



MANCHESTER CAPITAL MANAGEMENT LLC

December 20, 2006

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*I believe the future
holds slower but
continued growth.*

Market Outlook

By Ted Cronin, CIO

We are coming to the end of another excellent year, with domestic stock market indices such as the S&P 500 up 14% or more for the year. Many international stock markets are even stronger. And the bond market is stable. It is hard to remember that in 1996, when Alan Greenspan gave us his warning about “irrational exuberance” on Wall Street, the Dow Jones Industrial Average was at 6,437. As I write today it is at 12,445.

Indeed, the late Milton Friedman, the Nobel Prize winning economist who guided much of economic policy in recent history, was quoted in *Imprimis* (July 2006) as saying, “The economic situation during the past 20 years has been unprecedented in the history of the world. You will find no other 20 year period in which prices have been as stable – relatively speaking – in which there has been as little variability in price levels, in which inflation has been so well controlled, and in which output has gone up as regularly. You hear all this talk about economic difficulties, when the fact is we are at the absolute peak of prosperity in the history of the world. Never before have so many people had as much as they do today.”

We will surely miss Dr. Friedman’s guidance in the future, and hopefully his comment about being at the peak of prosperity doesn’t imply that the best is behind us. As I have mentioned in previous newsletters, I believe the future holds slower but continued growth, moderate inflation, and positive bond and stock market appreciation.

The triple deficits (government debt, household debt, and foreign trade balance debt) will put pressure on the dollar and interest rates. We can already see a shifting balance in the US dollar versus foreign currencies. The euro, for example, is now trading at around \$1.32, up from \$1.18 at the start of the year. European vacations will be more expensive.

We can expect more of the same in 2007, with interest rates increasing in the face of tight labor markets, global demand, and our spending habits. We continue to spend \$106 for every \$100 we earn, and this difference will eventually be corrected by a depreciated US dollar.

While this bodes well for international stock market returns, and

3657 Main Street
Manchester, VT 05254
(802) 362-4410

1155 Coast Village Road
Montecito, CA 93108
(805) 969-5670

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argues for expanding allocations to international securities and assets, it doesn't mean our own stock market will suffer unduly. Equity market valuations remain reasonable, and may already reflect the relative slowdown in corporate profits next year as the economy grows at a more modest rate.

*Equity market
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China continues to expand as the world's manufacturer of low value-added goods, but the US is maintaining its share of value-added goods. The job losses in Detroit are being matched by job gains at Toyota plants in the South and West. The global economy as a whole is expanding, and the US is doing both its share of consuming and producing (both services and goods).

The developing countries of the world will demand ever increasing amounts of energy, which will continue to drive up prices despite anyone's efforts at conservation or adopting alternatives.

At this holiday season, we are deeply thankful for all the blessings we are privileged to enjoy, and especially, the honor to be of service to you. Everyone here joins me in wishing you, your family, and your friends the very best Holiday Season and Happy New Year.

Some Thoughts on Commodities ***By Vito Gioiello***

In 1975, Investment Manager John Train wrote *Dance of the Money Bees*, a wonderful book which used biological phenomena to describe a common event in the financial world. As bees return from foraging expeditions, the more agitated their dance, the greater the find. Money managers follow the same pattern when they are excited by a stock. Of course, fellow money managers and investors follow — like bears to honey. It's not something we readily admit, but there's a great deal of truth here. Today, it is known as the "swarm effect", which brings us to commodities.

*Diversification is an
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We all know that diversification is an important risk management tool. Long-term returns can be increased and risk dramatically lowered by diversifying among multiple asset classes. Over the past five years, an investor that added a 50% position in international stocks outperformed the S&P 500 Index by 4% annually. Even where long-term returns converge, diversification most times smoothes out quarterly returns by avoiding quarter-by-quarter volatility of any one asset class allowing investors to sleep more soundly.

This is done by finding what we call "uncorrelated asset classes." Along these lines, a belief has developed that commodities fit the bill. This could be possible. Remember, junk bonds spent two hundred years as a niche (distressed debt) and only in the last 20 years as a genuine asset class (high yield bonds). Why not commodities? Our concerns and caveats are as follows:

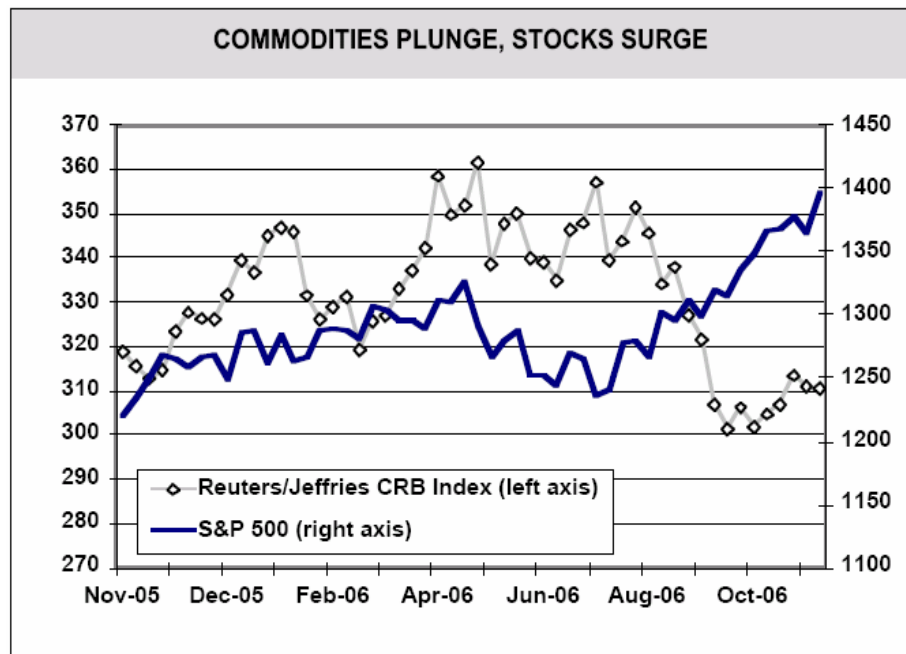
- First, commodity prices have historically exhibited periods of climactic gains or losses. Over time, the risk versus return profile for commodity fu-

The risk versus return profile for commodity futures does not encourage a long-term investment.

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- tures does not encourage a long-term investment.
- The asset class itself is not correlated. For instance, soybeans have nothing in common with energy or aluminum. The only reason they've been put together is because they are raw materials. As such, we believe they have only the appearance of an asset class.
- Outside of energy, the sector is too small to not be affected by the large influx. You could purchase the entire US wheat crop for approximately \$8.4 billion.
- It is duplicative of other portfolio segments. Depending on the commodity index used, as much as half is invested in energy. Portfolio managers run the risk of unknowingly increasing their bets in certain sectors. If a portfolio manager wants to make a bigger bet on energy, they should just buy more energy stocks.
- Fifth, this is an old story and certainly not undiscovered. Being late to a trend rarely works out.
- Lastly, the tremendous inflows that have artificially driven up prices will ultimately stimulate supply. High prices will create supply which will lead to lower prices.

By treating commodities as a stand alone asset class, investors could be inadvertently raising portfolio risk and creating a performance bubble by inflating this sector. Generally speaking, we believe this has occurred.

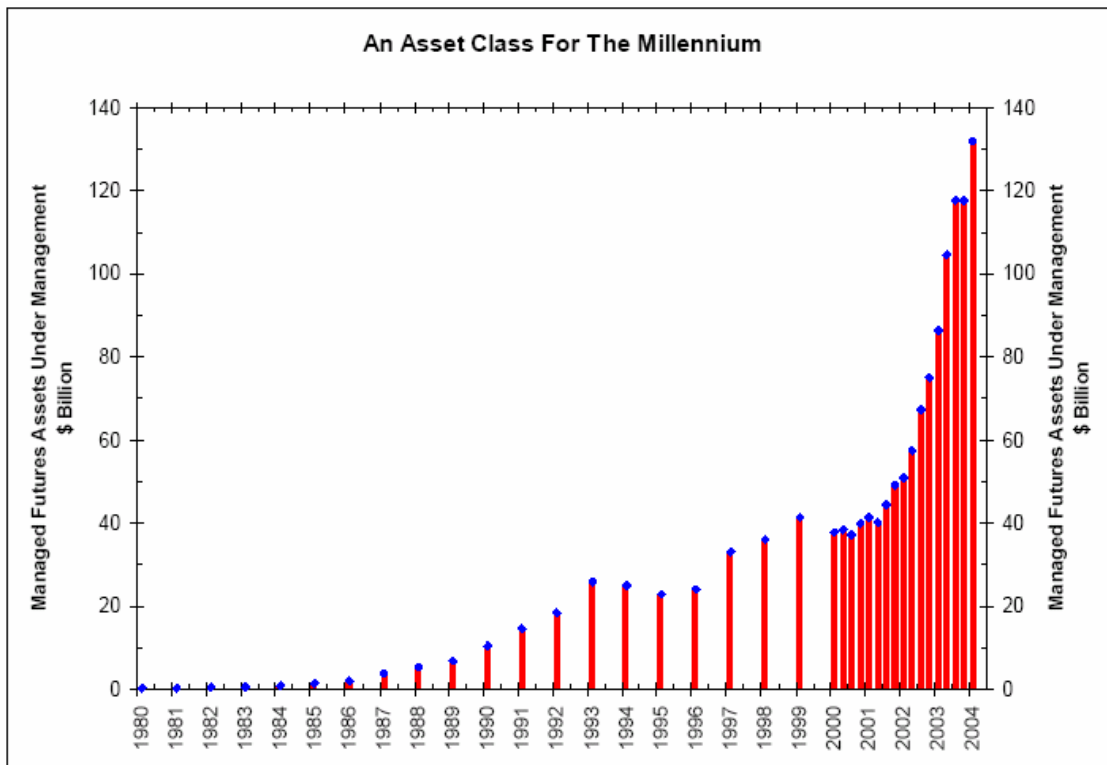


On a positive note, they are uncorrelated.

Commodities are important to the world economy as well as our everyday lives.

Commodities are important to the world economy as well as our everyday lives. Sometimes, such as when commodity prices have suffered, there may be an attractive investment opportunity. However, given the extreme current prices, we do not believe they are appropriate long-term investments. We have taken, and will continue to take, advantage of opportunities such as energy,

timber, etc. However, this “asset class” is not undiscovered and is not cheap. Historically, secular moves in commodity prices have lasted eight to nine years. The current move began in late 1998/early 1999.



In five years, the amount of money pouring into commodity funds has tripled.

Inside MCM

We are pleased to welcome Scott Swenor to MCM!



Scott manages the firm's financial operations, including budget and reporting functions, from our Manchester office. Previously he was a Division Controller with Corporate Express, and the Manager of Mergers, Acquisitions, and Divestments with Buhrmann NV after starting his career at Price Waterhouse. Scott is a CPA and received his Masters in Finance from the University of Denver and his BS from Bryant College.

Our Best Wishes For A Happy and Healthy Holiday Season!