solid investment process combined with our positive outlook for the overall market will lead to continued good long-term performance. The U.S. equity market has enjoyed a nice, uninterrupted run from the mid-July lows and we wouldn't be surprised to see a short-term stumble at any time if storm clouds appear. As always, our challenge is to tune out the noise and focus on the prize of superior long-term performance. We thank you for the trust and confidence you've placed in us and wish you and your families a healthy and prosperous 2007.

Regards,

Kirr, Marbach & Company, LLC