January, 2008

2007 Review and 2008 Outlook

Review: Stocks finished the year with a 3.2% loss in the final quarter. In contrast, bonds had a return of 2.9% in the quarter. For the year, the S&P 500 increased a modest 5.5%, while the Merrill Lynch Intermediate Bond Index gained 7.4%. This is the first year since 2002 bonds have outperformed stocks.

Annual	***2007***	***2006***	***2005***	***2004***	***2003***	***2002***
S&P 500 Index	***5.5%***	15.9%	4.9%	10.9%	28.7%	-22.1%
Merrill Lynch Int. Bond Index	***7.4%***	4.1%	1.6%	2.9%	4.2%	9.7%

The Economy: At the beginning of the year, the forecast was for moderate economic growth. The consumer sector was supported by strength in the job market which was sufficient to offset the weakness becoming evident in the housing market. However, as the year progressed, the problems in housing and mortgages intensified, and energy prices rose sharply. Consumer spending slowed further. Strong exports to developing economies, aided by the weak dollar, helped globally oriented companies weather the storm in the domestic consumer economy.

Looking ahead, the economy appears to be weakening further, and a recession is increasingly likely. The consumer is under pressure from a declining housing market, high energy prices, and a slowing job market. Growth of the other developed economies is expected to slow in concert with the US. That leaves the emerging economies as the major engine of global growth. While there are good fundamental reasons for the emerging economies to continue to grow on a secular basis, they are not immune to a slowdown of the global economy. In the US, we expect a slowing of growth, if not a recession, in the first half of this year. Consumer-oriented businesses will feel the most impact, while global companies will be less affected. The Fed is likely to cut interest rates further in response to the weak economy. These cuts will continue to pressure the dollar, but it has probably already discounted some additional Fed easing.

In summary, after years of good global growth, a cautious forecast seems prudent.

Stock Market: Last year, the weakest sectors of the S&P 500 were financials and consumer discretionary- not surprising given the turmoil in the credit markets and the pressures on the consumer. The best-performing sectors were energy and materials. Crude oil prices rose 70% during the year and demand for basic materials such as metals was strong. Both sectors benefited from strong demand from emerging economies.

This year we expect the underperformance of the consumer discretionary and financial sectors to continue for at least the first half. There is no quick and easy solution to the housing problem and the associated mortgage crisis.

Bond market: Last year, the flight to quality was the dominant feature of the bond market. The highest quality segment, treasury bonds, had a total return of 8.9% while lower-rated bonds did less well. For example, single A rated corporate bonds were up only 4.2%.

In 2008, the bond market will face competing forces. A slowing US economy will be supportive of lower interest rates, and higher bond prices. However, inflation has shown signs of moving higher, pushed by the dollar and surprisingly high energy prices, and will put upward pressure on interest rates.

We expect concerns about inflation to be the pivotal factor. Therefore, we believe bonds will provide only mediocre returns this year.

Strategy: The first part of the year will be difficult for stocks because of concern about the economy. Stock valuations are attractive, but the slowing economy puts earnings estimates at risk. We plan to be defensive in stock selections until the economy shows signs of bottoming. Bonds are not attractive, given the low yields and inflation risk. Average maturities should be kept short. International growth should continue and provide good return in international equities.