"A Lump Of Coal"

Market Commentary – December 2007

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Growth in Gross Domestic Product (GDP), a measure of the value of goods and services produced in the U.S., was revised up from 3.9% to 4.9% for the third quarter of 2007. Exports surged an annualized 18.9% on the heels of the weak U.S. dollar, lifting GDP. Consumer spending, however, makes up approximately 70% of U.S. GDP. Consumer confidence, according to The Conference Board, has fallen 22% in the last four months. It is at the lowest level since October 2005. The Federal Reserve sees fourth quarter GDP growth coming in at 1.5%. Looking into next year, the Fed recently lowered its 2008 GDP growth forecast from 2.5%-2.75% to 1.8%-2.5%.

With election season heating up, Washington is attempting to solve the mortgage crisis. The Treasury department is proposing that mortgage lenders freeze loans at their low introductory "teaser" rates for several years before they adjust higher. Initial dialogue is hinting that relief would only be available to borrowers who are current on their mortgage payments, but cannot afford a payment that adjusts higher. Relief would not apply to those who owe more than their real estate is worth. While the politicians are trying to help, the financial markets will sort out these issues on their own. It takes time.

Futures markets are pricing in a 100% probability of the Federal Open Market Committee cutting its benchmark Fed Funds rate by 0.25% to 4.25% when it meets on December 11. One month ago, this was only a 28% probability. Within the past month, the financial markets have become fearful of the risk associated with the subprime loan situation. Fed Chairman Ben Bernanke acknowledged that the economic outlook has been "importantly affected over the past month by renewed turbulence in the financial markets". In turn, the Federal Reserve has become more dovish, viewing the fight against economic weakness as a more significant priority than cooling inflation. Every month between now and October 2008, futures are pricing in lower Fed Funds rates (currently 4.50%): 3.80% by April, 3.47% by July, and 3.24% by October. Futures markets are clearly predicting that the Fed has entered a prolonged period of accommodative monetary policy.

Technical factors of the market are mildly bearish (more supply than demand), while fundamentals are attractively priced – therefore, we are mildly bearish on the market. The price-to-earnings (P/E) ratio for the S&P 500 is 18.4, giving an earnings yield (E/P) of 5.43%. Compared to the 3.97% yield on the 10-year Treasury note, stocks are attractive relative to current interest rates. Globalization has helped companies diversify profit centers. Standard & Poor's estimates that 45% of revenue at S&P 500 firms comes from foreign sources. Strength in international earnings has helped to offset domestic weakness.

Our proprietary market breadth indicator, which turned negative on October 23, continued lower throughout November. The indicator would have turned positive in early November with some modestly positive days. That was not to be, however, as broad declines in stocks across the board knocked the indicator firmly into negative territory. Narrowing breadth tells us that the underlying market is not healthy. Volume in November was heavier on days the stock market declined, suggesting more conviction behind the move lower. Tax loss selling will likely weigh on weak stocks in December.

Recent stock market volatility has proven the importance of using cash liquidity to balance stock market risk. Those who are fully invested when the market declines (or 100% cash when it rises) inject emotion into their investment decisions at the wrong time. A balance of stocks and cash helps to keep emotion out and logic in. A rally in December may present an opportunity to sell some covered calls. On our buy list, we are focusing on undervalued stocks with strong earnings prospects. We are also tempted to selectively nibble on some stocks which have been decimated out of fear. Still, it is prudent to maintain ample liquidity, since it can help generate handsome profits when the stock market is on sale.