2007 Outlook and Opportunities

Overview

• Review of 2006
• Outlook for 2007
  – Interest Rates (Fed decisions)
  – Inflation
  – Housing
  – U.S. dollar
  – Company earnings
  – Geopolitical
# 2007 Outlook and Opportunities

## 2006 Performance

### Market and Sector Performance

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</thead>
<tbody>
<tr>
<td>S&amp;P 500</td>
<td>1,412.84</td>
<td>-0.3%</td>
<td>2.7%</td>
<td>12.7%</td>
<td>15.8%</td>
<td>4.9%</td>
<td>10.9%</td>
<td>28.7%</td>
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<tr>
<td>Dow Jones Industrials</td>
<td>12,423.49</td>
<td>-0.2%</td>
<td>5.2%</td>
<td>13.1%</td>
<td>19.0%</td>
<td>1.7%</td>
<td>5.3%</td>
<td>28.3%</td>
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<tr>
<td>NASDAQ Composite *</td>
<td>2,438.20</td>
<td>0.9%</td>
<td>-1.5%</td>
<td>11.2%</td>
<td>9.5%</td>
<td>1.4%</td>
<td>8.6%</td>
<td>50.0%</td>
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<tr>
<td>Russell 2000</td>
<td>776.99</td>
<td>-1.3%</td>
<td>8.2%</td>
<td>9.4%</td>
<td>18.4%</td>
<td>4.6%</td>
<td>18.3%</td>
<td>47.3%</td>
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<tr>
<td>MSCI EAFE</td>
<td>2,051.56</td>
<td>-1.1%</td>
<td>10.5%</td>
<td>14.8%</td>
<td>26.9%</td>
<td>14.0%</td>
<td>20.7%</td>
<td>39.2%</td>
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<tr>
<td>MSCI Emerging Markets</td>
<td>888.97</td>
<td>-2.5%</td>
<td>7.3%</td>
<td>23.5%</td>
<td>32.6%</td>
<td>34.5%</td>
<td>26.0%</td>
<td>56.3%</td>
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<tr>
<td>Lehman U.S. Aggregate</td>
<td>1,197.13</td>
<td>0.4%</td>
<td>-0.7%</td>
<td>5.1%</td>
<td>4.3%</td>
<td>2.4%</td>
<td>4.3%</td>
<td>4.1%</td>
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<tr>
<td>Lehman U.S. Govt. &amp; Credit - Interm.</td>
<td>1,297.44</td>
<td>0.3%</td>
<td>-0.2%</td>
<td>4.3%</td>
<td>4.1%</td>
<td>1.6%</td>
<td>3.0%</td>
<td>4.3%</td>
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<tr>
<td>Lehman U.S. Govt. &amp; Credit - Long</td>
<td>1,782.07</td>
<td>0.9%</td>
<td>-4.8%</td>
<td>7.9%</td>
<td>2.7%</td>
<td>5.3%</td>
<td>8.6%</td>
<td>5.9%</td>
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<tr>
<td>Lehman U.S. Short Treasury - Bills</td>
<td>83.25</td>
<td>0.1%</td>
<td>2.2%</td>
<td>2.6%</td>
<td>4.8%</td>
<td>3.1%</td>
<td>1.2%</td>
<td>1.1%</td>
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<tr>
<td>Lehman Municipal Bond</td>
<td>631.68</td>
<td>0.2%</td>
<td>0.3%</td>
<td>4.6%</td>
<td>4.8%</td>
<td>3.5%</td>
<td>4.5%</td>
<td>5.3%</td>
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<tr>
<td>Percent of S&amp;P 500 Sector</td>
<td></td>
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<tr>
<td>Consumer Discretionary</td>
<td>10.7%</td>
<td>-0.2%</td>
<td>2.5%</td>
<td>15.8%</td>
<td>18.6%</td>
<td>-6.4%</td>
<td>13.3%</td>
<td>37.4%</td>
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<tr>
<td>Consumer Staples</td>
<td>10.1%</td>
<td>0.4%</td>
<td>4.5%</td>
<td>9.4%</td>
<td>14.4%</td>
<td>3.6%</td>
<td>8.2%</td>
<td>11.6%</td>
</tr>
<tr>
<td>Energy</td>
<td>9.4%</td>
<td>-4.8%</td>
<td>13.7%</td>
<td>9.2%</td>
<td>24.2%</td>
<td>31.4%</td>
<td>31.5%</td>
<td>25.6%</td>
</tr>
<tr>
<td>Financials</td>
<td>22.3%</td>
<td>-0.3%</td>
<td>3.1%</td>
<td>15.6%</td>
<td>19.2%</td>
<td>6.4%</td>
<td>10.9%</td>
<td>31.0%</td>
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<tr>
<td>Health Care</td>
<td>12.1%</td>
<td>0.8%</td>
<td>-3.8%</td>
<td>11.8%</td>
<td>7.5%</td>
<td>6.5%</td>
<td>1.7%</td>
<td>15.1%</td>
</tr>
<tr>
<td>Industrials</td>
<td>10.7%</td>
<td>0.1%</td>
<td>7.1%</td>
<td>5.8%</td>
<td>13.3%</td>
<td>2.3%</td>
<td>18.0%</td>
<td>32.2%</td>
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<tr>
<td>Information Technology</td>
<td>15.8%</td>
<td>1.7%</td>
<td>-5.9%</td>
<td>15.2%</td>
<td>8.4%</td>
<td>1.0%</td>
<td>2.6%</td>
<td>47.2%</td>
</tr>
<tr>
<td>Materials</td>
<td>2.9%</td>
<td>-1.7%</td>
<td>7.0%</td>
<td>10.9%</td>
<td>18.6%</td>
<td>4.4%</td>
<td>13.2%</td>
<td>38.2%</td>
</tr>
<tr>
<td>Telecommunication Services</td>
<td>2.8%</td>
<td>-1.6%</td>
<td>13.8%</td>
<td>20.2%</td>
<td>36.8%</td>
<td>-5.6%</td>
<td>20.0%</td>
<td>7.1%</td>
</tr>
<tr>
<td>Utilities</td>
<td>3.3%</td>
<td>-1.9%</td>
<td>4.5%</td>
<td>15.8%</td>
<td>21.0%</td>
<td>16.8%</td>
<td>24.3%</td>
<td>26.3%</td>
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</tbody>
</table>

* NASDAQ Composite performance calculated by percent change and does not include dividends.

Source: Piper Jaffray & Co.
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2006 Performance

- Energy—Crude Oil
  - Run-up contributed to lackluster first-half returns; price declines contributed to second-half rally.

Source: FactSet Research Systems Inc.
2007 Outlook and Opportunities

2006 In Review

- Energy—Gas Pump
  - Run-up contributed to lackluster first-half returns; price declines contributed to second-half rally.

![Graph of U.S. Gasoline and Diesel Fuel Prices, 01/01/07](source: Energy Information Administration)
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Interest Rates

• Fed Decisions
  – Official position—biased toward higher rates; sees inflation risks.
  – “Economic growth has slowed over the course of the year…the economy seems likely to expand at a moderate pace on balance over the coming quarters…readings on core inflation have been elevated…the Committee judges that some inflation risks remain.”

FOMC December Minutes

2007 FOMC Meetings

| January 30-31 | August 7 |
| March 20-21  | September 18 |
| May 9        | October 30-31 |
| June 27-28   | December 11  |
2007 Outlook and Opportunities

Interest Rates

- Fed Decisions
  - Fed still believes that the risks favor more tightening; indications suggest some slowing.
  - U.S. Treasury curve is likely to flatten as year unfolds.
  - By some estimates, the service sector represents up to 80% of the U.S. economy.
  - Economic score card

<table>
<thead>
<tr>
<th><strong>Acceleration (inflationary)</strong></th>
<th><strong>Deceleration (cooling)</strong></th>
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<tbody>
<tr>
<td>ISM services (57.1%)</td>
<td>Declining shipping volumes</td>
</tr>
<tr>
<td>Unemployment (4.5%)</td>
<td>Soft Holiday retail sales</td>
</tr>
<tr>
<td>Company earnings</td>
<td>ISM manufacturing (51.4%)</td>
</tr>
<tr>
<td></td>
<td>Housing</td>
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<tr>
<td></td>
<td>Business capex spending</td>
</tr>
<tr>
<td></td>
<td>Lackluster auto sales</td>
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<td></td>
<td>CRB Index</td>
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</table>
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Interest Rates

- Inflation is key.
- Fed bias remains toward raising rates; future Fed cut seems unlikely until mid-year at the earliest and even then sparingly.

![Graph showing change in CPI, less food & energy, 6-month span and Federal Funds Rate from 1975 to 2006. Source: FactSet Research Systems Inc.](image-url)
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Interest Rates

- Commodities as a proxy…suggests benign inflation pressures.

Source: FactSet Research System Inc.
2007 Outlook and Opportunities

Interest Rates

- Inverted curve puts the U.S. economy on “recession watch.”
- Inverted curve is not necessarily an indicator of recession.
  - 1) Yield curves likely to fluctuate around a flatter level; 2) growing pension fund demand for longer-duration fixed income assets; 3) influenced by global forces.

Source: FactSet Research Systems Inc.
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Housing

- Virtually all key economic statistics du jour reference housing.
- Homes values are up.
- Inventories are up; sales are down; at issue is whether the industry has bottomed.
- Consumer debt levels are high.
- Of concern is that falling home values can undermine net worth, particularly if employment/wage conditions deteriorate.
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Housing

- Housing values have skyrocketed in past 25 years.
- Housing cycles typically last years and not months; history suggests that bubble characteristics still exist.
- Seems premature to call an end to the cycle.
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Housing: Too Soon To Declare Bottom

• Overall consumer debt levels have increased.

• Downside risks are high.
  – Declining asset values tend to undermine net worth.
  – Economic slowing typically results in loss of jobs.
  – Hard to envision a secular trend of rising interest rates until these imbalances are corrected.
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Housing

- Housing deterioration has widespread implications.
- Wealth effect of home price appreciation is greater and more widely distributed among U.S. households.
  - Rise in home prices has provided for 70% of the increase in household net worth since 2001 (studies by Christopher Carroll, Misuzu Otsuka, and Jirka Slacalek).
  - Approximately 68.5% - 70% of American families live in their own homes (John Mauldin, author, President of Millennium Wave Advisors).
  - Stock market participation is roughly 50% of all Americans (typical family has a rather small percentage of their net worth in equities).
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Dollar

- Levers of economic growth: tax cuts, personal savings, low interest rates (home equity cash-outs), lower dollar.
- Path of least resistance for the U.S. dollar is down.
- Unlikely for many countries to let their currencies meaningfully rise against the U.S. dollar.

*Source: The Federal Reserve
Note: Shaded areas correspond to periods of falling dollar
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Employment/Wage Growth

- Consumer spending/economic stability is largely contingent on wage growth/employment and employment levels.

Source: Piper Jaffray & Co.
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S&P 500 Earnings

- Outlook for 2007 remains inconclusive; early indications suggest a slower rate of growth.

### Earnings Projections

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<tbody>
<tr>
<td>S&amp;P 500</td>
<td>1,406.99</td>
<td>$86.58</td>
<td>16.3x</td>
<td>$91.00</td>
<td>15.5x</td>
<td>$97.00</td>
<td>14.5x</td>
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</tbody>
</table>

**S&P 500 Earnings Growth**

|               | 13.5%         | 5.1%           | 6.6% |

Actual and estimated earnings are on an operating basis.
*Year-over-year
Source: First Call Corporation estimates
2007 Outlook and Opportunities
S&P 500 Earnings & Valuation

- Valuation levels are near 10-year lows; provides some downside protection to equity prices.

Data Source: First Call Estimates
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Historical Valuation Levels

Historical Price-to-Earnings Ratio of S&P 500 and Yield on 10-Year Treasury Bond

Data Sources: Standard and Poor's, FactSet Research Systems Inc. and Piper Jaffray
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Summary

• Stable wage growth/employment conditions along with favorable earnings outlook warrant continued economic expansion; expect rate of growth to slow and recession to be avoided.
• Risks are elevated; equity correction is due and could be construed as being healthy.
• Bonds are likely to remain range-bound.
• Fed move is not likely until mid-year.
• Dollar’s path-of-least-resistance is down.
• Expect 2007 returns to be favorable, albeit below 2006 levels.
Strategic And Tactical Portfolio Themes For 2007

• Active portfolio management – be opportunistic.

• Be very aware of the risk-reward dynamic of various sectors and instruments.

• Adopt a total return orientation.

• Look to pick up incremental yield when possible.
Agencies

- Use options judiciously to pick up incremental yield, buy discount bonds to mitigate call risk.

- 3 year bullets offer some value and good protection from a front end rally.

- Beyond the 5 year area of the curve there is too much risk for too little reward.

- Manage tactically and look to buy dips and back ups in the market as they occur to mitigate reinvestment risk.
Generic Five Year Corporate Credit Spreads Versus Treasuries Over A Five Year Period

Source: Bloomberg
Corporates

• A cautious approach to this market would seem to be warranted at this time.

• Little to no reward for going down the credit ladder – don’t get caught reaching for yield.

• Buy sound names with good credit ratings and track records.

• Collapsing credit spreads have created the opportunity to upgrade the overall quality of your portfolio.
Mortgages

• Solid performance in 2006 should be repeated in 2007.

• Consider adding agency hybrids prior to their inclusion in the Lehman US Aggregate Index.

• Look for prepayment speeds to slow down this year as housing continues to slow and refinance activity remains muted – this is positive for spreads.

• The increasing use of mortgages by central banks should stabilize spreads at lower levels.

• Extension risk could materialize this year – buy structures such as VADMs to protect against this.
Municipals

• Municipals currently offer good value on a tax adjusted basis.

• The risk reward equation indicates that you should stay on the high end of the credit ladder.

• Municipal curve still has a normal shape.

• Look for yields to decline as the market goes through structural changes.

• Collapsing credit spreads create the opportunity to increase the credit quality of your portfolio without sacrificing yield.
‘A’ Rated Municipal Yield Curve And Tax Equivalent Yield Versus Off The Run Treasuries

Source: PJC
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