Market Review and Outlook—January 14, 2008

Ow, that really hurt! US stocks rose steadily in 2007 through mid-July, but then began a roller coaster ride primarily ruled by gravity (they fell). Smaller US stocks fell more than large companies, and even foreign stocks have begun to weaken. Housing prices fell while foreclosures rose, losses in subprime investments caused astounding writeoffs by financial firms, oil prices hit $100 a barrel causing some inflation fears, and most recently, a recession in 2008 is becoming probable, rather than possible. That is a long list of worries.

Geopolitically, tens of thousands of more US soldiers have brought little political progress to Iraq in 2007 and Afghanistan is looking much shakier than a year ago. The December 27th assassination of Benazir Bhutto in Pakistan completed the painful triple-play. Oil rose over 60% in 2007 (good if you own oil stocks, bad if you own a car). This helped economies rich in natural resources, including many emerging economies, most notably in Latin America. China's economic juggernaut continued in 2007, boosted by their efforts to prepare for the Olympics this year and the Worlds Fair in 2010. For the first time in many years, Europe enjoyed stronger economic growth than the US, reflected in the Euro's 11% appreciation against the US dollar in 2007. The weakened US dollar actually magnified the gains US investors earned in foreign stocks and energy stocks and mutual funds.

Results from bonds in 2007 were solid for taxables, due to both the 'flight to safety' (investors grabbing up super-safe Treasuries in uncertain times), and also due to the Fed's rate cuts late in the year. I expect that rate cuts will continue for at least six months, but that the flight to safety could reverse. I do expect that municipal bonds will do well in 2008 for higher tax bracket investors. I also expect that high-yield bonds will begin to outperform general bonds by late 2008, that the US dollar will stabilize a bit, and that foreign bonds will provide only modest results after a strong 2007.

The following table shows results through year-end. After four straight recovery years, US stocks had a rough 2007. Foreign stocks continued to excel, Real Estate mutual funds finally took a very serious hit, Natural Resources went straight up, while technology and growth both had a wonderful year, likely the best this decade.

In 2008 I expect a continuation of turnarounds; the last shall be first and first shall be last. Should this come to pass, you will want to look now to rebalance your portfolio, harvesting gains in strong areas, and replenishing areas that have been suffering a drought.

PSB

Category	3 Months	Past Year	3-Yr Avg	5-Yr Avg	10-Yr Avg
Taxable Money Market	+1.15%	+4.70%	+3.06%	+2.14%	+3.38%
Intermediate Term Bond	+1.73%	+4.70%	+3.53%	+4.07%	+5.16%
Intermediate Muni Bond	+1.05%	+2.75%	+2.79%	+3.12%	+4.14%
Large-Cap Core Stock	-2.82%	+6.16%	+8.71%	+12.63%	+5.92%
Mid-Cap Core	-4.14%	+4.85%	+8.84%	+15.64%	+8.98%
Small-Cap Core	-5.65%	-1.10%	+6.93%	+15.72%	+8.30%
International Stock	-1.41%	+12.71%	+17.22%	+20.31%	+7.94%
Real Estate	-12.18%	-14.66%	+7.50%	+17.70%	+10.46%
Natural Resources	+7.09%	+37.12%	+27.77%	+28.99%	+15.43%
Science/Technology	-1.61%	+16.12%	+9.39%	+16.33%	+6.81%
Multi-Cap Growth	-0.64%	+15.02%	+10.69%	+15.44%	+6.51%
Multi-Cap Value	-5.39%	+0.41%	+7.87%	+13.74%	+7.42%
Balanced	-1.28%	+5.93%	+7.05%	+9.63%	+5.64%

The data in this table comes from Morningstar and the Wall Street Journal's Quarterly Fund Analysis Markets Data Center.

As I do each January, I review the accuracy of my prior year's expectations, and then share my expectations for the upcoming year. On January 8, 2007, the MARKET REVIEW AND OUTLOOK suggested that 1) stock returns would be positive, but lower than in 2006, 2) bond results would be stable , 3) high-yield and foreign bonds would outperform US bonds, 4) growth would outperform value, and 5) real estate would stumble.

I was generally on the money, and in some cases incredibly so. I was correct on points 2, 4, and 5, and half-right on points 1 and 3. Stock returns were lower in 2007 than 2006, and were positive for all but small-cap US stocks. Bond results were stable. Foreign bonds sharply outperformed US bonds, however high-yield bonds posted very low gains. Growth outperformed value by over 15%. Real estate fell almost 15%. Here I am reminded of the line 'economists predicted seven of the past two recessions'. I have shared my concern about overpriced real estate mutual funds for years. Finally in 2007 my fears were realized.

Overall, 2007 was an acceptable year for investors, despite a painful fourth calendar quarter. There were wide variations, with energy funds, emerging markets stocks, and Latin American funds returning over +30%, while real estate and financial services funds fell from 13 to 15%. As is always the case, proper diversification smoothes the ride.

Sector	2007 Prediction	2007 Actual	2008 Prediction
Large-Cap US Stocks	Up 8 to 10%	+6.2%	Up 7 to 9%
Smaller US Stocks	Up 6 to 9%	+2.9%	Up 7 to 10%
Non-US Stocks	Up 6 to 9%	+12.7%	Up 3 to 6%
Growth vs Value	Growth leads by 3%	Value +0.4%, Growth + 15.0%	Within 4% of each other, likely led by growth
Real Estate	Flat at best	-14.7%	Up 4 to 7%
General Bonds	Up 4 to 6%	+4.7%	Up 4 to 6%
High yield bonds	Up 5 to 8%	+1.5%	Up 6 to 9%
Non-US bonds	Up 5 to 7%	+11.45%	Up 4 to 6%

Turnaround Time—Energy and natural resource investments have been red hot. You may wish to lock in some gains before economic weakness in the US and abroad reduces demand. Real Estate funds rose 34% in 2006 and fell 15% in 2007. I look for a modest turnaround for Real Estate funds in 2008. Growth stock funds underperformed value funds 8% versus 17% in 2006, but this reversed in 2007 as growth jumped 15% while value was flat. I expect the value/growth horse race to resume in 2008, but with an edge to growth funds which aren't held back by housing and financial stocks. These sectors hammered value funds in 2007 and are unlikely to recover much until the second half of 2008.

I agree with many analysts and expect that the US economy will slow sharply in 2008, but should avoid any harsh recession, due partially to aggressive rate cutting by the Fed. I expect that the Fed will be able to continue to cut rates this year due to the 2008 core inflation picture, which is tamed by slower growth globally, and rising US unemployment. The most likely path out of the housing slump will wait until the lowering of Fed rates eventually brings mortgage rates low enough to finally produce more homeowners (remember way back when there were buyers of homes?).

Predictions—In 2008 I expect US stocks to do fine, however I worry that foreign stocks will take a well-deserved rest. I expect stable results from high quality bonds, with foreign bonds falling back to earth, stronger results from high yield bonds , and a strong showing from municipal bonds (4% or more returns). I expect that the growth will again outperform value in 2008, but by a **much** smaller margin than in 2007. I may be early (again), however I feel that real estate could begin a recovery in 2008, while I worry that energy will fall back to earth in 2008.

Always keep an eye on your overall allocation of stocks versus bonds/cash. The declines in most stocks in late 2007 and early January may provide an opportunity for you to rebuild your positions and bring your allocations up to target levels.