



Harbor Views

DECEMBER 2006

Thoughts on the Economy

The U.S. economy had a good year in 2006. Real GDP growth will probably be in the range of 3-3.25%, inflation peaked mid-year, along with oil prices, and by year-end was running at 2.2% on the core rate. Corporate earnings per share advanced by 13-15% and the dollar weakened against the currencies of our major trading partners.

Of particular note is the fact that as domestic growth moderated during the year, growth outside the U.S. strengthened. The emerging economies grew dramatically with China's growth leading the way at approximately 10% and India at 8%. The European Union (EU) countries accelerated their growth to 2% and even the formerly moribund Japanese economy grew by 2%. This growth along with a depreciating dollar should provide additional export demand for U.S. companies and help compensate for a slowing domestic economy.

The U.S. economy is beginning 2007 at a run rate of about 2% growth in GDP which we believe will pick up during the year to provide full year real GDP growth of 2.5-3%. We anticipate inflation will run at about 2% on the core level which should allow the Federal Reserve to lower the Federal funds rate by .25-.50% during the year. We would expect job growth to slow from a 2006 monthly average of 150,000 new non-farm jobs to about 125,000 new jobs monthly. Energy prices should stabilize, once winter finally arrives, and increase during the year with oil trading between \$60-65/bbl.

The dollar should decline moderately throughout the year with low single digit losses. This environment would allow corporate earnings per share to advance by 7-9%. World economies should have another good year in 2007 providing export demand

for U.S. products that should be additive to our GDP growth.

Our view of the Financial Markets

2006 was a good year with financial markets as U.S. stocks outperformed their long-term average rate of return. The S&P 500 produced a total return of 15.80% and the Lehman Aggregate Bond Index gained 4.33%. The market's valuation held steady after experiencing P/E contraction for 6 consecutive years.

International stock markets also had very good performance with many outperforming our U.S. indices.

Our outlook for 2007 is for another year of gains in stock prices as 2007 could see multiple expansion for the first time since 1999 adding to earnings per share growth of 7-9%. The expansion of valuations would come as a result of the Federal Reserve reversing monetary policy with one or two quarter point reductions in the Federal funds rate. Also adding to the probability of better valuations would be a further moderation in the core rate of inflation to 2% from a 2006 peak of 2.9%. We are of the opinion that a slowing economy and a weaker dollar should favor the large, multinational blue chip companies which we have long owned for Harbor clients.

We expect returns on commercial real estate, which we participate in by owning REITs, to moderate this year to a single digit level after another year of extraordinary returns in 2006. For this reason, we have reduced our holdings in domestic REITs and have established a position in international real estate through a holding in the StreetTracks DJ Wilshire International Real Estate Index.

We believe bonds will again have a lackluster year of returns in the mid-single digits similar to last year's 4.3% advance in the Lehman Aggregate Bond Index. We hope to provide a better return for Harbor clients by owning special situation bonds such as the GMAC notes we purchased last year as well as a new addition this past summer of the Euro denominated Ford Motor Credit notes.

Trust Law in New Hampshire

The state of New Hampshire is liberalizing the rules governing trusts in an effort to attract trust business to the state. This can potentially be beneficial to residents of states other than New Hampshire in certain circumstances.

The state has removed the rule against perpetuities which allows for the creation of Dynasty Trusts, potentially eliminating multiple levels of estate taxation over the generations.

The state has also adopted the Uniform Principal and Income Act which can potentially allow for more liberal income distributions to current income beneficiaries.

The Trust Modernization Act of 2007 also allows for the creation of private trust companies in which families might be able to

manage the assets of family members or even a limited number of people outside the family with much reduced regulatory oversight.

401(k) Contribution Limits

The elective deferral limit on 401(k)s has been increased from \$15,000 to \$15,500 for 2007. The catch-up contribution remains unchanged at \$5,000.

Safe Harbor in Shifting Winds

Most of our clientele come to us from existing clients or professionals who know our work. If you know of a family who is seeking counsel and might appreciate personalized and attentive financial advice from an independent firm we would welcome the opportunity to serve.

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Nod to the ubiquitous disclaimer:

While we are not infrequently, and always quite accurately, accused of being of strong opinion...we want to let the reader know we've been wrong before...will be again and please don't hold it against us. The forward looking parts of the letter are the best educated efforts of fallible humans here at Harbor.