



Looking Ahead: 2008 Economic and Investment Outlook

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As in 2005 and 2006, the U.S. economy was resilient in 2007. Throughout the year, the economy continued to perform well despite the worst real estate market since the Great Depression, the price of oil increasing from \$58 to \$90 per barrel, a subprime mortgage mess developing into a significant credit crunch, and financial institutions experiencing billions of dollars in losses. Meanwhile, the consumer was battered with falling home values and rising food and energy prices. Yet, the economy chugged along posting real Gross Domestic Product (GDP) growth of 2% plus for the year.

However, 2007 was anything but a smooth ride for investors and the financial markets. Market volatility increased significantly throughout the year as investors attempted to determine the extent of the subprime damage. It did not help matters that the financial institutions themselves were not certain of their own subprime exposure and the resultant financial losses. The housing market was deteriorating, the economy was slowing, fear of a recession was increasing, inflation concerns were growing, and the value of the U.S. dollar was dropping. Housing, financial, and consumer discretionary stocks all came under pressure. Given these circumstances, it would appear as though 2007 was a painful year for investors. Not at all. As in previous years, a well diversified portfolio of domestic and international stocks and bonds rewarded the prudent investor with positive and meaningful returns.

So where is the U.S. economy headed in 2008? How will the financial markets perform in the year ahead in light of current and anticipated economic conditions? What type of returns can investors expect? How should investment portfolios be positioned

to maximize return yet preserve principal?

We will examine these questions and share our insights. As we strive to maximize portfolio returns while managing risk for our clients, it is imperative that we fully understand current economic conditions and market fundamentals and the direction in which we are headed. Our 2008 Economic and Investment Outlook will guide NexTier Wealth Management's investment decisions and recommendations in the coming year.

U.S. Economy

The biggest question regarding the 2008 U.S. economy is whether or not it will go into a recession sometime during the first half of the year. There seems to be a lot of debate over this issue. In reality, from an investment perspective, the debate is purely academic. By definition, a recession occurs when the U.S. economy experiences two consecutive quarters of declining growth. Once the recession is officially recognized, six months have passed since the onset of the event. At that time, the economy will most likely be on the road to recovery and the financial markets will be stronger and headed higher.

Therefore, whether or not the economy will go into a recession is not a great concern of ours. That is because, regardless of the definition, it is clear that economic activity has and will continue to slow. We would not be surprised to learn in the summer of 2008 that the economy was already in a recession by year end 2007.

The economic slowdown is the direct result of the subprime mortgage fiasco, tighter lending standards, declining home values, and higher food and

energy prices. Credit will be more expensive and harder to come by than previous years as banks are tightening lending standards across residential, consumer, and commercial segments. We anticipate real economic growth of approximately 1.5%-2% in 2008, the slowest growth since 2002.

Stronger global growth and economic activity may or may not help offset the slowdown in the U.S. economy as U.S. exports are expected to increase to meet the growing international demand. Historically, domestic and international economies have been highly correlated. When the U.S. economy slowed, the rest of the world economies soon followed. The old adage states that when the U.S. sneezes the rest of the world catches a cold. However, recently, many economists are suggesting that the U.S. and world economies have "decoupled." In other words, should the U.S. economy slow, it is far from certain that other world economies would also experience a slowdown. This sounds eerily similar to the most dangerous words to an investor's ears - "It's different this time."

The U.S. consumer is responsible for approximately 70% of domestic GDP. The U.S. is responsible for 20% of the world's economic activity. Therefore, the U.S. consumer is accountable for between 12-14% of global economic activity. It is tough to imagine the U.S. consumer weakening without having a significant impact on global GDP. We believe that while "decoupling" may indeed be a phenomenon in the future global environment, we are not there yet. It will not be different this time. The Federal Reserve and its chairman, Ben Bernanke, are in an awkward position. To be clear, the Fed is stuck between a rock and a hard place. Fear is a wonderful motivator but in this instance, there is not much the

Fed can do. What does Bernanke fear more....inflation or a recession?

Sitting at the Fed's 2008 dinner table are inflationary pressures, a declining U.S. dollar, weakening economic conditions, a credit crunch, a subprime mess, and a deteriorating housing market. Tasty and filling food, i.e. lower interest rates, served to strengthen the financial sector, economy, and housing market may sicken the already weak dollar and further fatten inflation. A stricter diet of fewer calories, i.e. higher interest rates, would make for a healthier dollar and leaner inflation but may well starve the weak and tired consumer and housing market, thus further weakening the economy.

This year the consumer will face higher credit card payments, adjustable rate mortgage resets, declining home values (2% in 2008), and higher food and energy prices. These factors will put a lid on consumer spending.

We expect oil to average \$80-85 per barrel in 2008. Gasoline prices may reach \$4 per gallon during the summer months due to continued tight supplies and increasing demand, particularly from developing nations. Political instability in oil producing nations and extreme weather are the wildcards that could push energy prices higher. A global recession would obviously crimp demand and result in lower prices. Nonetheless, we expect oil prices to be higher in 2008 than 2007.

The bursting of the housing bubble was caused primarily by an oversupply of houses, not by interest rates gradually moving higher. The oversupply was the direct result of cheap credit terms and to some degree fraudulent activity caused by sleazy

mortgage brokers, corrupt appraisers, and avaricious loan originators. Lower interest rates will not, in and of themselves, eliminate the housing woes. Low unemployment, lower home values, a reduction in new home construction, and affordable interest rates are the medicines necessary to cure the housing ills. We anticipate housing markets on average will remain weak throughout most of 2008 but begin to show signs of recovery as we approach 2009. The housing sector will detract approximately 1% of growth from the 2008 GDP.

The fixed income markets are predicting the Fed will lower interest rates in the first half of 2008 as fears of an economic slowdown and possible recession are greater than inflationary concerns. As of this writing, the yield on the two-year Treasury note of 3.25% is 1% lower than the Federal Funds rate of 4.25% (the interest rate banks use to lend to one another). Because the bond market is extremely efficient at discounting future economic weakness, we believe the Federal Reserve is lagging behind where short-term rates need to go given current economic conditions. Therefore, at the risk of fueling inflation, we expect the fed fund rate to drop to 3.5-3.75% by mid-year.

We anticipate intermediate and longer-term interest rates will rise throughout the year pressured by rising inflation, higher treasury issuance due to projected wider budget deficits (\$180 billion in 2008 versus \$163 billion in 2007), and a diminished appetite for U.S. fixed income securities by foreign investors.

Inflationary pressures will not go away in 2008 as higher food and energy prices will remain a thorn in the consumer's ever swelling paw.

The Federal Reserve focuses on core inflation as one of its primary determinants for Fed policy. In an attempt to smooth out changes in the inflation rate, the core inflation rate was created to exclude both food and energy prices (both of which have volatile price fluctuations) from the calculation. Excluding food and energy from the inflation rate is foolish. How many consumers are able to exclude food and energy products from their monthly expenditures and are not impacted by these higher prices? At some point during the second half of 2008, the Fed will need to focus its attention on an inflation rate which has risen above its comfort zone. The Fed will raise interest rates at the risk of slowing the economy.

Financial Markets

2008 could shape up to be a difficult year for the average investor. But all is not lost. We can all recall that the financial markets in 2007 were somewhat challenging for investors, yet delivered healthy returns for those with a well diversified portfolio. For the most part, we anticipate the 2008 financial markets will be similar to last year. Therefore, a well diversified, defensively positioned portfolio should protect an investor's portfolio and generate positive and acceptable returns.

Stocks

January 2008 marks the 58th month of the bull market for stocks that began in March 2003. We look for the equity markets to post positive gains in 2008, which should run our bull market monthly tally to 70. Modest U.S. stock gains will be driven by foreign investors (including sovereign funds) who are taking advantage

of bargain prices and the cheap dollar, corporate share repurchases, continued leveraged buyouts and M&A activity (albeit at lower levels than previous years), and reasonable equity valuations. On a fundamental basis, stocks appear fairly valued trading 17-18 times 2008 estimated operating earnings.

Not all segments of the equity market will perform similarly, however. So it is prudent to discriminate among the various equity styles, sectors, and market caps when constructing an investment portfolio.

Once again, we anticipate that large cap growth stocks will be the best performing domestic equity group because of tighter credit markets and a slower domestic economy. Also, large cap growth stocks tend to be more defensive in nature with a more predictable earnings stream than value stocks. In fact, we recommend the growth over value style for both mid and small cap stocks as well which appear to be overvalued relative to large cap stocks.

The slowing U.S. economy, combined with the stronger global economy, favor large cap growth stocks which typically have greater exposure to overseas markets. According to S&P 500, a higher percentage of the S&P 500 revenues are coming from abroad. Foreign revenues for the S&P 500 represented 32% of total revenue in 2001 and grew to 44% of total revenue in 2007. It is estimated that foreign revenue will total 50% of overall revenue in 2008.

We continue to be impressed by the strength of the oil and metals and mining sectors. Growth primarily in the BRIC (Brazil, Russia, India, and China) nations as well as the rest of Asia will continue to place upward

pressure on energy and commodity prices. Simply stated, supplies of these precious commodities are not coming online fast enough to keep pace with the unprecedented growth of these developing countries. Therefore, we recommend an overweight position in these equity sectors. However, a global slowdown sparked by the U.S. economic slowdown would necessarily cause us to reevaluate the appropriateness of our overweight position in commodities.

Continuing to perform well will be large and small cap international equities from developed countries, emerging market stocks, and international real estate. Most global economies, except Japan, are growing at a faster rate than the U.S. with manageable inflation. Combining the stronger global economies with a declining dollar and reasonable equity valuations provides a compelling case for international investing.

We do expect higher levels of market volatility to remain with all equity markets until the credit markets stabilize, inflation is no longer a concern, and a clearer sense of our economic direction emerges.

Fixed Income

Some economists see a slowing economy and financial strains leading to sharp declines in interest rates while others expect nettlesome inflation and continued modest growth to lead to a rebound in interest rates in the second half. Among 10 leading economists, there exists a wide range of forecasts for 2008 interest rates. The forecasted fed funds rate ranges from a low of 2.5% to a high of 5.25% by year-end. Similarly, the forecasted rate on the 10-year Treasury note ranges from a low of 3.70% to a high of 5.40% by year-end.

Because the 2008 outlook for interest rates is anything but clear, we recommend investing the fixed income portion of portfolios in high quality securities with relatively short maturities and duration. For reasons previously stated, we believe intermediate and longer-term interest rates will move modestly higher by year-end. A fixed income portfolio invested in shorter-term quality holdings will be able to take advantage of price movements in a rising interest rate environment.

International bonds remain attractive and should have representation in a fixed income portfolio. We would continue to avoid high yield or "junk" bonds. The tighter credit markets and slower economy will lead to higher default rates (1.7% currently versus 4% expected in 2008 by Moody's). The current lowered appetite for risk has shifted investor focus toward capital preservation and away from yield pick-up.

In summary, the 2008 economy and financial markets will face several challenges, all of which are not insurmountable if assessed and managed properly. A well diversified, defensively positioned portfolio should protect portfolios and generate positive and acceptable returns. At NexTier Wealth Management, we believe it is prudent to position a portfolio in 2008 for a slowdown in the U.S. economy.