

QUARTERLY
COMMENTARY

A quarterly commentary on the markets and the economy from Rorer Asset Management, LLC

10 LARGEST HOLDINGS AS OF
DECEMBER 31, 2006

Large Cap Equity:

Morgan Stanley (MS)
Cisco Systems Inc. (CSCO)
General Electric Co. (GE)
ConocoPhillips (COP)
Citigroup Inc. (C)
Merrill Lynch & Co. (MER)
AFLAC Inc. (AFL)
L-3 Communications Holdings Inc. (LLL)
The St. Paul Travelers Co. (STA)
American International Group, Inc (AIG)

Mid Cap Equity:

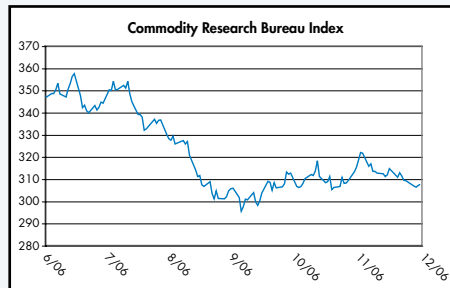
Thermo Fisher Scientific (TMO)
Express Scripts, Inc. (ESRX)
Staples, Inc (SPLS)
Parker Hannifin Corporation (PH)
Thomas & Betts Corporation (TNB)
Janus Capital Group Inc. (JNS)
Community Health Systems (CYH)
Biomet, Inc. (BMET)
TD Ameritrade Holding Corp. (AMTD)
The Bear Stearns Companies Inc. (BSC)

RORER
ASSET MANAGEMENT, LLC

THE RORER REVIEW

Ebb and Flow

Last summer's edition of *The Rorer Review*, *The Turn of the Tide*, posited that the financial tide, which had been coming in since the recession of 2001-2002 had ended, was starting to ebb and that economic growth was destined to slow over the next year or so. As a corollary, we argued that industrial commodities had peaked and that the highs recorded in the spring of 2006 for gold, oil, and a host of other industrial commodities would likely be the peak prices for the cycle as the economic tide started to recede. Indeed, since then the CRB Index, a broad indicator of commodity prices, is down about 20% (see graph). Our rationale



for these thoughts was that the Fed had created an economic undertow by raising interest rates 17 times in a row. We went on to say that rising inflation fears were overblown, that interest rates had peaked, and that rising earnings from corporate America, even in the face of a slowing economy, would be a catalyst for rising equity prices, particularly those of high quality large capitalization companies. In this issue of *The Rorer Review*, we argue that economic events seldom occur in a linear fashion and the normal ebb and flow of economic activity is likely to create a temporary rebound in the domestic economy as we launch into 2007.

The Fed minutes from its most recent meeting have just been released, and they show a Board that is still very much concerned about the

potential for rising inflation even while it sees a slowdown in the economy. We respectfully disagree with this outlook. Nonetheless, investors' hopes that a Fed interest rate cut could come sooner rather than later have been thwarted once again. This is a boat ride that investors have endured time and again over the past six months when the Fed has released meeting minutes or Board members have spoken publicly. Though the Fed has not shown any inclination to cut interest rates during its last several meetings, the overall tone of the equity markets has been anything but dour. In fact, with dividends included, the S&P 500 posted a solid gain of just under 16% in 2006, with virtually the entire advance coming in the second half of the year, a timeframe that coincides with the final interest rate hike by the Fed. Though we think the Fed Funds rate will eventually be reduced, an accelerating economy in the first quarter will make this a second half 2007 event, in our opinion.

In each of the past several years, U.S. economic growth has accelerated in the first three months of the year, and subsequently slowed as the year progressed. 2007 looks like it will start out in much the same way. While the economic news of late continues to be mixed, there have been several areas of unexpected strength. Most prominently, consumer spending has remained much stronger than many economists had predicted. For much of the past two to three years, prognostications of a bursting of the housing bubble leading to the death of the consumer have been rampant. The consumer has proven extremely resilient, however, and quite willing to spend given an attractive enough opportunity. During the holiday shopping season for instance, flat screen TV's were flying off the shelves at heavily discounted prices at Wal-Mart, Best Buy and Circuit City, with even Home Depot getting in on the action. Sales over the internet were robust during

the holidays, and the new video gaming systems were extremely popular. As we go through the first quarter the consumer will get the added benefit of bonus checks and tax refunds. Consequently, we would expect a healthy level of spending to continue.

We believe the refusal of the consumer to retrench is explained by the high level of employment in the U.S. Through 2006, the average monthly payroll gain was roughly 150,000. While these numbers aren't huge by historic norms, and they may even slow as we progress through 2007, there is reason to believe some level of strength will continue. For starters, corporations in the U.S. have never been more profitable, and small businesses, which make up the vast majority of employees, have been hiring at a healthy pace. Further, demand for U.S. goods and services from overseas has been increasing at a steady pace thanks at least in part to the weakening dollar. The percent of U.S. output shipped abroad stands at 17.6% today versus 13.5% just three years ago. We believe these trends will continue to provide some buoyancy for the consumer going forward.

With the help of the consumer and continued demand from abroad, we think the U.S. economy can grow at a 3.0%-3.5% pace in the first quarter of 2007, up from an estimated 2.5% clip in the fourth quarter of 2006. Part and parcel of the first quarter growth phenomenon however, is an attendant inflation scare, which arises from fears of overly robust demand both here and abroad. While we think this could happen in early 2007, we do not believe inflation will be an issue for the full year. In fact, during the past two years, despite strong pricing in many commodities including oil, worldwide inflation has been virtually non-existent. With the economies of the world experiencing slower growth in general and commodity prices cooling off, if not falling, we see little chance of inflation ahead. However, given the

economic growth mentioned above, we doubt the Fed will be cutting rates before the second half of 2007 as it keeps its eyes on inflation and economic news in the near term.

Part of our optimism for a second half interest rate reduction has to do with our feeling that the housing market is likely to remain weak for a while. After years of robust housing growth, the "bubble" finally seemed to burst in 2006. Sales of new and existing homes each had double digit declines for the year, and the inventory of existing homes for sale, while off slightly from its peak, still stands at a lofty 7.3 months. As we began the new year a prominent homebuilder, Lennar, lowered its forecast for fourth quarter profits and said it has yet to see signs of a recovery in the housing markets it serves. Going forward, fewer folks may qualify for mortgages as tougher lending standards for esoteric mortgages become a focal point by banking regulators. Furthermore, we believe mortgage interest rates are likely to rise in the first part of this year as economic growth accelerates, making housing sales even more difficult. So, while many have viewed the firming in the housing market in the fourth quarter of 2006 as a sign of a bottoming, we think it will take a while longer for the excesses of the past several years to be fully shaken out. The effects of steady, or even slightly rising, interest rates, coupled with continued housing weakness, will cause the economy to slow as we go through 2007, making the prospect of Fed cuts more likely in the latter part of the year.

We believe this scenario portends good things for the equities market in 2007. For starters, corporate margins are at all time highs and, even in the slow growth economic environment we envision, we believe this profitability can be maintained as the forces of globalization, productivity and technology continue to exert their positive influence on profit margins. To be sure, earnings growth is

likely to decelerate in 2007 after several years of double digit increases. However, if we assume the S&P 500 earns roughly \$92 per share this year, or about 6% growth over 2006, then the market, as defined by the S&P 500 Index, is currently trading at a price/earnings multiple of only slightly higher than 15 times earnings. In an environment where the long bond is trading under 5%, where inflation is drowning in excess global capacity, and where consensus earnings estimates, in our view, are too low, there is little doubt in our mind that high quality equities are undervalued.

While we are bullish on the prospects for full year equity market returns, we think there could be some choppiness ahead. When the economy is in a slow-down phase and investors are eagerly anticipating an interest rate cut by the Fed, good news for the economy can be bad news for the stock market. Simply put, strong economic news reduces investor confidence that the Fed will reduce rates in the near future and may even cause fears that the Fed might raise rates if the economy heats up too much. This would subsequently retard the anticipated economic recovery, causing some angst among investors.

Given today's modest valuations, any market weakness would be a tremendous buying opportunity for the long-term investor. By historic standards, the current Fed Funds rate of 5.25% is low enough to keep the economy healthy without overheating. If the Fed reduces this key rate in the latter part of 2007 as we suspect, this will provide further stimulation for the economy and the stock market. Needless to say, throughout the course of the year we will be using our proprietary Relative Valuation models to identify the most attractive long-term opportunities available.

January 2007

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