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## 2008 – THE YEAR AHEAD

Few years have better demonstrated the resiliency of the U.S. economy and stock market than the one just past. Consider what transpired. Oil prices soared, home prices fell, residential construction spending plummeted, and there was a meltdown in the sub-prime mortgage and related fixed income markets. Loose lending practices during the previous boom, along with aggressive creation and marketing of collateralized debt obligations, led to major write offs at several large financial institutions. The reaction by the banks was to tighten lending standards, which resulted in a growing credit squeeze. Additionally, the war in Iraq continued, Congress was generally ineffectual, and we had a very unpopular U.S. president. Yet, despite all that happened, the U.S. economy continued to expand, and the stock market, including dividends, rose some 6% from this time last year.

Now, however, our economy seems to be at a tipping point, and the burning question for the coming year is, "Will the U.S. economy fall into recession?" The outcome will affect inflation, interest rates, and the stock market.

With that in mind, what follows is our outlook for 2008 – the year ahead. We would remind you, however, that while we are attempting to forecast the future, our continued investment success will depend much more on our ability to interpret and adjust to trends and events as new information becomes available.

### The Economy

Despite what can certainly be characterized as lopsided news coverage, there is no simple answer to the recession question. The evidence is mixed. On the negative side, we expect that the downward adjustment in home prices and residential construction will continue to be a drag through most, if not all, of 2008. Lending standards have been tightened and there is a significant build up in the number of vacant and unsold housing units. With home prices falling, credit harder to obtain, and very high energy costs, the consumer is under pressure, too. Since residential housing and the consumer sector combine to account for some 75% of GDP (gross domestic product), we think that if the consumer caves in, the economy is likely to slide into recession, as well.


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While the downside risks are evident, there are also a number of positive economic factors. First, the U.S. economy will benefit from continuing growth in the global economy, which is no longer quite so dependent on the U.S. consumer. Growth in the core emerging economies seems sustainable, and consumers in the emerging world have become much more important in fostering their own domestic growth. Inter-Asian trade is growing, as well. In effect, world economic cycles have become less interdependent.

Second, U.S. consumption has historically been very closely aligned, with employment and income growth. As long as employment continues to grow, consumer spending may moderate but it should not collapse. It will be important to monitor U.S. labor market trends. Thus far, the employment numbers have been encouraging, because the corporate sector, excluding financials, has continued to grow profitability. Moreover, productivity is strong and the weak U.S. dollar is serving to boost exports. As a result, there is little pressure to cut costs by reducing headcount. Also, because U.S. companies are in their strongest financial position in decades, adjusting to tighter bank lending standards should not be a problem.

And third, the generally favorable inflation outlook should allow the Federal Reserve Board and other central banks around the world to respond to the ongoing financial dislocations and the prospect of slowing economic growth by aggressively lowering short-term interest rates. Though such action may do little to lift residential property prices, it should serve to raise confidence among investors and businesses, and act to buffer the healthier segments of the economy.

The bottom line, in our opinion, is that U.S. economic growth will be sluggish, at best, this coming year. The biggest risk we see is that very high energy costs and continued weakness in the housing and financial sectors could combine to more severely impact consumer spending. Yet even if there is a recession in 2008, we would not expect it to be deep or long lasting, given the countervailing positive forces.

## Inflation and Interest Rates

The fact that there wasn't much inflation or employment-cost pressure in this country when growth was stronger makes it highly unlikely that inflation will become a problem now that the economy is weakening. In fact, a sharp U.S. recession would actually increase the risk of deflation, as excess financial leverage is further unwound. Modern-era financial crises in this country have almost always been followed by a drop in inflation. While inflationary pressures may build down the road, those pressures should not be meaningful until sometime after the economy re-strengthens. And even then, ongoing globalization, strong productivity, continuing technological advances, and generally responsible central banks are likely to keep prices under control. Expanding global capitalism is inherently deflationary because increasing competition acts to suppress goods price inflation.

Outside of the U.S., reported inflation has been rising. For the most part, however, that increase has been driven by rising food and energy prices. A case in point is China, where a porcine disease and resulting meat shortage lead to a 6.5% jump in inflation. Yet, China's non-food inflation during that same period was only 1.1%. Core inflation remains low just about everywhere in the world.

Given the weakening economy and low-inflation environment we foresee, the Federal Reserve Board is likely to continue lowering short-term interest rates. But with a weak dollar and the fact that bond yields are already quite low, we are not expecting longer-term interest rates to decline much below their current levels. As a result, we find the fixed-income markets to be generally unattractive. For the time being, bond-market investors are likely to earn coupon rates of return, but little more. And when the economy recovers and interest rates rise once again, the principal value of fixed-income investments will come under pressure. Thus, we are keeping client fixed-income maturities quite short.

## The Stock Market

The current bull market is getting long in the tooth. But that doesn't mean that stocks can't move higher in 2008. Liquidity remains plentiful and valuations are quite reasonable.

The U.S. stock market, as measured by the S&P 500, has risen some 84% since the end of 2002. Through most of that period, the driving force has been rising earnings. At the same time, stock market valuations actually trended lower because corporate earnings grew even faster than stock prices. The price/earnings ratio, calculated on S&P 500 operating earnings, has declined from more than 18 times in early 2003 to its current level of close to 15 times. Declining valuations are typical of periods during which the Fed is raising interest rates. But now the Fed is easing and, historically, that has led to rising valuations, albeit with increased volatility. In fact, the later stages of bull markets are most often driven by increasing valuations.

Stocks will usually rise if earnings increase, even if the rate of profit growth is slowing. So in 2008, the direction of stock prices is likely to be determined by earnings expectations and investor confidence. With a slowing economy and the possibility of recession, earnings growth is now in doubt, and the questions one must ask are, "How big a hit will there be to earnings?" And, "When will expectations become sufficiently pessimistic that investors begin to look toward the next recovery?"

If recession is avoided, lower interest rates combined with moderate earnings growth should drive stock prices higher. But if there is a recession, earnings expectations will trend lower and stock prices are likely to decline, even if the downturn is mild, as we anticipate. Nonetheless, the negative effect on corporate earnings should be mitigated by the fact that growth remains quite healthy outside of the U.S. Foreign subsidiaries now account for some 30% of U.S. corporate profits, and that does not include the additional benefit from rising exports.

It is very important for investors to distinguish between the current period and that preceding the 2000-2002 stock market decline. Periodic recessions and bear markets in stocks are normal events. Some declines are shallow and mild, such as we expect this one will be, and some are deeper. The truly outsized events, such as the big bear market at the beginning of this decade, happen only two or three times a century, and almost always from much higher levels of valuation.

We remain quite optimistic toward stocks, longer term. The global economy will continue to grow and equity valuations in most of the world's markets are at very attractive levels. Nonetheless, we also find it prudent to be cautious about the near-term outlook. Fears of economic weakness could well result in further stock market declines. Were that to occur, falling stock prices would present a very attractive buying opportunity, in our opinion. Currently it is most important for us to make sure that the stocks we own now are the ones we want to own coming out the other side.

From a sector point of view, we don't expect major changes from the emphasis that has helped to drive performance in recent years, with one major exception – the financial stocks. BTR's relative performance has benefited from maintaining very limited exposure to the sector. However, given the sub-prime shake out and the extensive, sometimes indiscriminate damage that has occurred to so many of the financial stocks, relative valuations have become quite attractive. The Federal Reserve Board is taking action to steepen the yield curve, and that should serve to restore banking sector profitability. Thus, we believe a key decision going forward will be when and by how much to re-weight our financial sector exposure.

Beyond the financial sector, we continue to prefer globally focused companies that are well positioned to benefit from the ongoing themes of global infrastructure and emerging- nation consumerism. These themes are broad, and the participants include companies in the technology, energy, metals, manufacturing, and consumer sectors. And, depending on the sector, our preferred holdings may be either U.S. or foreign based.

## Conclusion

The economy is slowing, and it seems likely to remain sluggish for several more quarters. With high energy costs, tighter lending standards, and continuing weakness in the housing sector, a U.S. recession is a real possibility. We doubt, however, that such a recession would be deep or long lasting. The global economy continues to expand and U.S. corporations are in great shape. With little expected inflation, the Federal Reserve Board should be willing to aggressively lower short-term interest rates. But we think it is important that the Fed move to get ahead of the curve.

We anticipate a volatile stock market in the months ahead and we think that a mild bear market is a distinct possibility. Yet the housing sector will eventually stabilize, and the financial sector difficulties will pass, as well. Once investors have adjusted to lower earnings expectations, they will begin to bid stocks up again, anticipating the recovery on the other side. Financial crises are bullish for stocks because they force the central banks to provide liquidity. With abundant liquidity, low interest rates, and little inflation, we find stocks to be quite attractively valued at current levels – more so, we think, than real estate, commodities, or bonds. And although we know that periodic interruptions are likely, we think that the eventual end to this secular rise in stock prices will come further out in time, and at significantly higher levels of valuation. We remain bullish, long term.

## Additional Thoughts

In capitalistic societies there is an ideal balance between overburdensome regulation and the freedom to be creative and competitive. Periodic excesses inevitably occur in such an environment, but that is a normal outgrowth of human psychology. Over time, the process is self correcting, although unfortunately, there are sometimes innocent victims along the way.

A presidential election is ahead in this nation, and it seems likely that the political pendulum is once again about to swing. By 2009, the Presidency, Senate, and House of Representatives may all belong to the same party. There is no doubt that we have problems in our great nation. The environment, healthcare system, and retirement system are all in need of repair. Additionally, the gap between the "haves" and the "have nots" continues to widen. We think that taxes are likely to be raised under the next administration, and new regulations proposed. But the problem, in our view, is not that our government requires more money to spend. Rather, it needs to spend what it has more wisely and efficiently. We must be careful not to overcorrect.

America's role in the world is changing. With the rapid industrialization of China, India, and other emerging nations comes great opportunity. Hundreds of millions of people around the world are rising into the middle class and consuming accordingly. In order to prosper during this evolution, we must embrace free trade and globalization. Also, we must bolster our educational standards and foster the entrepreneurial spirit that has made this nation so great. And, we must not overregulate. The chaos of competitive markets can be a beautiful thing.

As a final note, we wish all of our friends and clients peace, joy, health, and prosperity in the new year, and for many years to come.

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