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Market Outlook

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The crisis in credit markets that unfolded last summer quickly evolved into a crisis of confidence in the Federal Reserve, government leaders and the entire financial system. January began as one of the worst months for the stock market on record, with a decline in the Standard & Poor's 500 of nearly 20% from the October highs, before the Federal Reserve finally responded with a 75-basis-point inter-meeting cut in short-term interest rates on January 22. The Dow Jones Industrials (-4.6%), Nasdaq Composite (-9.9%), and Standard & Poor's 500 (-6.1%) all recorded losses for the month. Financials led sector performance with a loss of less than 1%, while the technology sector was the worst performer, posting a loss of 12.5%.

The stock market decline began in late December with the release of inflation data that showed a 4.1% year-over-year rise in nominal inflation and a 2.7% rise in core inflation. This was the highest reading in 17 years. As the economic slowdown in the US accelerated, market pundits piled on the recession bandwagon, and the print and television media fanned the flames. Goldman Sachs forecast that the recession would begin in the second quarter of this year. Stagflation (rising inflation coupled with slowing growth) arose as a new concern for investors. The continued lack of acknowledgement and action by the current administration and the Federal Reserve Board drove stock prices lower. The absence of timely and aggressive Fed action in response to lower home prices and the slowdown in the rate of consumer-spending growth has been our key concern.

> We believe current stock market valuations are reflecting a significant decline in corporate profits that has not and will not materialize.

Ultimately, the decline in stock prices forced the Fed to cut short-term interest rates an astonishing 75 basis points last week, followed by an additional 50 basis points during the FOMC meeting this week, resulting in a Fed Funds rate of 3%. Washington leaders quickly outlined details of a $150 billion economic stimulus package. These actions tempered the psychological meltdown in investor confidence that rang in the New Year.

The stimulus package is designed as a bridge to increase consumer spending and corporate capital expenditure until the recent rate cuts take full effect later this year. We think these combined actions will prevent the US from falling into recession, although they are not a long-term solution to our nation's problems. They will be instrumental in mending the negative consumer confidence and investor sentiment that led to the stock market meltdown at the beginning of the year. They will help avoid the negative-wealth effect of falling home prices and stock prices–a combination that would most certainly lead to a full-blown US recession.

Our longer-term concern with the stimulus package is that the federal government is sending $100 billion that it doesn't have in rebate checks to debt-laden consumers that need to save, in hopes that they will spend it. Isn't this how we ended up where we are today? The budget deficit will increase and the consumer balance sheet will be no better off than before. This must be an election year! We are most likely delaying the inevitable–a consumer-led recession that will ultimately take hold, but now probably not until 2009. We see this as the lesser of two evils, for no response would surely lead to recession now. We are standing by our forecast for a continuation of the current economic expansion with economic growth of 1-1.5% in 2008.

Despite a continuation of the housing slump and lack of growth in consumer spending, we see reasons to be optimistic about the stock market this year in addition to the previously mentioned Fed actions and the economic stimulus package. Mortgage rates are near all-time lows and refinancing has soared. A proposal within the stimulus package to raise the GSE conforming loan limit from $417,000 to $729,725 will lower the interest rate on jumbo loans. LIBOR rates on which many adjustable-rate loans are based have fallen dramatically in the past month. All of these factors will reduce borrowing costs for many home owners.

We see both the core and nominal rate of inflation declining throughout the year. Declining home prices and restrained wage gains are limiting consumer purchasing power and the ability of service companies and retailers to raise prices. Globalization and advancements in technology combined with the huge increase in money supply are creating excess capacity and more competition, all of which are deflationary in our view. A decline in the rate of inflation will remove concerns about stagflation and, when combined with declining interest rates, should lead to multiple expansion and higher stock prices.

We believe current stock market valuations are reflecting a significant decline in corporate profits that has not and will not materialize. The S&P 500 is currently valued at a mere 14 times expected 2008 earnings, a level not seen since the corporate-led recession in 2002. Whether or not a recession does occur, we would argue that it has already been priced into the stock market. Bearish investor sentiment has reached a level not seen since the recession and market bottom in 1990. Both are factors which lead us to believe stock prices are set to rise in the months ahead. Declining rates of return for cash equivalents, as a result of lower short-term interest rates, also make stocks more appealing from a valuation standpoint.

We believe corporate earnings growth, while slowing, is much stronger than the headlines suggest. While fourth-quarter earnings for the S&P 500 are estimated to decline 20%, when we exclude the financial sector, earnings are on track to rise 11.4%. The majority of the 100% decline in financial-sector earnings is attributable to mark-to-market write-downs of mortgage-related securities. The value of these write-downs serves as a deduction against pre-tax income, despite the fact that no losses may have been incurred and the mortgage-related securities may recover their value over time. We believe this acceleration in write-downs into year-end (approximately $100 billion) now exceeds the ultimate loss that will be incurred by financials, presenting a great investment opportunity in the sector.

There is $1.2 trillion worth of sub-prime and Alt-A mortgage loans outstanding today, and approximately 15-20% of those mortgages are delinquent. If we were to assume the unlikely scenario that all of the delinquent mortgages went into foreclosure, and the recovery on sale was a mere 50% of the home value, the losses would amount to $90-120 billion. This is an amount that has already been collectively written down by the financial institutions holding these loans.

We remain overweight the energy, industrial and material sectors that benefit from a weak dollar and developing market growth. We are in the midst of a multi-year boom in the agricultural and commodity sectors due to an ever improving standard of living for the five billion people that live in the developing world. The steady growth in capital expenditures by corporations should lead to improving profits in the technology sector, which also remains an overweight in our portfolios. We believe financial sector outperformance will be the greatest surprise in 2008, as these companies benefit from lower short-term interest rates, an improvement in net-interest margins, and easy year-over-year comparisons of profitability in the second half of 2008. We continue to avoid the domestic consumer-related sectors. ■

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