

3/1/07

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House & Senate Joint Finance Committee Economic & Capital Market Outlook

**Michael J. O'Leary CFA
Executive Vice President
Callan Associates Inc.
February 2007**

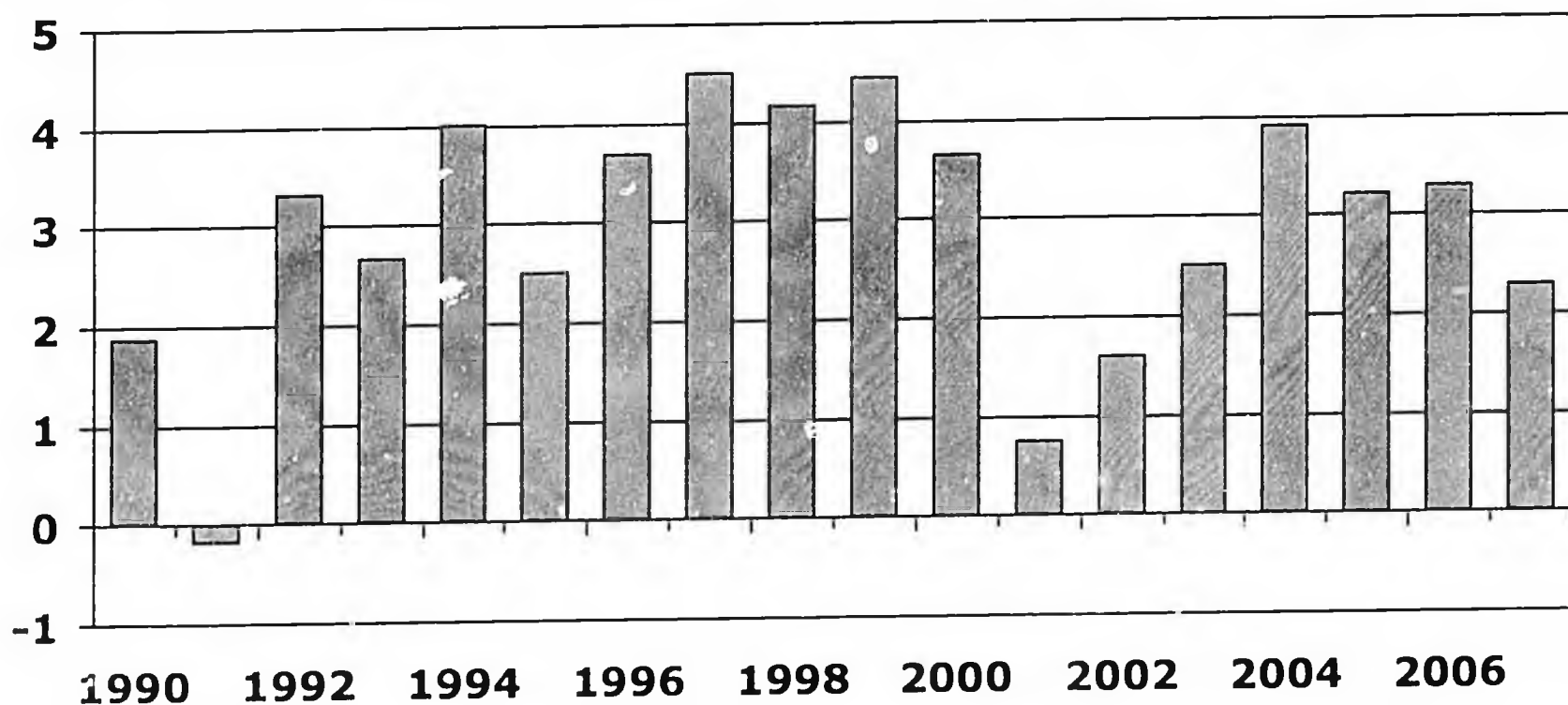
Economic Forecast: Contained Enthusiasm

- **Growth remained robust in 2006, but economy is slowing toward trend.**
- **Outlook for 2007 depends heavily on whether housing stabilizes and the effects of the downturn are contained.**
- **Consumers are spending all of their income, tax cuts are over, and the savings rate is negative. Confidence is high but vulnerable to shocks - housing, war, economy.**
- **Decent job growth, improving real wages, and lower gasoline prices will help support consumer spending.**
- **U.S. and China will continue to be the primary engines of growth.**
- **Oil prices will slide - gradually - but with a new floor of \$50 (\$60? \$70?).**
- **Inflation will remain a low level threat; oil prices are the wild card, labor costs represent the upside risk.**
- **The Fed tightened to 5.25 and paused; the rate cuts may still be up to a year away.**

Economy is Slowing After Three Strong Years - How Soft a Landing?

(Real GDP - annual percent change)

***2007 estimate - Global Insight**



Source: Global Insight

U.S. Economic Growth by Sector

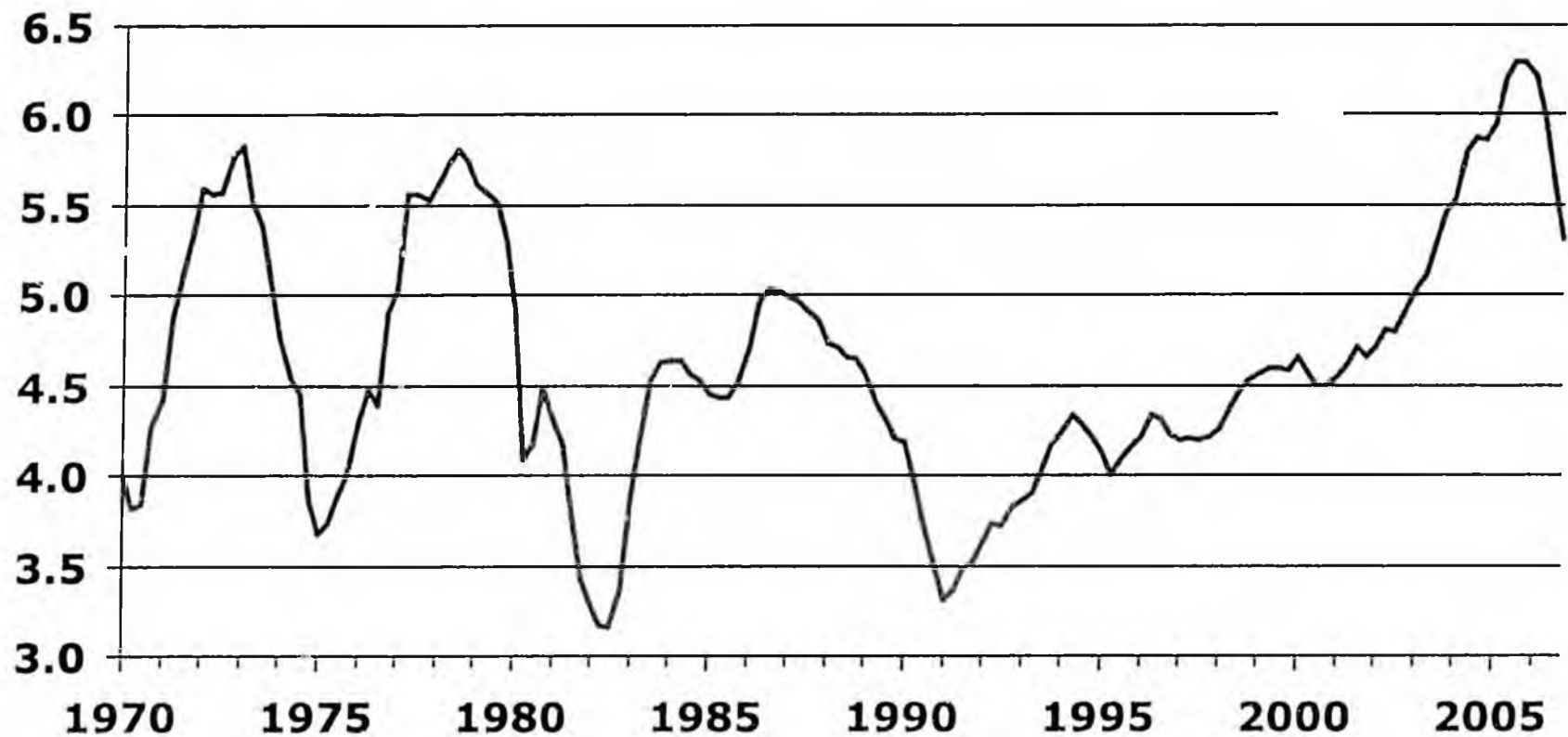
(Annual percent change)

	2002	2003	2004	2005	2006	Direction of Change
Real GDP	1.6	2.5	3.9	3.2	3.3	Moderating
Consumption	2.7	2.8	3.9	3.5	3.2	Moderating
Residential Investment	4.8	8.4	9.9	8.6	-4.2	Falling Sharply
Bus. Fixed Investment	-9.2	1.0	5.9	6.8	7.5	Surging
Federal Government	7.0	6.8	4.3	1.5	1.9	Winding Down
State & Local Govt.	3.1	0.2	0.5	0.5	2.0	Budget Pressures Easing
Exports	-2.3	1.3	9.2	6.8	8.7	Surging
Imports	3.4	4.1	10.8	6.1	5.9	Oil Prices

- Housing downturn reduced GDP growth in 3rd and 4th quarters of 2006 by 1.2% through direct effect on construction alone.

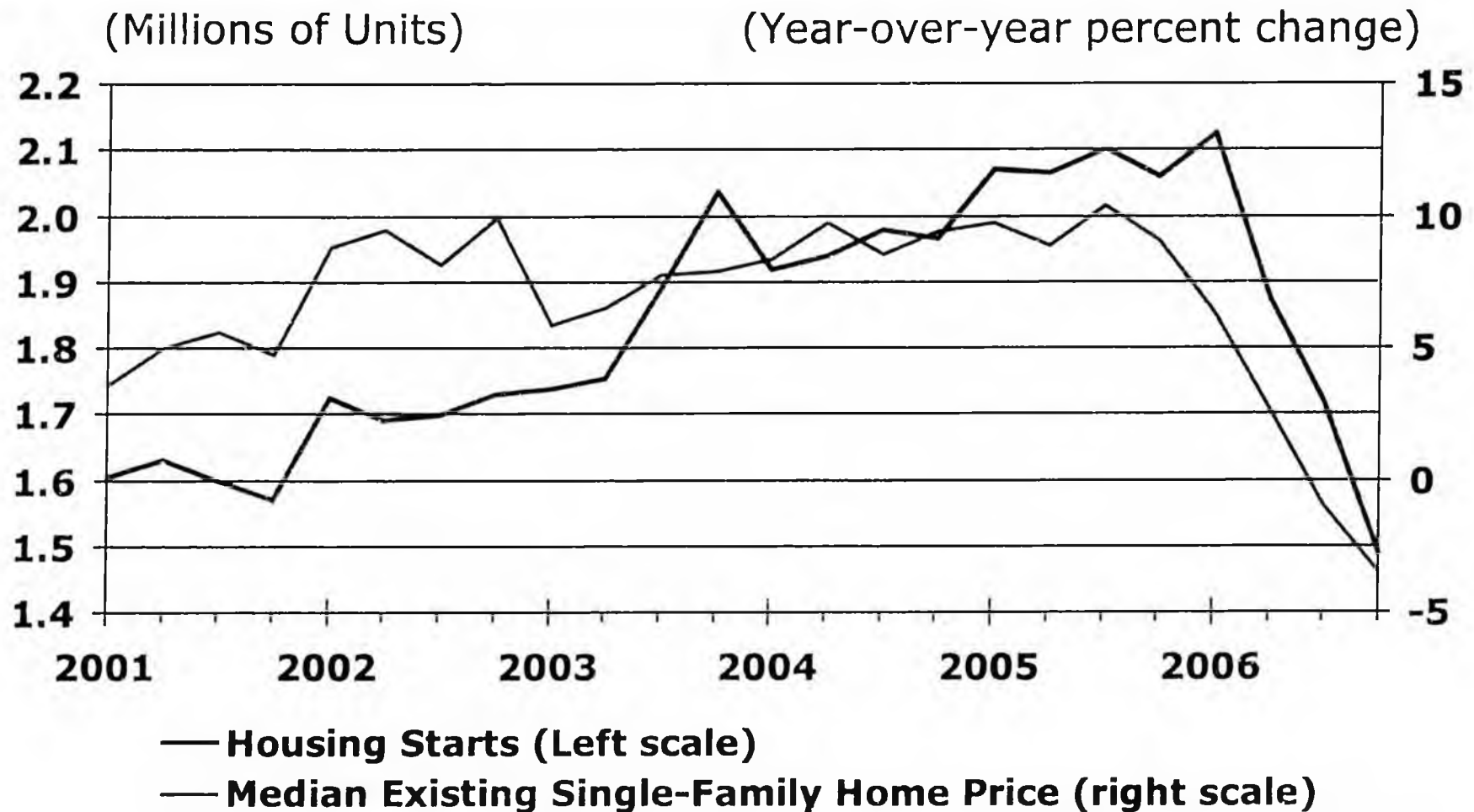
Residential Construction Overbuilt

(Residential Fixed Investment - % of GDP)



Source: Global Insight

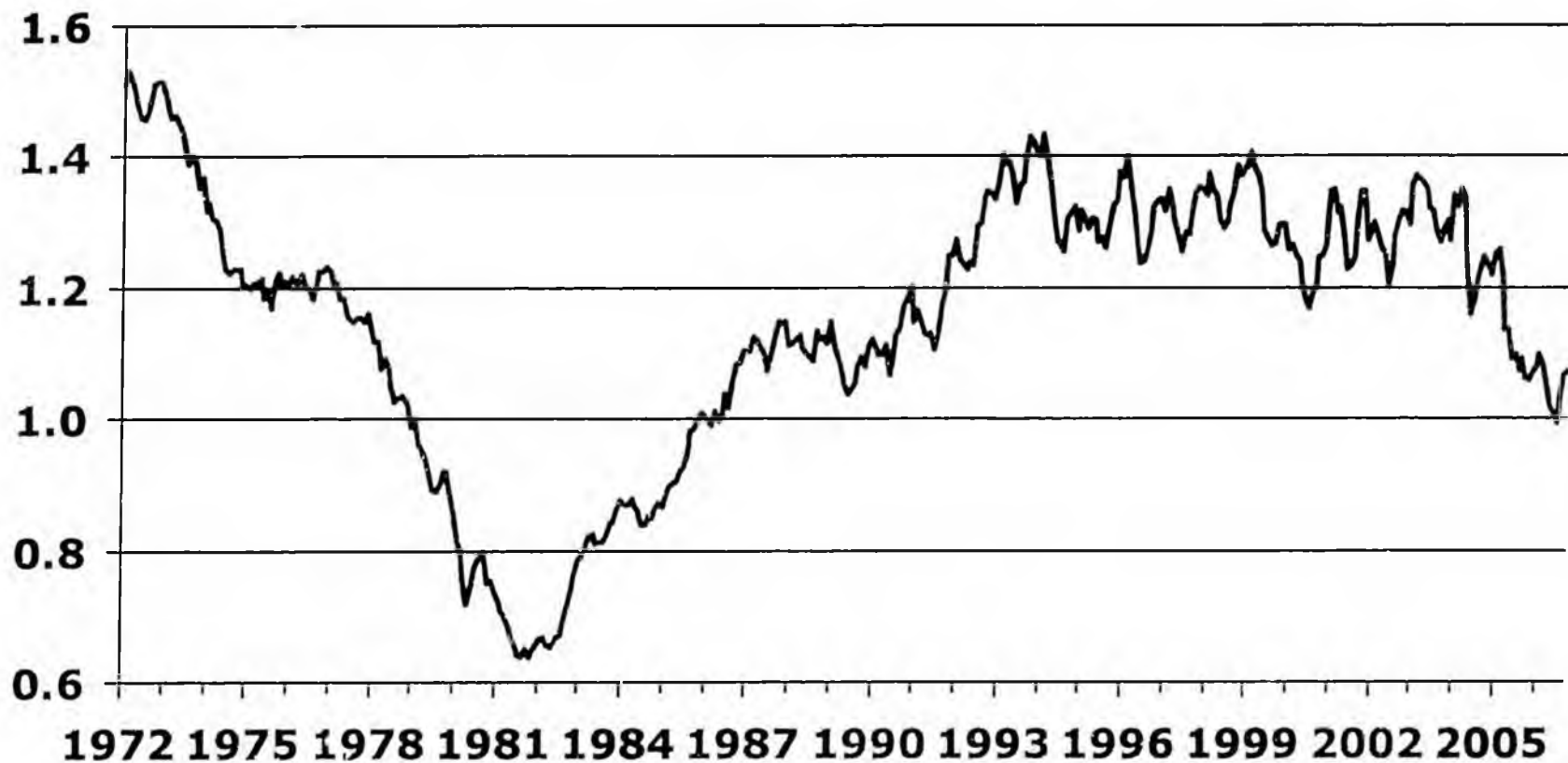
Housing Outlook: Hitting Bottom in 2007?



Source: Global Insight

Housing Affordability Deteriorated as Interest Rates Rose

A higher index means homes are more affordable.

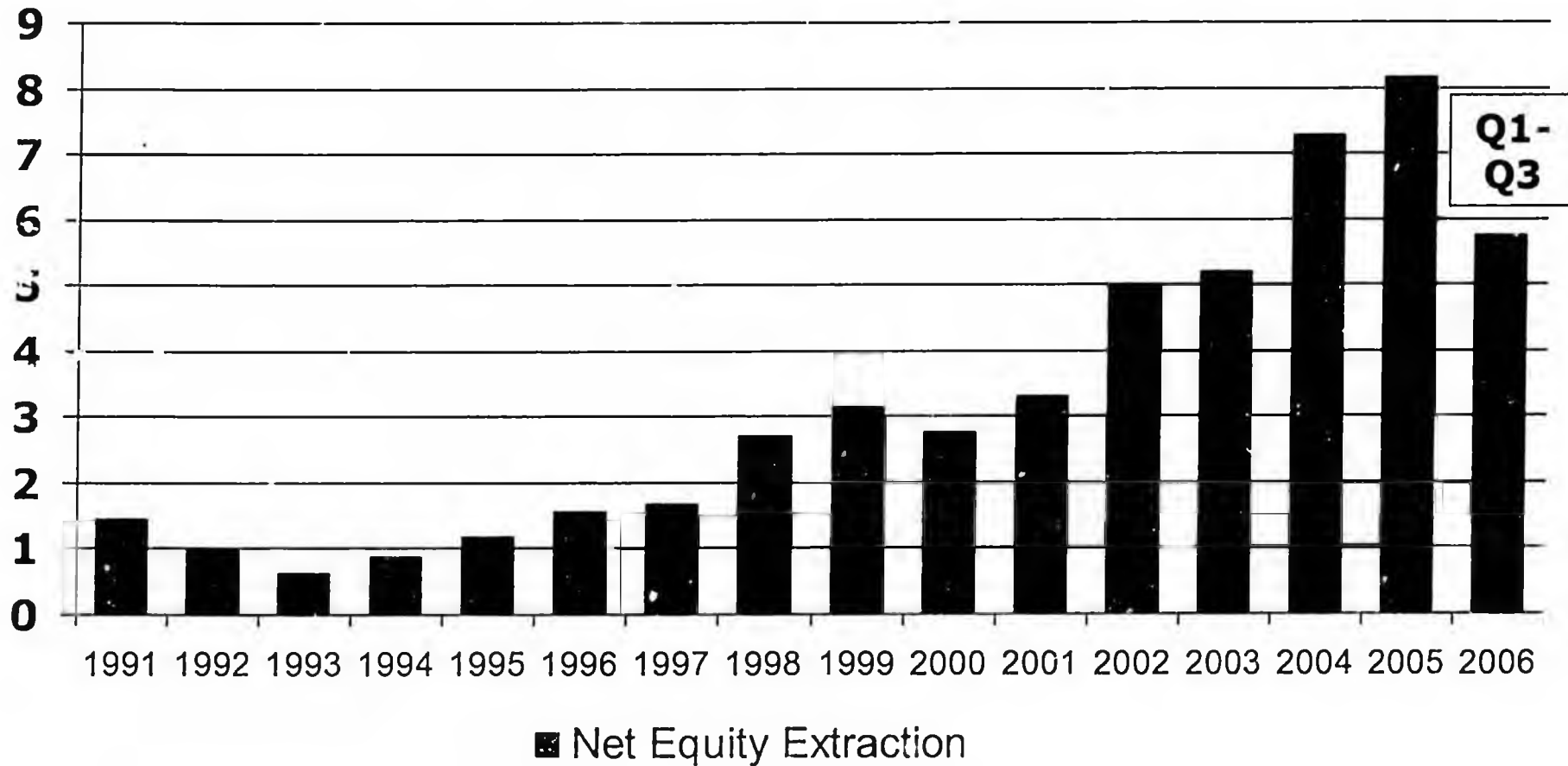


— Affordability Index for Existing Single-Family Homes

Source: Global Insight

Mortgage Equity Withdrawal Fueled Consumer Spending

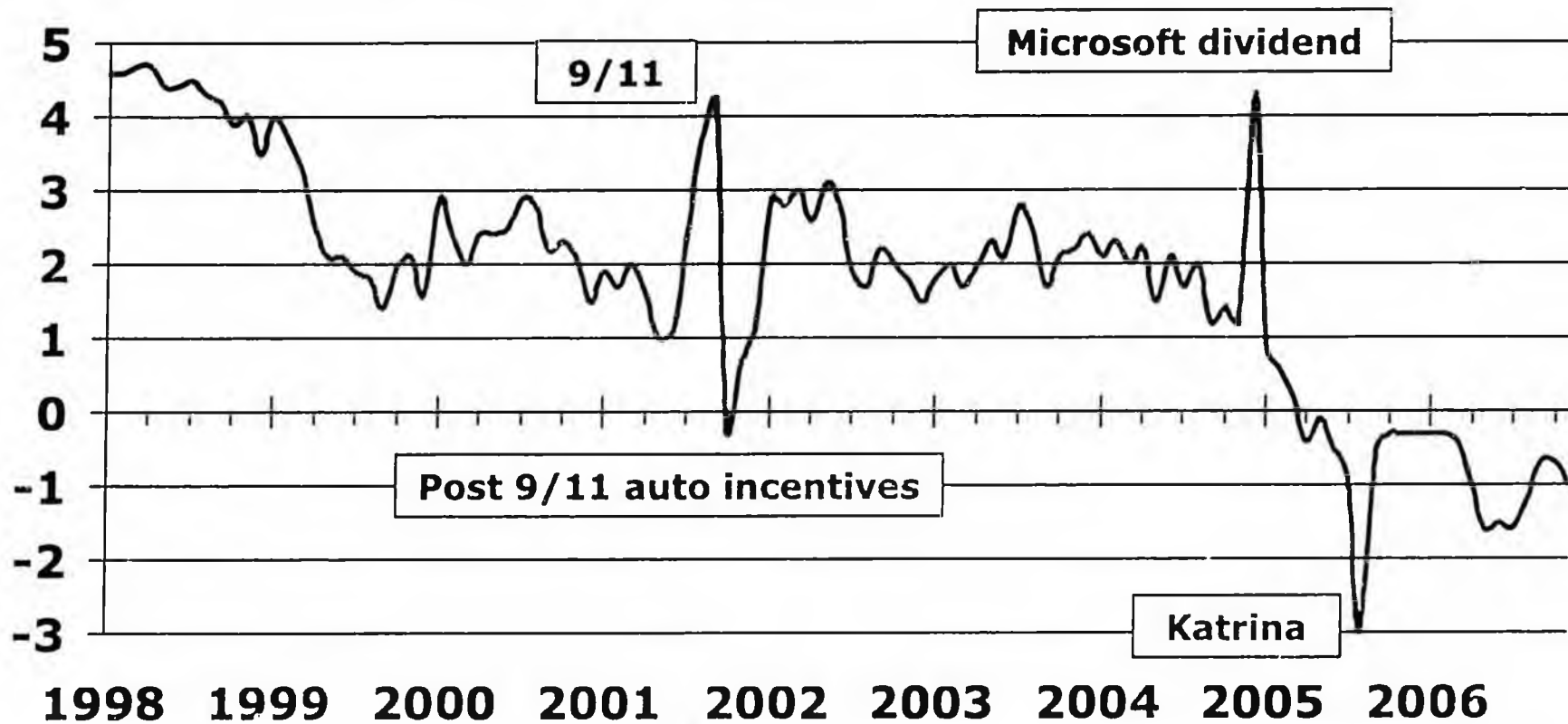
(Percent of Disposable Income)



Source: Federal Reserve - Kennedy/Greenspan data updated as of December 2006

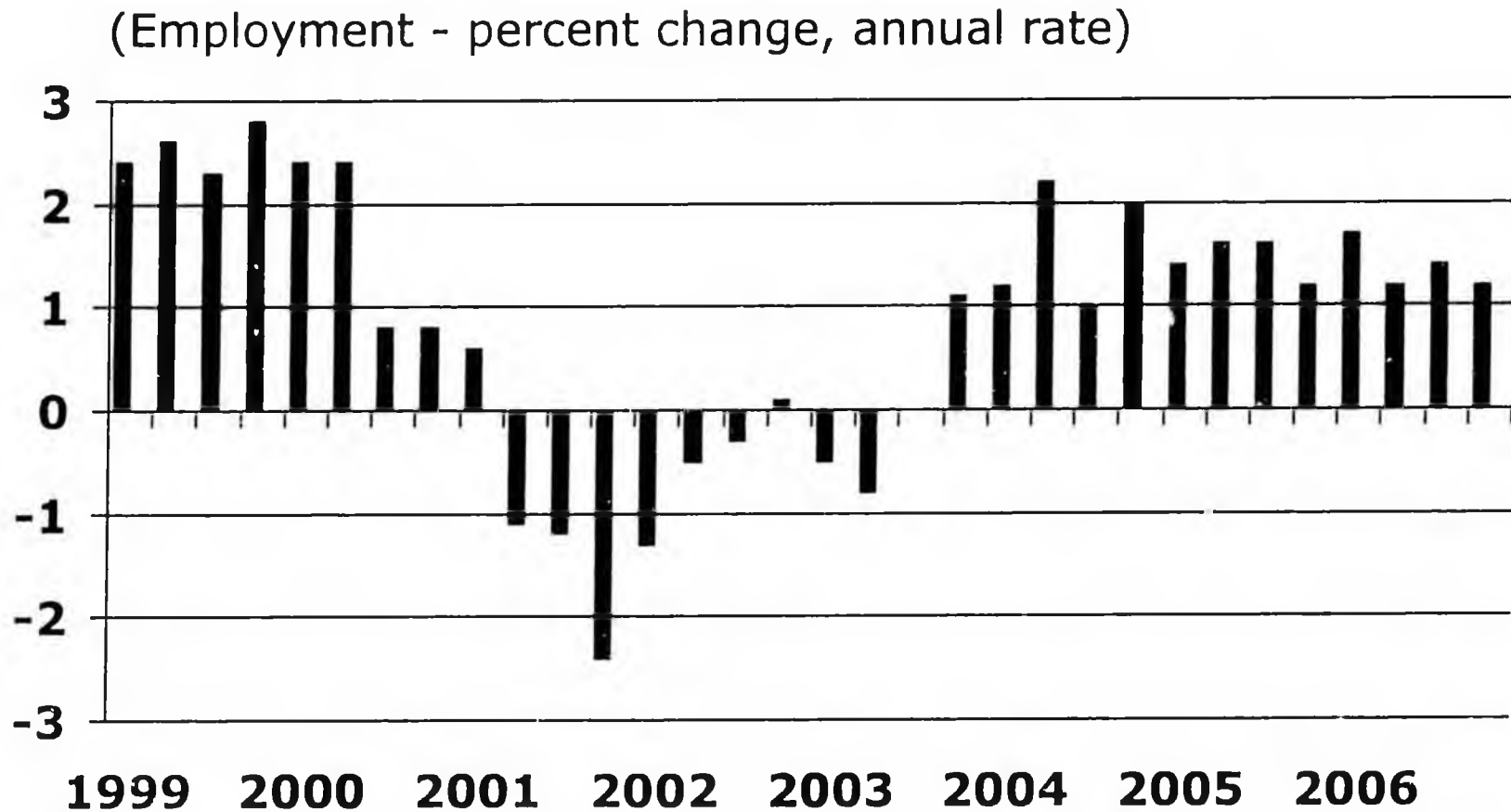
Personal Savings Rate Has Fallen Below Zero

(Personal savings rate, percent of disposable income)



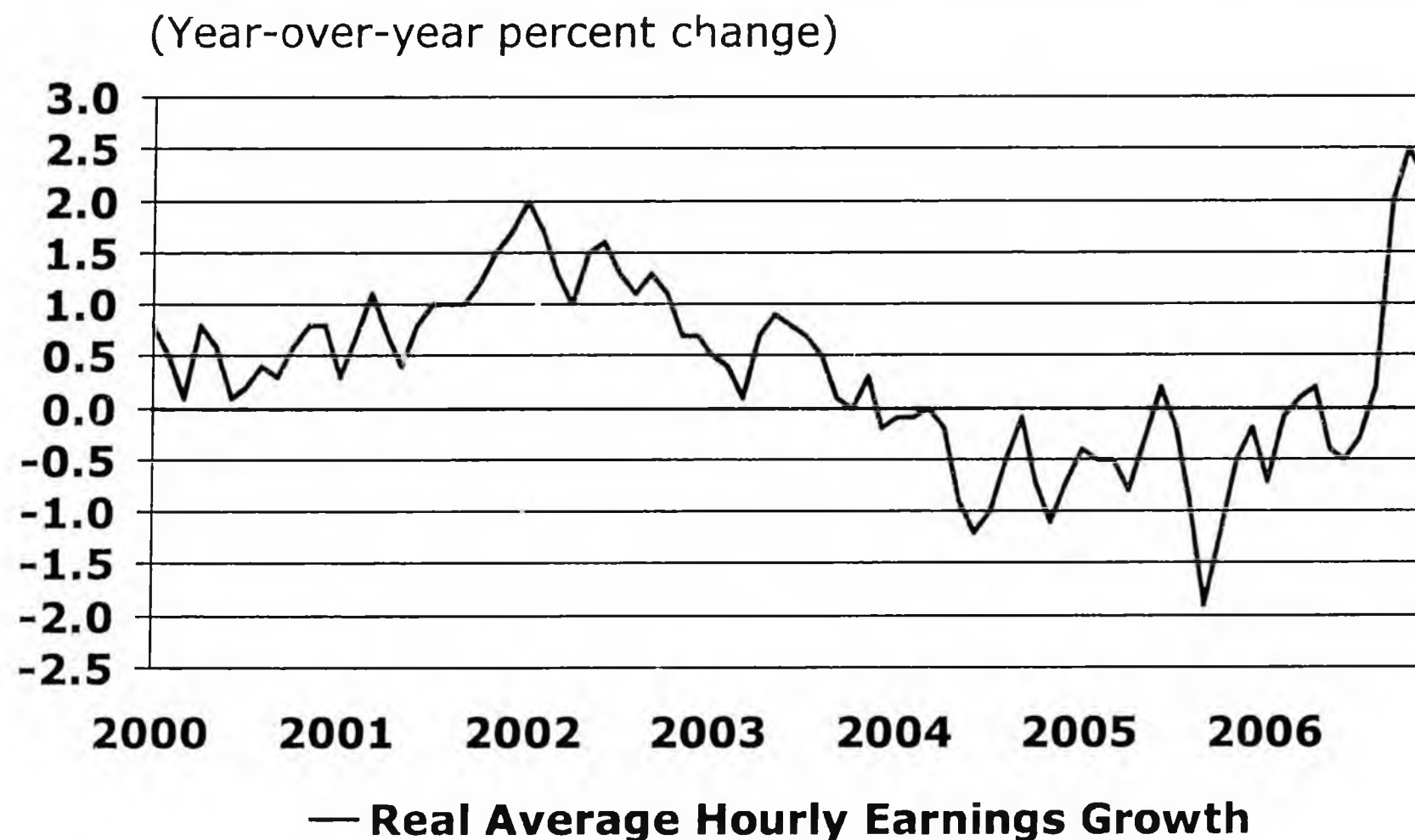
Source: Global Insight

However, Employment is Still Growing



Source: Global Insight

Wage Growth is Finally Beating Inflation

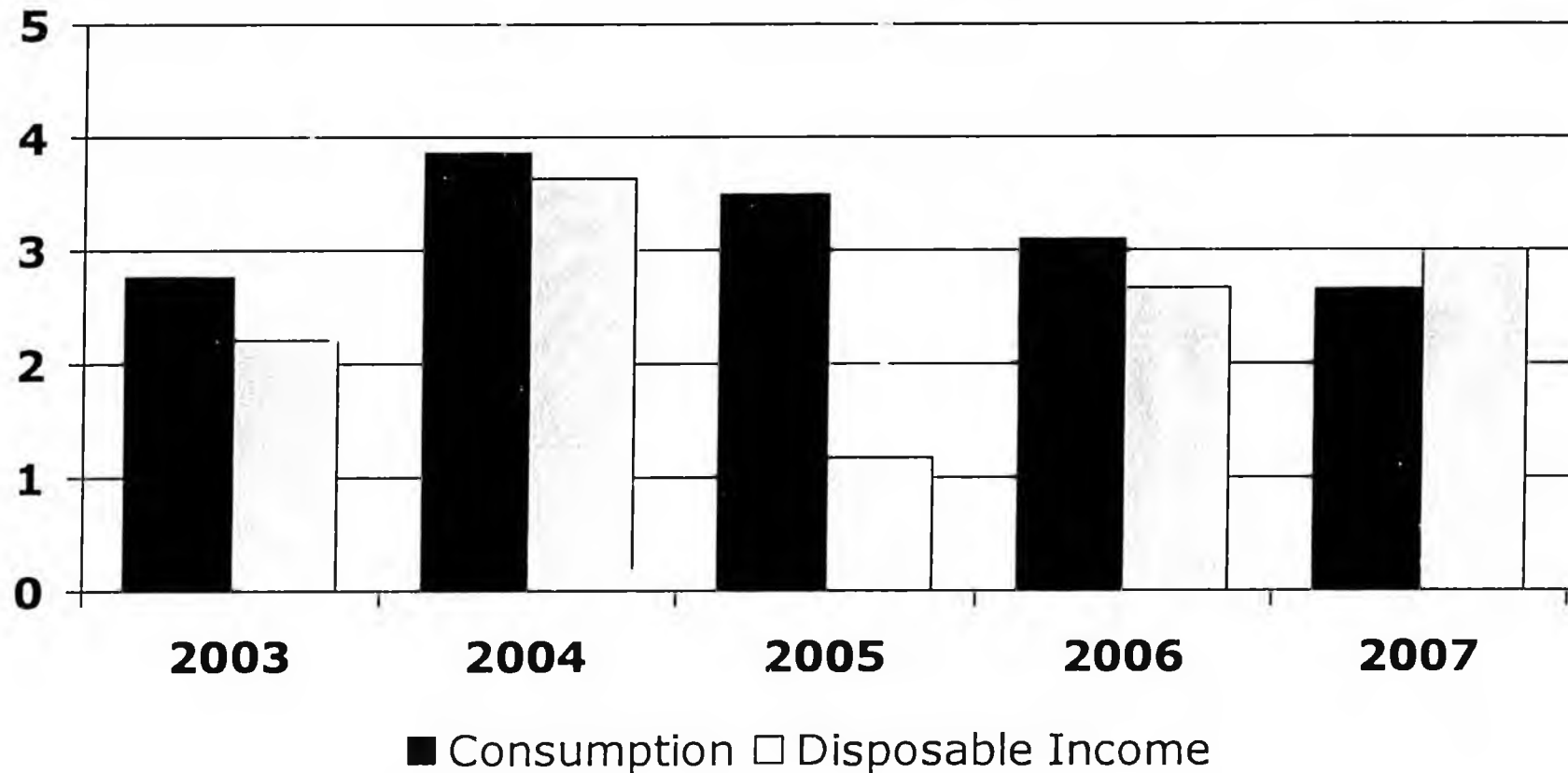


Source: Global Insight

Spending Has Outpaced Income Growth; Some Rebuilding of Savings is Likely

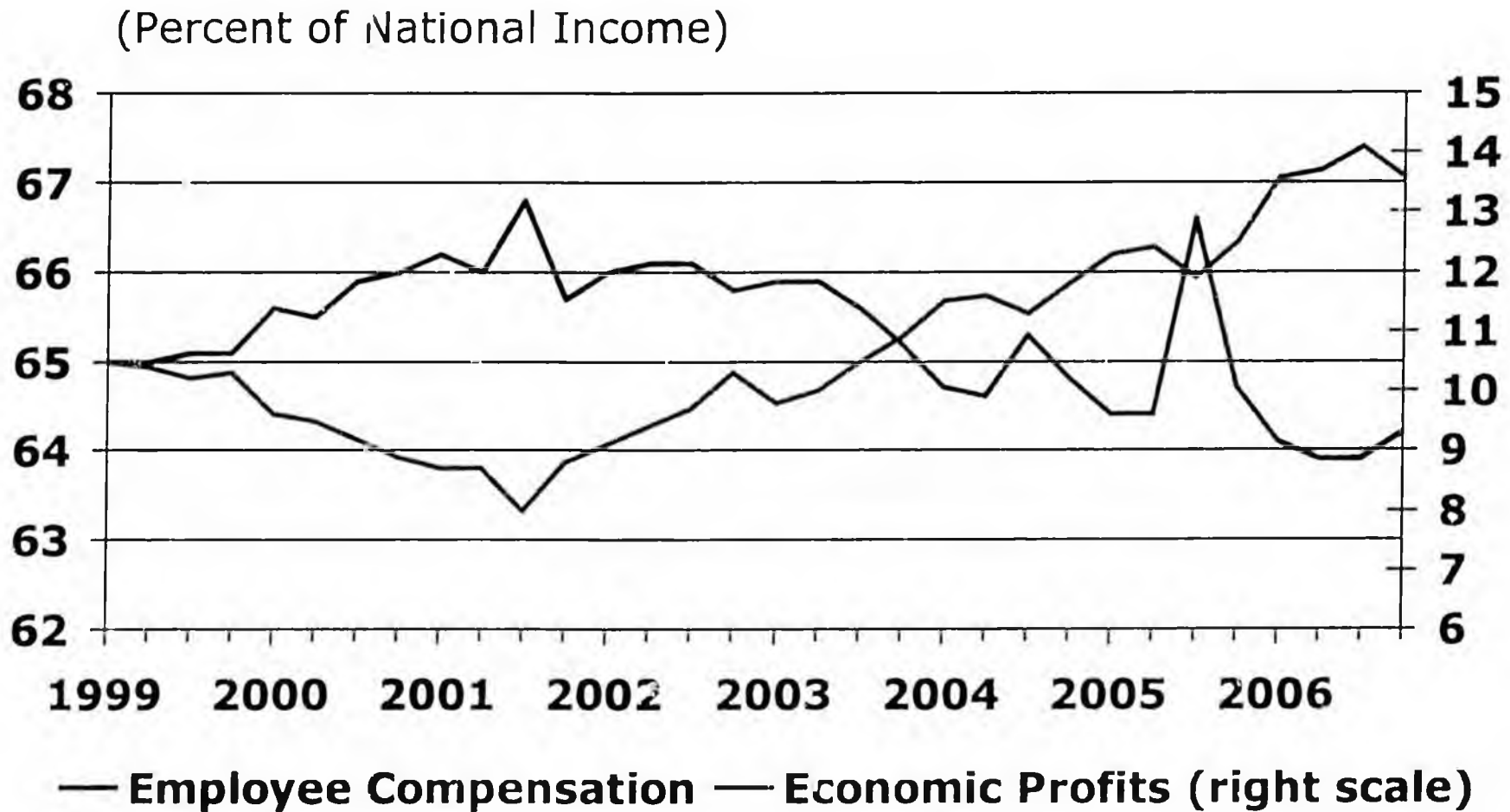
(Percent growth)

* 2007 estimate - Global Insight



Source: Global Insight

Productivity Growth Has Boosted Corporate Profits to Record Levels

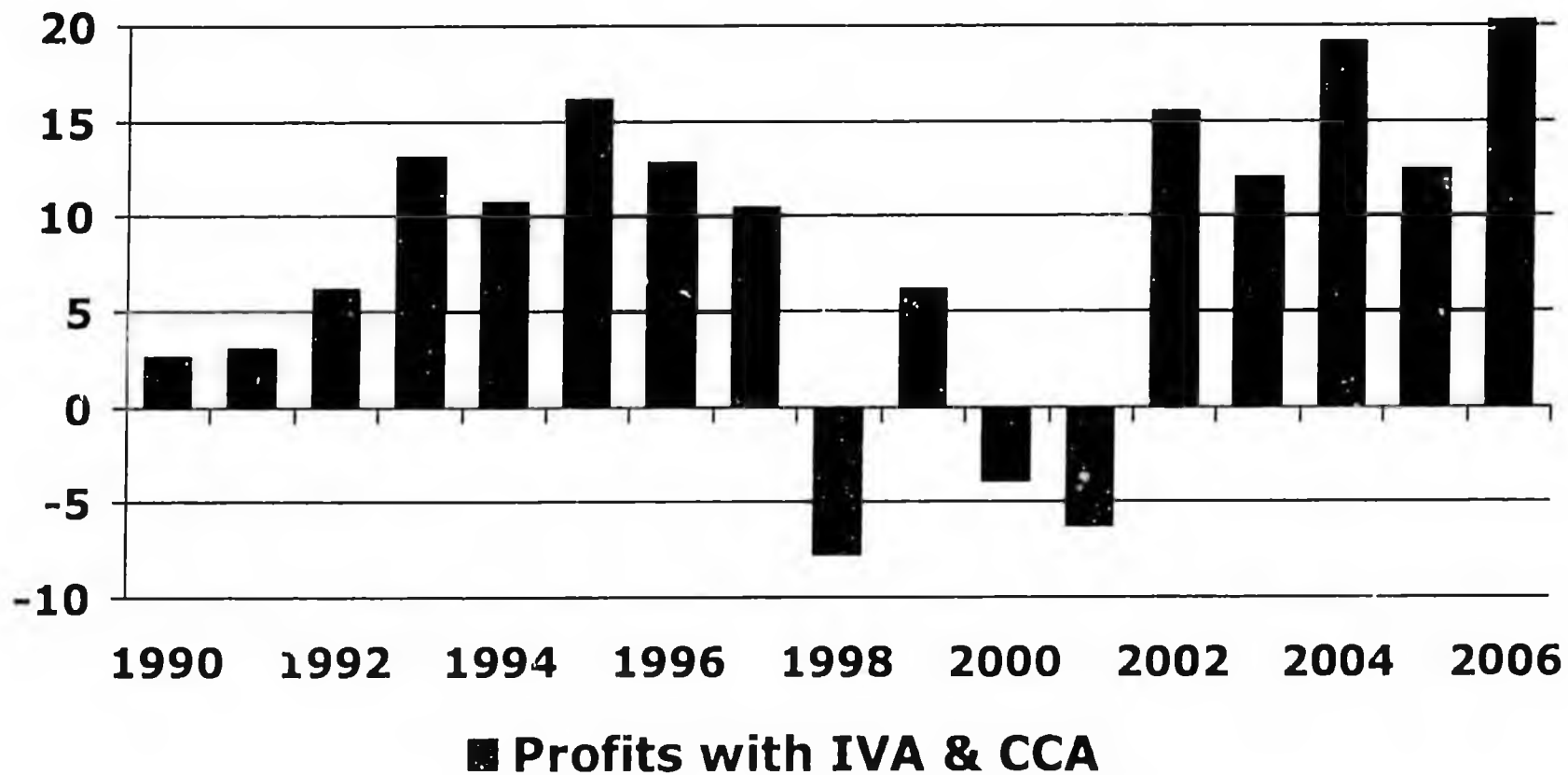


Source: Global Insight

An Incredible Run for Corporate Profits; Return to Earth?

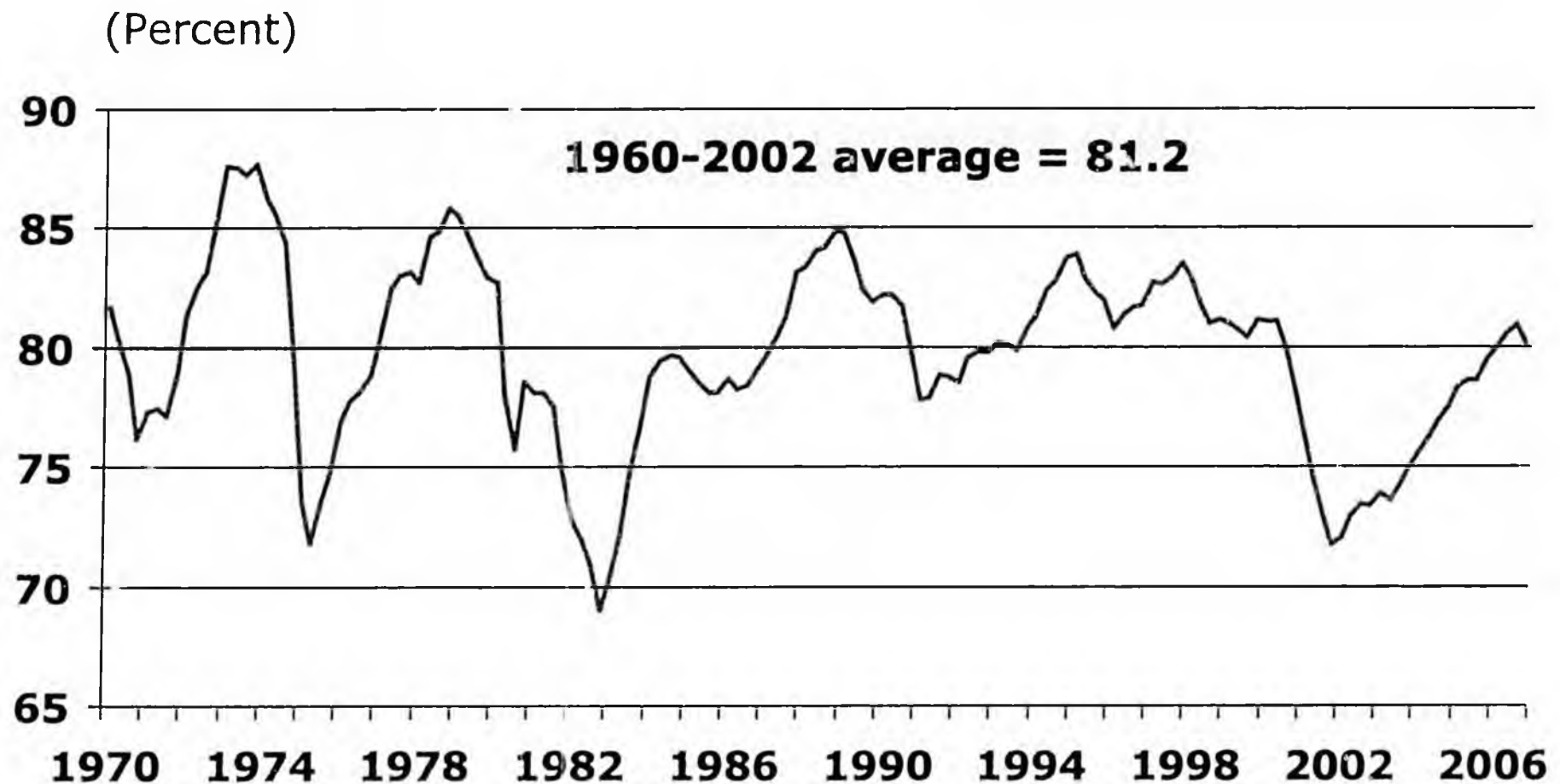
(Percent change)

* 2006 estimate - Global Insight



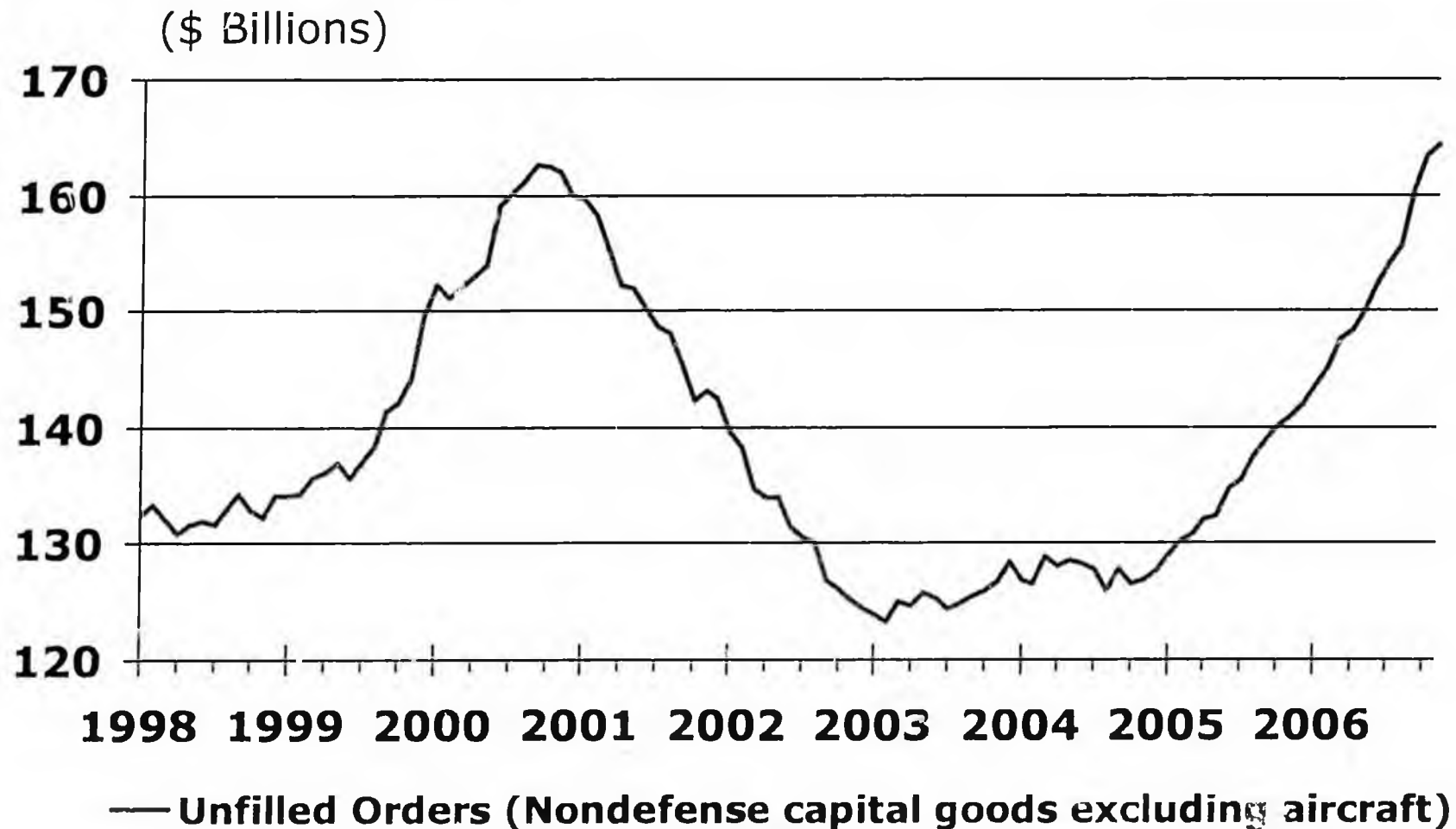
Source: Global Insight

Manufacturing Capacity Utilization Reaching the Trigger Point for Investment



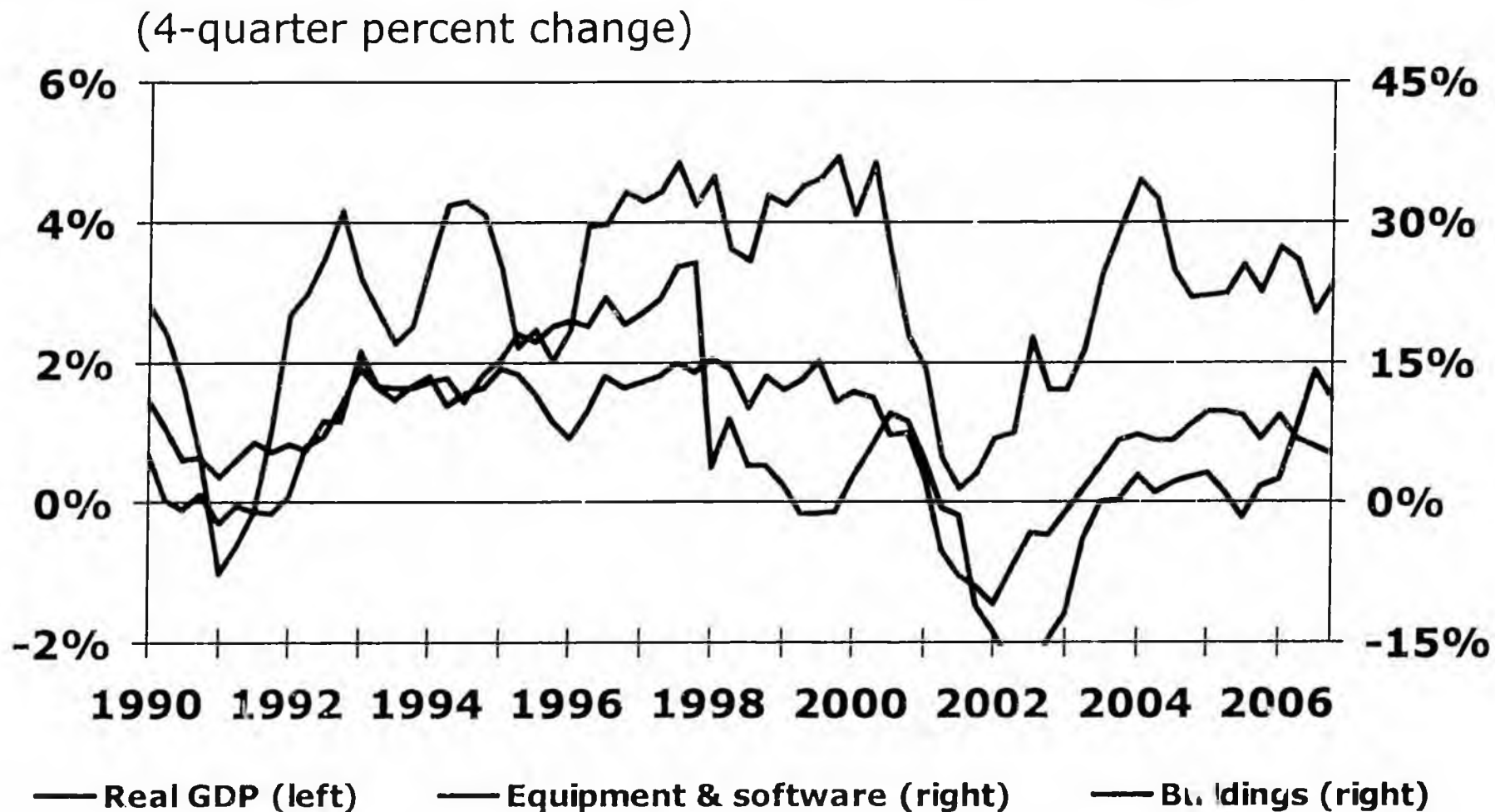
Source: Global Insight

Capital Spending on Business Equipment is Still Growing



Source: Global Insight

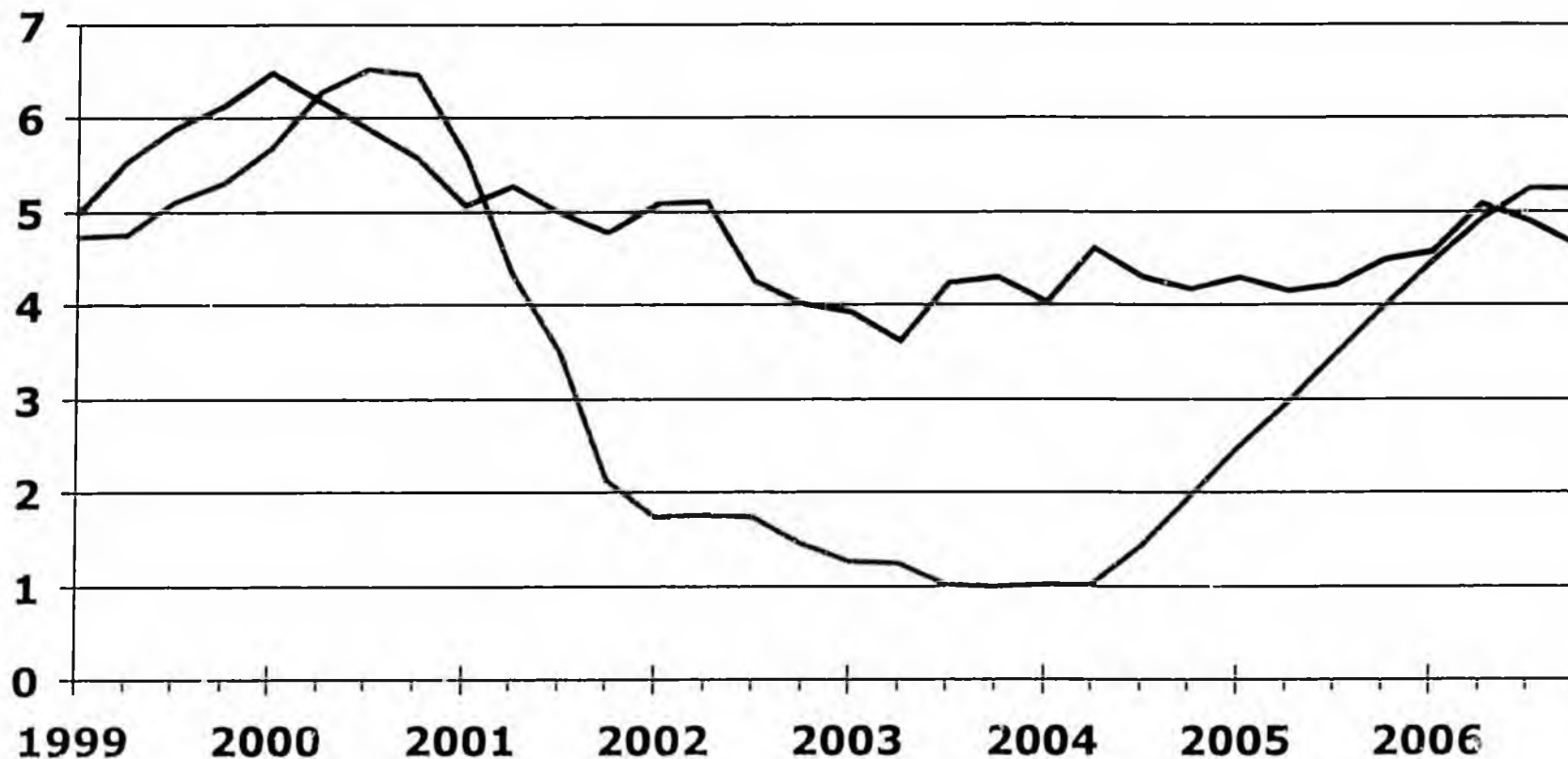
Non-Residential Construction is Taking the Lead



Source: Global Insight

Fed Will Have Room to Cut Interest Rates in 2007

(Percent)



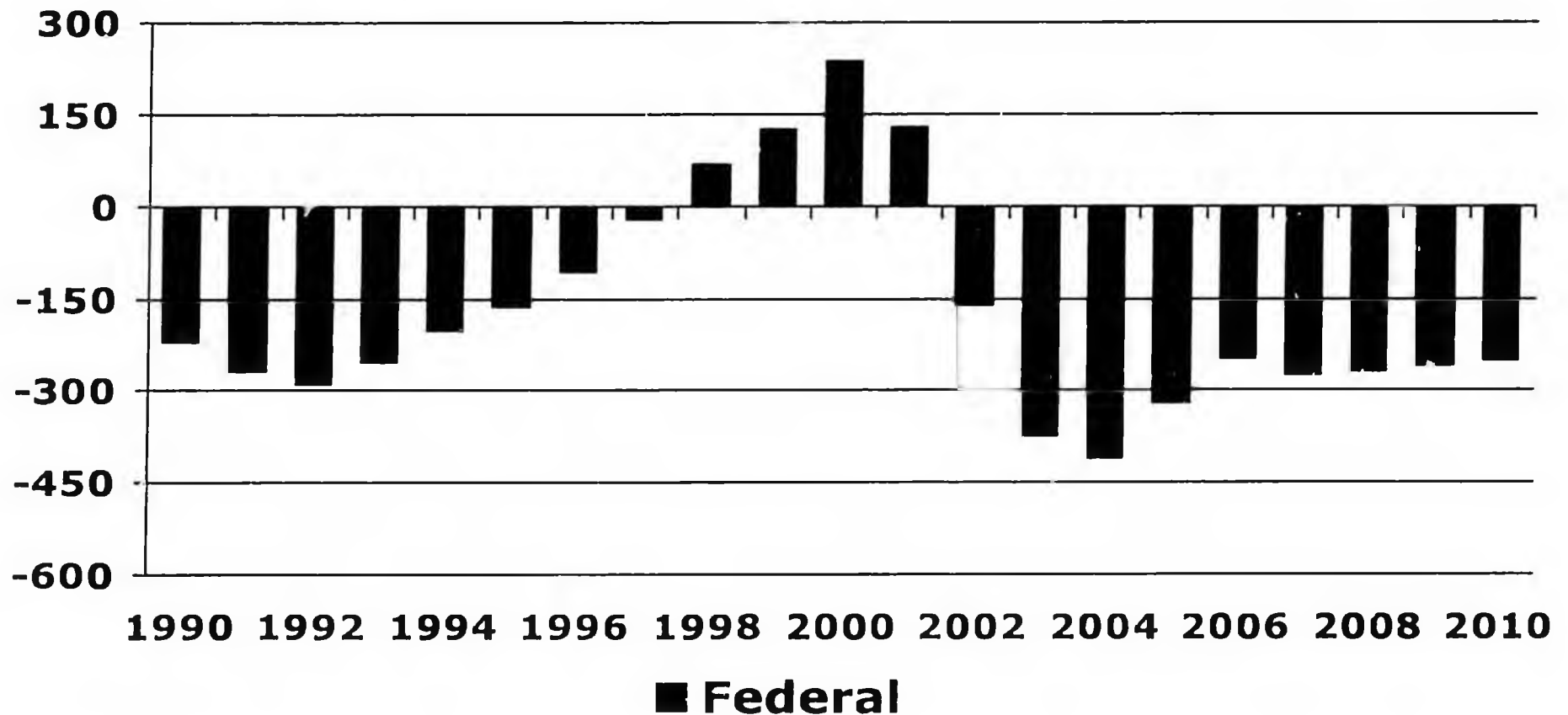
— Federal Funds — 10-Year Treasury Yield

Source: Global Insight

Federal Budget Deficit Has Actually Done Better Than Expected

(Billions of dollars, fiscal years)

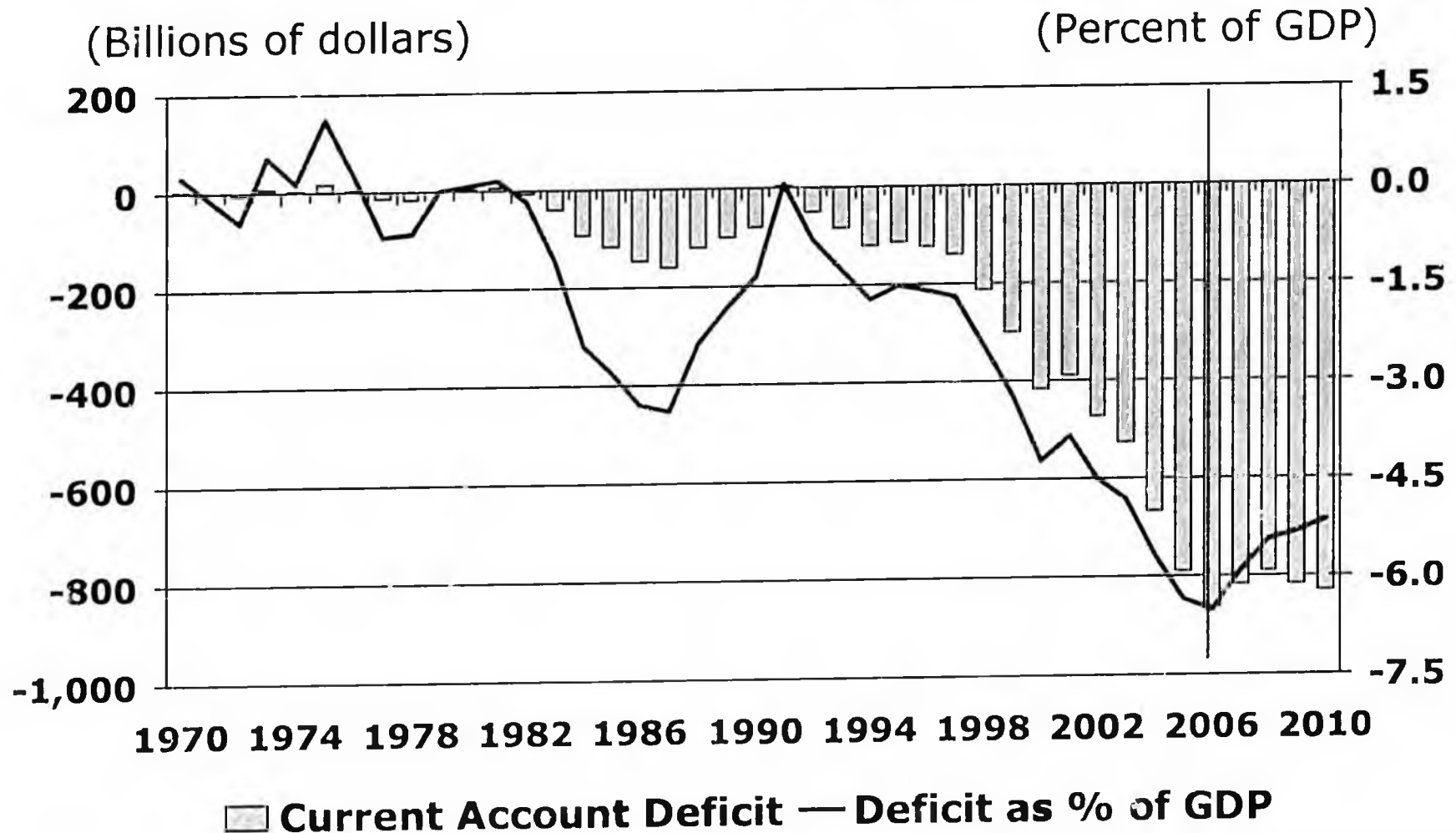
* 2007+ forecast - Global Insight



Source: Global Insight

The U.S. Current Account Deficit: Peaking at Last?

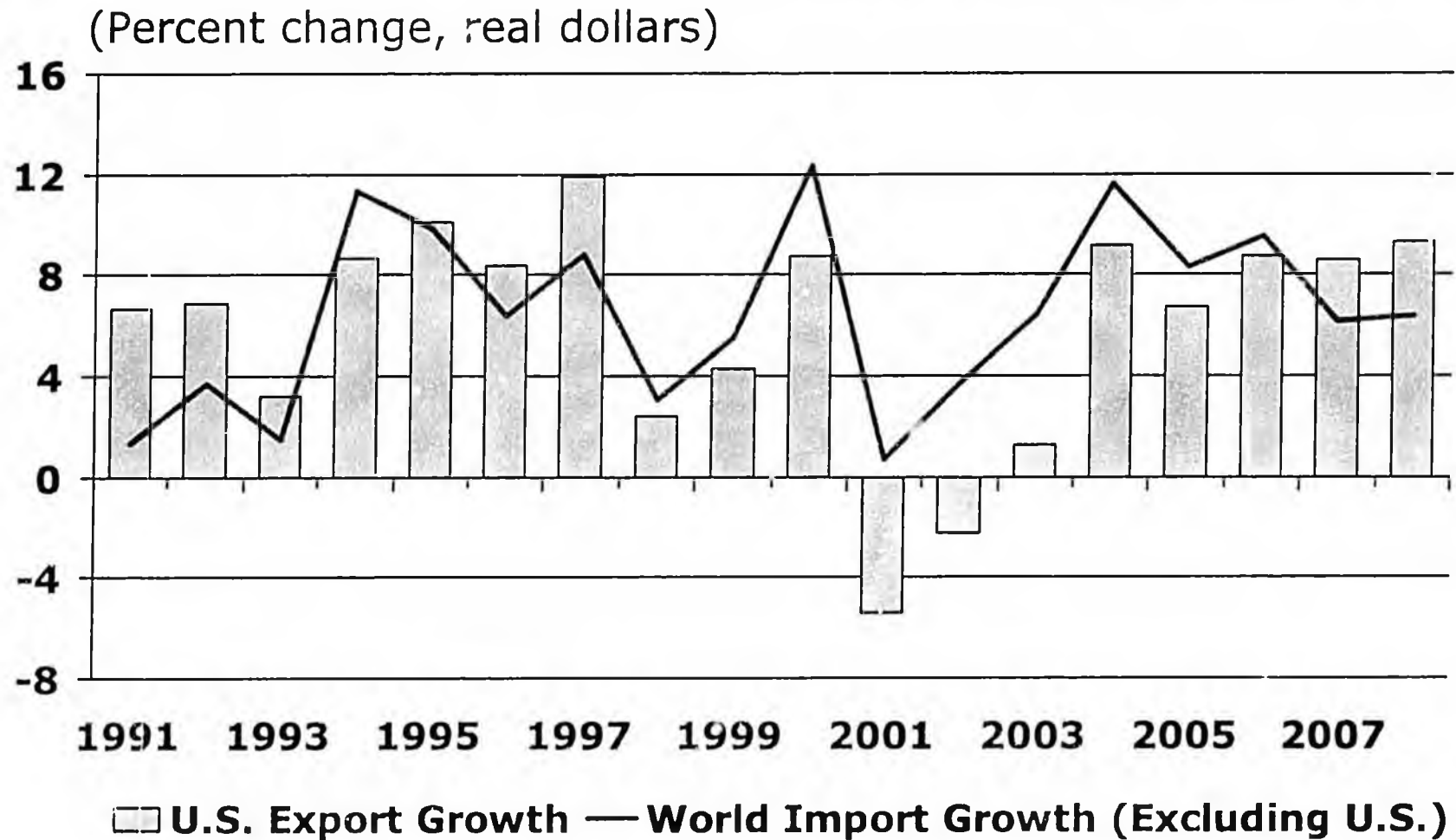
* 2007+ forecast - Global Insight



Source: Global Insight

U.S. Export Growth Catches Up to World Trade Growth - Falling Dollar Helps

* 2007+ forecast - Global Insight



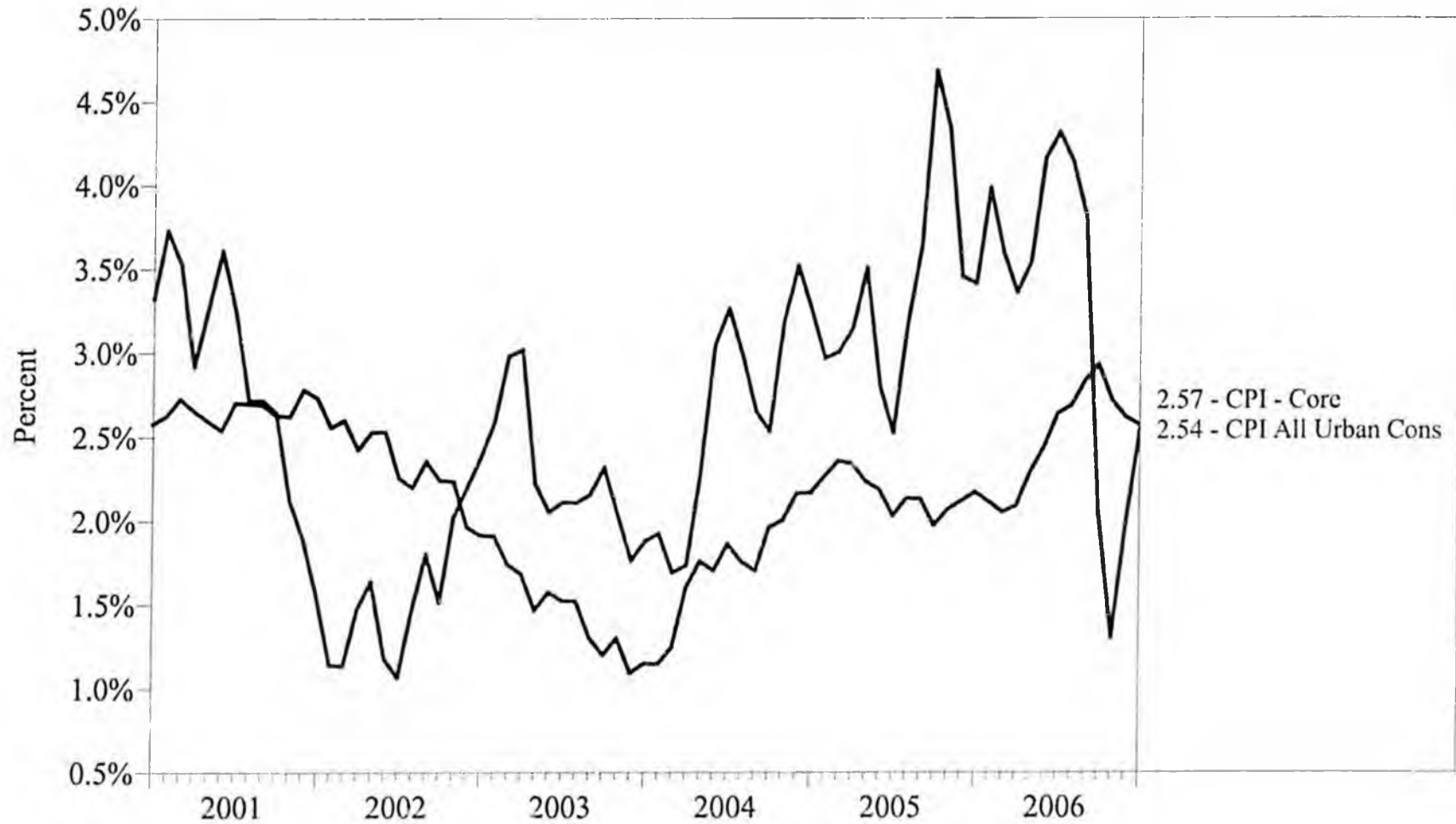
Source: Global Insight

Inflation Risk Remains Modest

- Despite soaring energy and commodity prices, inflation is contained. Outside of energy, core inflation has moved past the Fed's "comfort zone", but shows signs of moderating.
- U.S. is the most susceptible to inflation among industrialized economies - only one with above trend growth.
- Consumer prices surged at times during 2005-06, but came in at 2.5% for the year, down from the 3.4% recorded in 2005.
- Strong productivity growth and modest wage inflation keep prices in check.
- Oil prices in the \$50-60s don't seem to mean as much to the U.S. economy as once suspected - one of the consequences of a service economy.
- Growth in Europe remains below trend and unemployment rates are high. Japan is *still* shaking off the effects of a decade of deflation.
- While U.S. capacity is stretched, large amounts of spare capacity exist in other parts of the world. China and other Asian countries continue to export deflation.

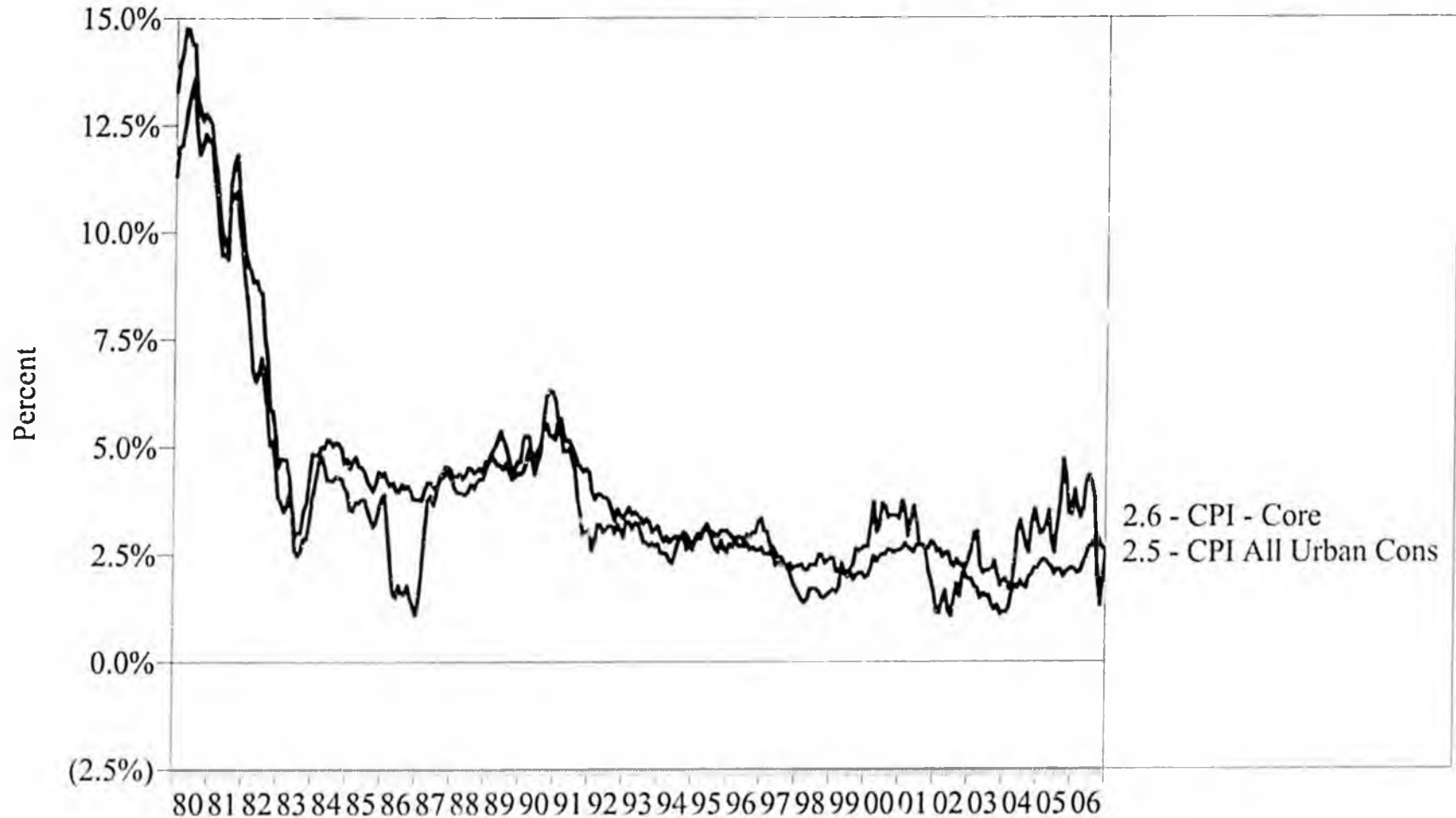
Inflation Has Ticked Up...

Year-Over-Year Change in Consumer Prices



...But Perspective Is Necessary

Year-Over-Year Change in Consumer Prices



The Capital Markets - Context

Wild Ride for Investors Over the Last Seven Years

	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	Average Annual Return		
								<u>Five Years 2002-06</u>	<u>Ten Years 1997-06</u>	<u>Fifteen Years 1992-06</u>
<u>Broad U.S. Stock Market</u>										
Russell 3000	-7.46	-11.46	-21.54	31.06	11.95	6.12	15.72	7.17	8.64	10.79
S&P Super Composite 1500	-6.98	-10.64	-21.31	29.59	11.78	5.66	15.34	6.79	8.83	10.89
<u>Large Cap U.S. Stocks</u>										
Russell 1000	-7.79	-12.45	-21.65	29.89	11.40	6.27	15.46	6.82	8.64	10.80
S&P 500	-9.10	-11.88	-22.10	28.80	10.88	4.91	15.79	6.19	8.42	10.64
<u>Small Cap U.S. Stocks</u>										
Russell 2000	-3.02	2.49	-20.48	47.25	18.33	4.55	18.37	11.39	9.44	11.47
S&P 600 Small Cap	11.80	6.54	-14.63	38.79	22.65	7.68	15.11	12.49	11.57	13.24
<u>Non-U.S. Stock Markets</u>										
EAFE (\$US)	-14.17	-21.44	-15.94	38.59	20.25	13.54	26.34	14.98	7.71	7.86
<u>Fixed Income Markets</u>										
LB Aggregate	11.63	8.43	10.26	4.10	4.33	2.43	4.33	5.06	6.24	6.50
Citi Non-US Bonds	-2.63	-3.54	21.99	18.52	12.14	-9.21	6.95	9.50	4.70	6.35
<u>Cash Market</u>										
90-day T-bill	6.18	4.42	1.78	1.15	1.33	3.07	4.85	2.43	3.81	4.00
<u>Inflation</u>										
CPI-U*	3.39	1.55	2.38	1.88	3.26	3.42	2.54	2.69	2.43	2.57

* Annual CPI-U data are measured as year-over-year change.

2007 Capital Market Projections

- **Modest changes expected from last year's projections. Fed executed policy exactly as expected. Strong equity returns, incredible corporate profits are likely not sustainable.**
- **Inflation at 2.75% implies moderation from recent levels; consensus expectations are even lower.**
- **Projected cash returns are lower than current short-term yields, reflecting expectations that interest rates peaked in 2006. 4% still implies a positive real return.**
- **Bond returns nudged up to 5.25%:**
 - Reflects current yield-to-worst.
 - Project upward sloping yield curve (very slight), with a very small risk premium for bonds over cash (1.25%).
- **Equity returns left unchanged, narrowing the premium over fixed income.**

Domestic Fixed Income

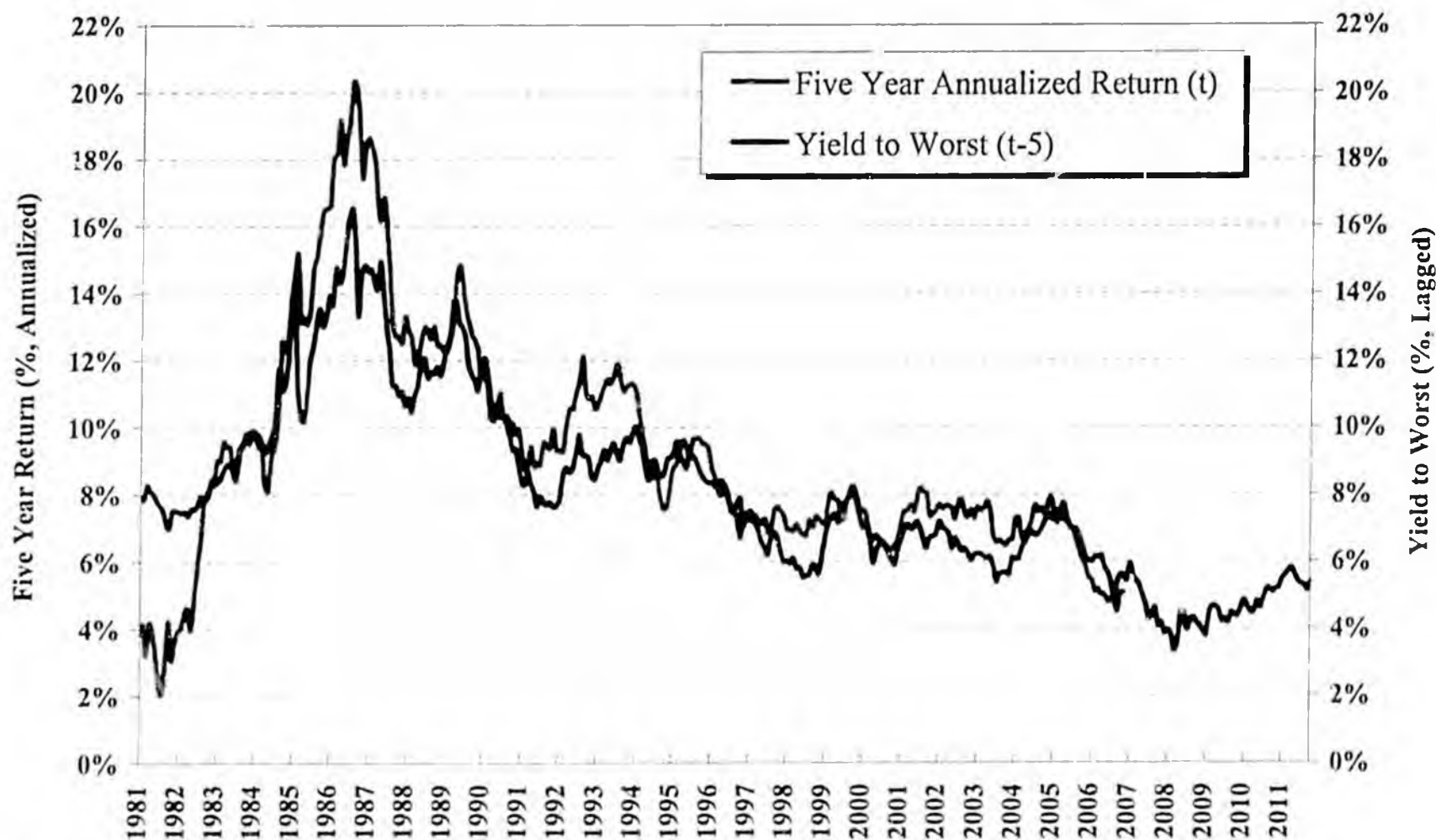
Lehman Aggregate Index - Daily Yield to Worst from 1/1/01 to 12/31/06



Domestic Fixed Income

Current Yield is a Strong Predictor of Returns

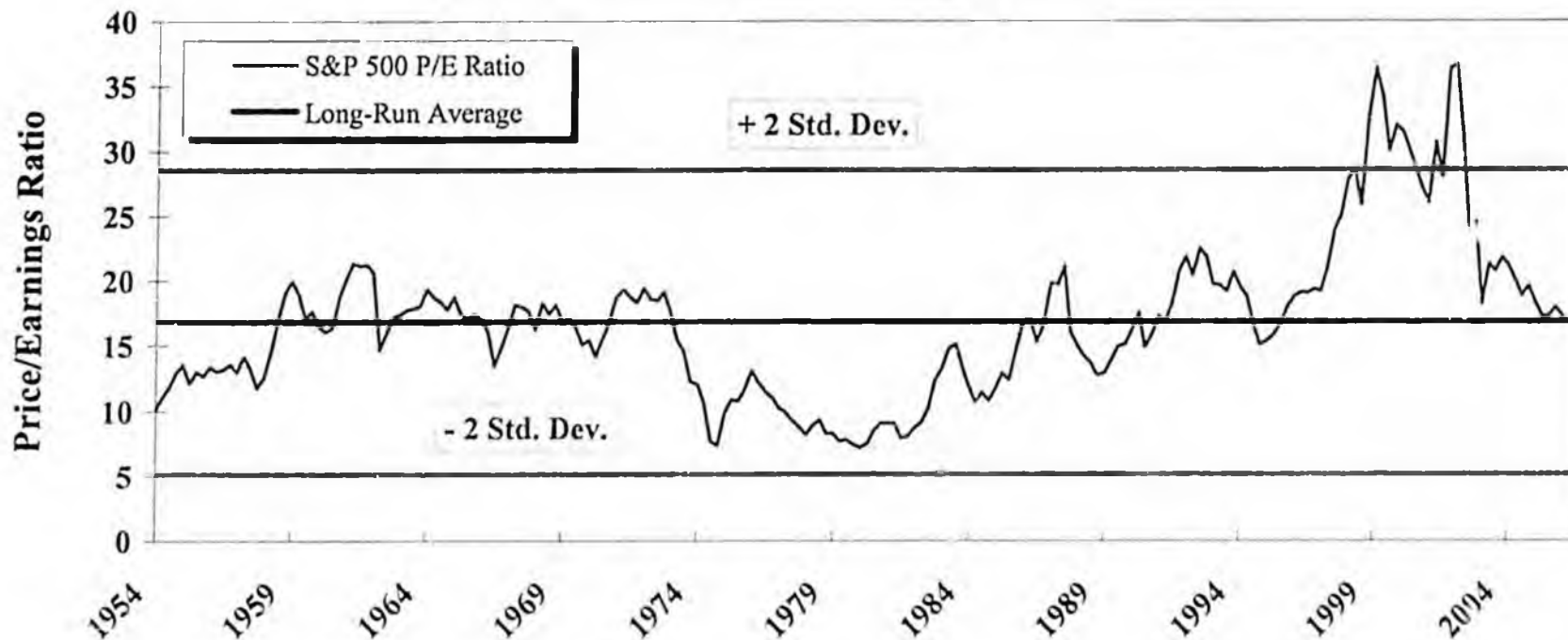
Lehman Aggregate Index 5 Year Returns vs. Lagged Yield to Worst



Equity Appears to be Reasonably Priced

Trailing P/E Approaching Long-Run Average

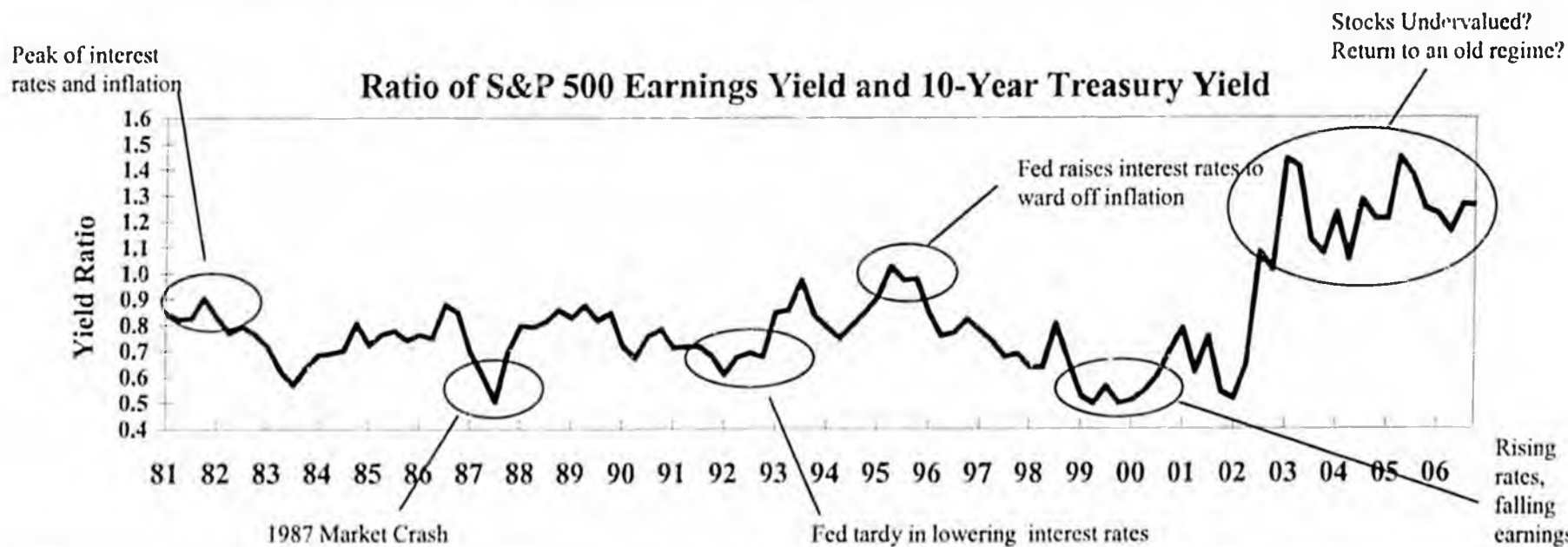
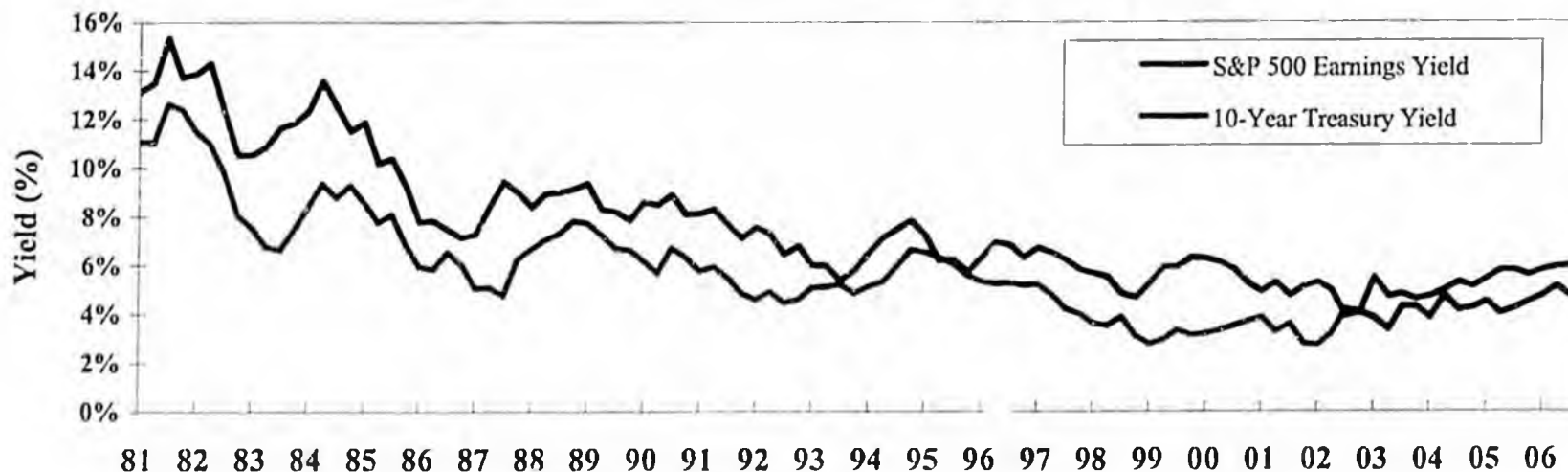
Price to Earnings Ratio for S&P 500 (1954 - 2006)



Trailing earnings as reported for the fiscal year; includes negative earnings from 1998 onward.

Domestic Equity vs. Bond Yields

S&P 500 Earnings Yield vs. 10-Year Treasury Yield



2007 Capital Market Projections

Asset Class	Index	Projected Annual Return		Projected Standard Deviation (Risk)	Projected Yield	2006 Projections	
		Real	Nominal				
Equities							
Broad Domestic Equity	Russell 3000	9.00%	6.25%	16.90	2.10	9.00%	16.90
Large Cap	S&P 500	8.85%	6.10%	16.40	2.20	8.85%	16.40
Small/Mid Cap	Russell 2500	9.85%	7.10%	22.70	1.20	9.85%	22.70
International Equity	MSCI EAFE	9.20%	6.45%	20.10	2.20	9.20%	20.10
Emerging Markets Equity	MSCI EMF	9.80%	7.05%	32.90	0.00	9.80%	32.90
Fixed Income							
Domestic Fixed	LB Aggregate	5.25%	2.50%	4.50	5.25	5.00%	4.50
Defensive	LB Govt 1-3 Year	4.25%	1.50%	2.30	4.25	4.25%	2.30
TIPS	LB TIPS	4.90%	2.15%	6.00	4.90	4.65%	6.00
High Yield	CSFB High Yield	7.00%	4.25%	11.50	7.00	6.75%	11.40
Non US\$ Fixed	Citi Non-US Govt	5.15%	2.40%	9.60	5.15	4.90%	9.60
Other							
Real Estate	Callan Real Estate	7.60%	4.85%	16.50	6.00	7.60%	16.50
Private Equity	VE Post Venture Cap	12.00%	9.25%	34.00	0.00	12.00%	34.00
Absolute Return	Callan Hedge FoF	6.50%	3.75%	9.70	0.00	6.50%	10.20
Cash Equivalents	90-Day T-Bill	4.00%	1.25%	0.80	4.00	4.00%	0.80
Inflation	CPI-U	2.75%		1.40		2.75%	1.40

Current Policy with 2007 Projections

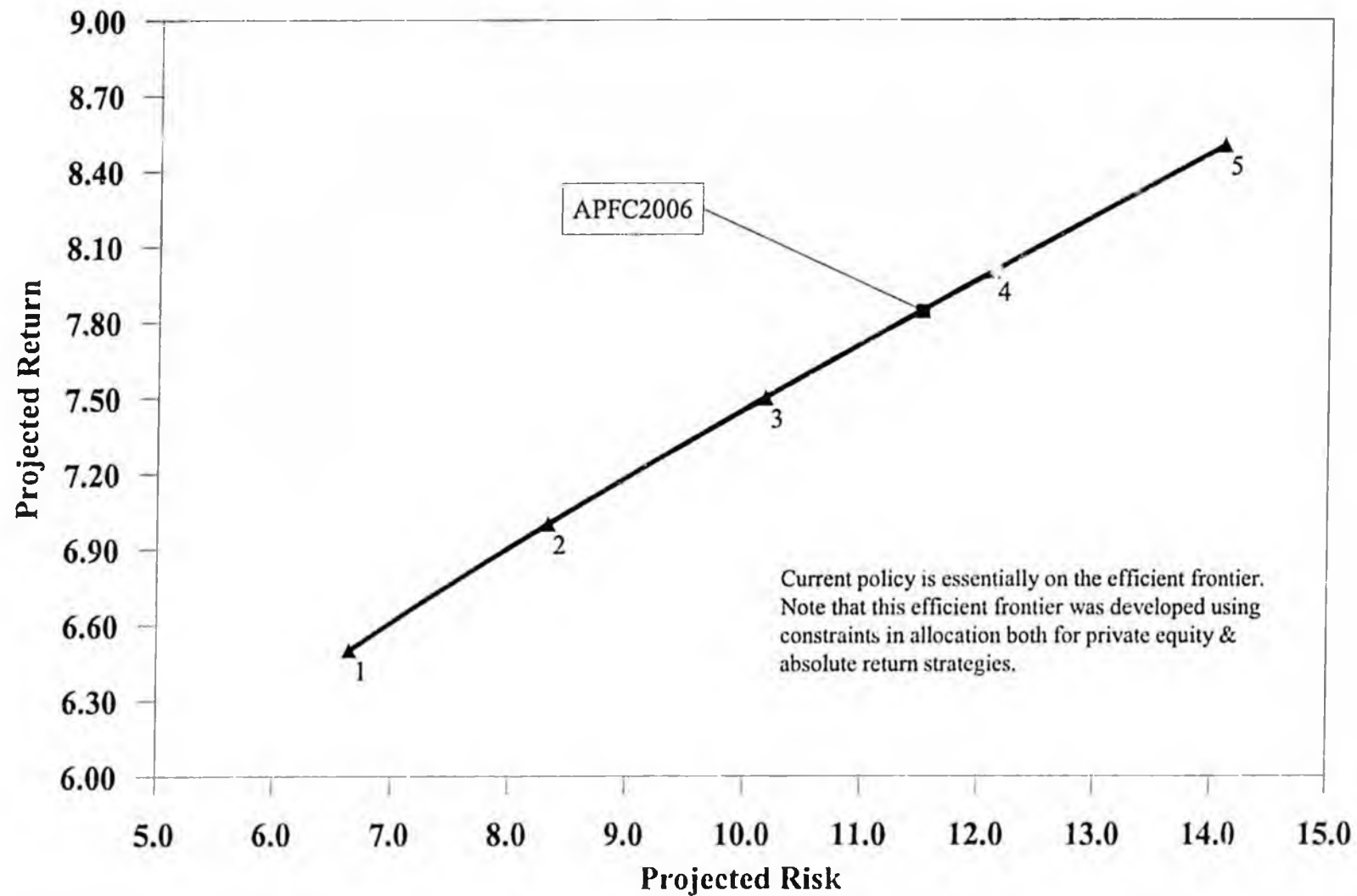
Asset Mix Alternatives Optimization Set: 2007

Portfolio Component	Max	Mix 1	Mix 2	Mix 3	APFC2006	Mix 4	Mix 5
Large Cap	100%	14%	19%	25%	29%	32%	38%
Small/Mid Cap	100%	4%	5%	7%	5%	8%	10%
International Equity	100%	6%	9%	12%	16%	15%	19%
Emerging Markets Equity	100%	1%	1%	2%	3%	2%	3%
Domestic Fixed	100%	59%	48%	36%	25%	24%	12%
Non US Fixed	100%	5%	4%	3%	4%	2%	0%
Real Estate	100%	5%	6%	7%	10%	9%	10%
Absolute Return	4%	4%	4%	4%	4%	4%	4%
Private Equity	4%	2%	4%	4%	4%	4%	4%
Cash Equivalents	100%	0%	0%	0%	0%	0%	0%
Totals		100%	100%	100%	100%	100%	100%
Expected Return		6.50%	7.00%	7.50%	7.84%	8.00%	8.50%
Standard Deviation		6.64%	8.33%	10.16%	11.50%	12.10%	14.09%
Sharpe Ratio		0.38%	0.36%	0.34%	0.33%	0.33%	0.32%

Note that the APFC's implementation of domestic and international equity is accomplished through both global and domestic/international portfolios. The current implementation plan has 14% allocated to global portfolios funded through 7% reductions in both international and domestic large cap.

Efficient Frontier Graph

Efficient Frontier



Alaska Permanent Fund Corporation Fiscal Performance Summary

For fiscal year 2006:

- **The Fund returned 11 percent, well ahead of our benchmark of 10.5%.**
- **For the first time the Fund reached \$31, \$32, \$33, \$34 and \$35 billion in value**
- **We earned \$3.1 billion on investments, and received an additional \$601 million in mineral revenues.**
- **And we paid \$689 million in dividends, ending the year with a balance of \$32.9 billion, a gain of almost \$3 billion over FY05.**

For the first six months of fiscal 2007:

- **The Fund returned 9.6%, and closed on December 31 with an unaudited value of \$36.4 billion.**
- **Statutory net income as of December 31 was \$1.9 billion. Statutory net income was only \$257 million for FY02, the year that falls out of the five-year average, so we expect dividends will be higher this fall.**
- **Performance since December was trending upward, and the Permanent Fund closed \$40 million short of \$38 billion on Monday.**
- **Most of this strong performance is the result of gains in both US and non-US stocks, and the markets have held on to some of the gains made since December 31.**



Official Business

Alaska State Senate

Senate Finance Committee

Mail Stop 3100
State Capitol
Juneau, Alaska 99801-1182

AGENDA

Thursday, March 1, 2007

9:00 a.m.

Alaska Permanent Fund Corporation Presentation

APFC Board of Directors

Joint with House Finance Committee