CENTURION
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Investment Management

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Q4 2006 Economic Review

Even in the best of times, economic forecasters rely on very cloudy crystal balls. A year ago, with stocks stagnating, the widespread expectation was that markets would struggle to rise more than 6% or 7% in 2006. As it often does, the market surprised the pundits.

The Dow industrials jumped 16.3% to 12,463 and set 22 records between October and year-end. Similarly, the S&P 500 index rose 13.6% to 1,418 while the Nasdaq, dominated by technology stocks, rose 9.5% to 2,415. Neither finished near the records reached during the technology-stock mania of 2000 but both did better than many experts predicted.

Investors now have a much rosier outlook. With the Fed seemingly finished raising rates, consumer inflation staying benign and the economy so far staying out of recession, hopes are high. Still, amid all the euphoria for last years stock gains, some investors and analysts are getting a little uncomfortable. They note that almost all the market's rise came in the second half of the year, and they worry that some of that surge may have come at the expense of this year.

The repeated stock gains that sent the Dow to a succession of record closes were based on a promising view of the economic outlook. That rosy expectation for low interest rates, strong corporate profits, and steady economic growth is already factored into the current stock prices. It will be hard for businesses as well as the economy to exceed those expectations and less difficult to fall short.

Investors now adopted (no pun intended), the word "Goldilocks" to describe the economy -- not too hot, not too cold -- which they think is the perfect environment for stocks. They believe Fed Chairman Ben Bernanke stopped raising rates at just the right time, stifling inflation without sending the economy into recession.

In some ways, the markets seem to have more faith in the Fed than the Fed has in itself. If Fed officials are too optimistic about the economy's resilience and delay an interest-rate cut too long, the economy could slide into recession leaving little chance for rescue. If they are too optimistic about inflation and wait too long to raise interest rates, they will have to raise rates a lot more -- and that's the traditional cause of recessions. That fear helped push the yield of the 10-year Treasury note to 4.71% at year-end, higher than the 4.39% at which it began the year, but well below the 5.25% it hit in late June.

Beyond the delicate balancing act the Fed must continue performing, capital spending by businesses is showing signs of slowing . . . as is hiring. Furthermore, the housing market

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may not have bottomed and if it weakens further could weigh on the economy and the stock market.

While all these downsides make sense from an economic standpoint, we are on the cusp of an unprecedented time in our history. The world, it seems, has become intoxicated by the steady flow of liquidity. We are awash in cash, and this flooding of capital to the markets has created a 'fountain of exuberance' to precisely the wrong audience. The most perilous among the emerging markets, the most hopeless of troubled companies, and the most overextended of home buyers continue to have available a steady stream of resources.

Last years market run-up is a good example. The access to cheap capital led to increased borrowing by sophisticated investors such as hedge funds. Even though they weren't full believers in the market itself, they borrowed at historically low interest rates and used much of the borrowed money to buy stocks in order to keep up with unexpectedly strong market gains.

Once the year ends, the need to chase hot stocks in order to improve annual performance evaporates. Those investors who never fully believed in the rally's underpinnings may choose to cash in some profits and shift their investments elsewhere, taking a great deal of demand out of the market. However, demand for stocks from cash-rich private equity funds, which buy publicly traded companies and take them private, could very well outweigh any selling by hedge funds. Money is cheap and looking for places to go.

Another example lies in the corporate-debt markets. According to Thomson Financial, one of the worlds leading information companies, the average spread on high-yield corporate bonds, or, in other words, the additional interest a company must pay over a comparable Treasury issue, narrowed in the past year to 2.82 percentage points from 3.71 at the end of 2005. With corporate default rates near historical lows, investor demand for these higher risk assets continues to be stronger than with safer investment-grade debt. In many cases, these investors are taking on too much risk in search of incremental yield.

Companies are taking advantage of easy access to capital as well. Thomson Financial further reported that a record $1.07 trillion in corporate bonds were issued in 2006 versus $770.5 billion a year ago. High-yield-bond issuance totaled $150.5 billion, exceeding the last peak of $143 billion in 2004. Companies, particularly those rated as junk, also raised record sums from the market for syndicated bank loans. From the company standpoint, why not raise money when rates are low if there are so many in the market who'll help finance it?

The swollen river of liquidity is also behind the "happy predictions" that housing will recover later this year. Despite rising default rates, mortgages remain cheap and easy. Lenders are still willing to let borrowers bury themselves in debt to buy a new home. The money gusher also helps explain why the federal government in Washington can keep spending away, without regard for projections of an exploding federal deficit; or, why the

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dollar remains relatively strong despite swelling trade deficits. Also, notably important is why the Dow Jones Industrial Average has managed to go for more than 912 trading days without a 2% daily decline -- the longest stretch of this kind in its history.

We start the New Year with much higher expectations than this time last year. However, don't be fooled into thinking that more drinking from the fountain of liquidity will ease the inevitable hangover. At some point, something -- a string of big defaults, a sharp decline in the dollar, etc., will cause the intoxicating stuff to stop flowing. The crystal ball may remain cloudy rendering perils unclear, but the world is still a risky place, and liquidity at the end of the day, is just another name for confidence. Eventually, this confidence game will end. Remember, the market has a knack for surprises.

Whether this New Year will bring us the best of times or the worst of times, it is the only time we have. Let us continue to help you make it the best time possible.

Advance Billing Notice

This is to provide you with notice that Centurion Counsel will charge your account for the **first quarter 2007** management fee. Your management fee for this quarter will be $1,574.64. This was calculated by multiplying your account value as of the end of the previous quarter by 1/4 of your annual fee rate, as stated in your client agreement. If assets are deposited into your account during the quarter, a pro-rata share of the quarterly fee will be charged. If you are currently paying your management fee by check, your check should be received by **March 1, 2007**. All checks should be made payable to **Centurion Counsel**. Please direct any questions regarding this advance billing notice to your registered representative.

SEC Rule 11Ac1-6: Quarterly Report on Routing of Customer Orders

SEC Rule 11Ac1-6 requires all brokerage firms to make publicly available quarterly reports on the order routing practices. This report provides information on the routing of “non-directed orders” – any order that the customer has not specifically instructed to be routed to a particular venue for execution.

Total Centurion Institutional Orders	*Market Orders*	*Limit Orders*	*Material Aspects Relationship*
NYSE, NASDAQ, AMEX, Options	>1%	+99%	Clearing Broker/Dealer

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Administrative Update

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