

Monthly Chartbook

2007 Year in Review

& 2008 Forecast

Executive Summary

This month's Chartbook provides an opportunity to review last year's economy as well as consider potential risks and returns for 2008.

Recently, we heard a commentator on the markets say that it was as simple as "EIEIO"... Earnings, Inflation, Employment, Interest Rates and Oil.

We are going to look at each of these over the past year, provide a forecast for them and offer some other data-points and risk concerns as well.

A word of caution – we are using 12 month data representing the time periods available as of the end of the year, so recent changes and early data will not be reflected in this analysis and the numbers we are calculating may not match what is available elsewhere.

Earnings - summary

Beginning of 2007 S & P EPS estimate = \$78.14

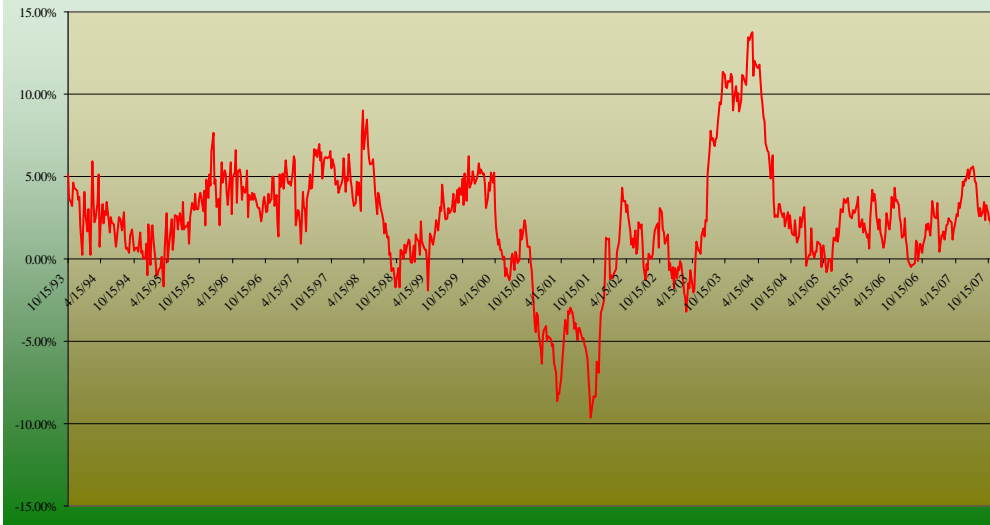
End of year = \$77.80



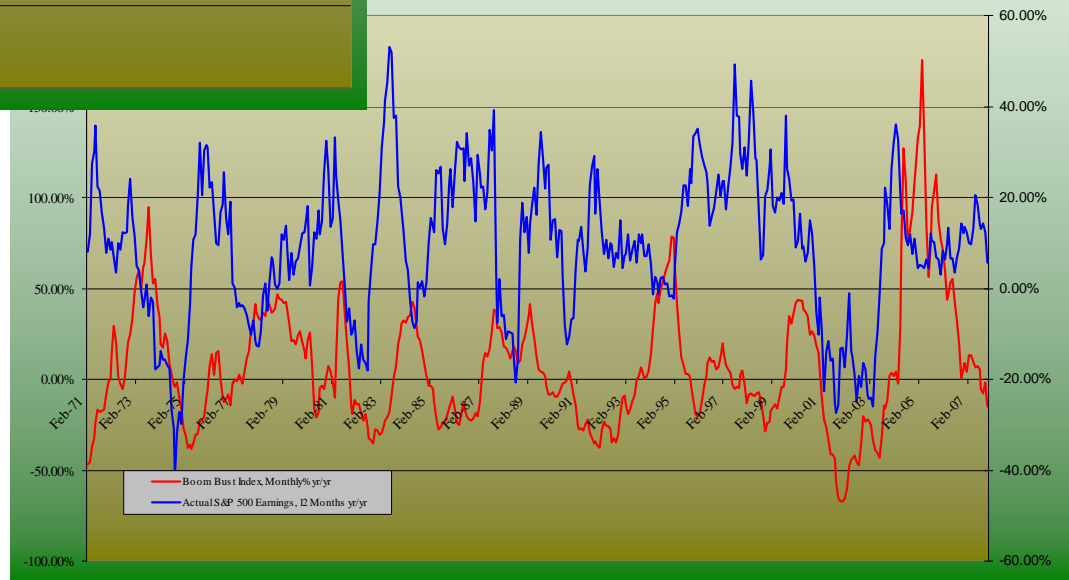
But, the annualized rate of growth for earnings is $-.44\%$, and there appears to be downward pressure on this metric due to input costs and pressure in the financial sector.

Earnings - forecast

Economic Momentum



Boom / Bust Index

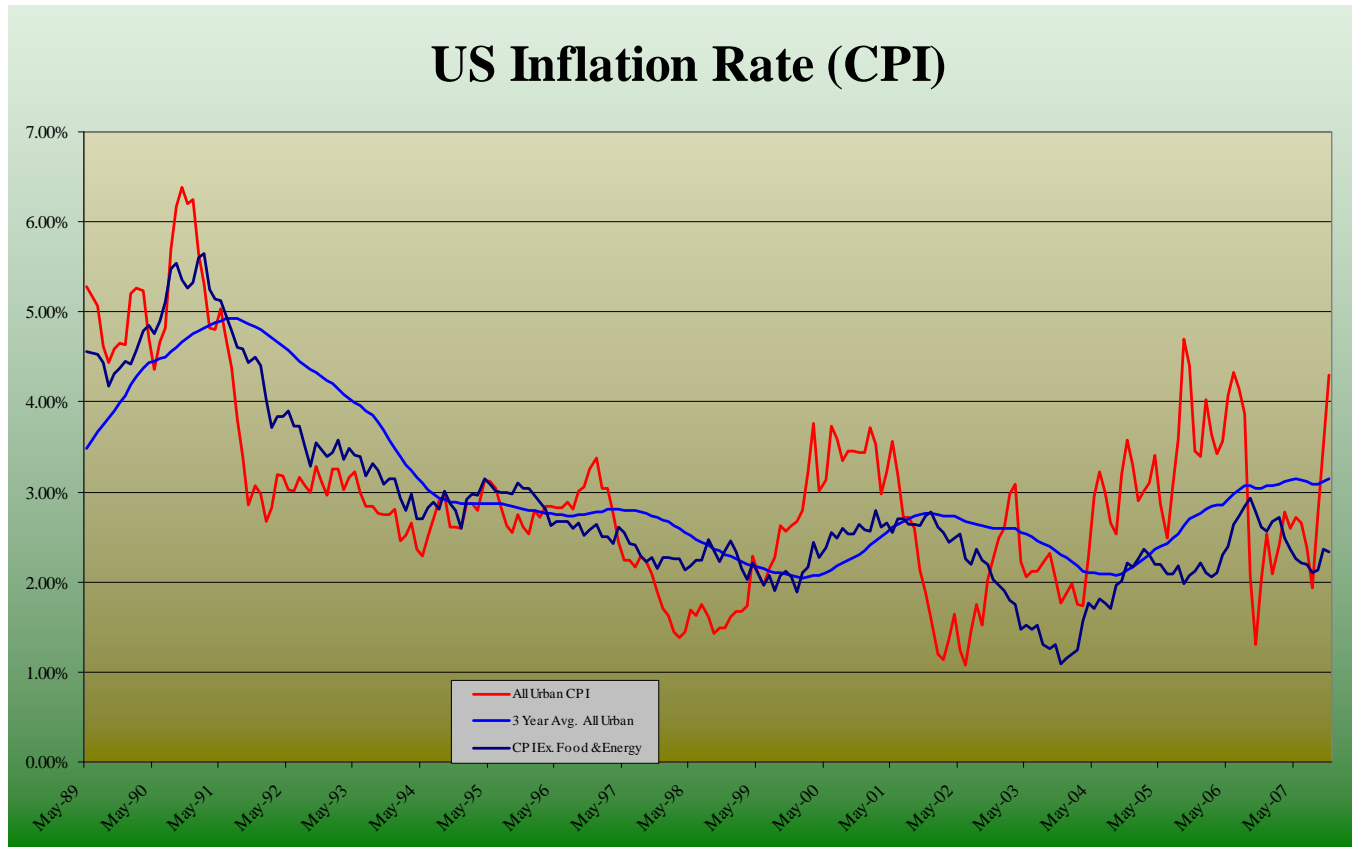


In addition, both of these have predictive power for future earnings, suggesting that earnings will fall slightly or stagnate in 2008.

Inflation - summary

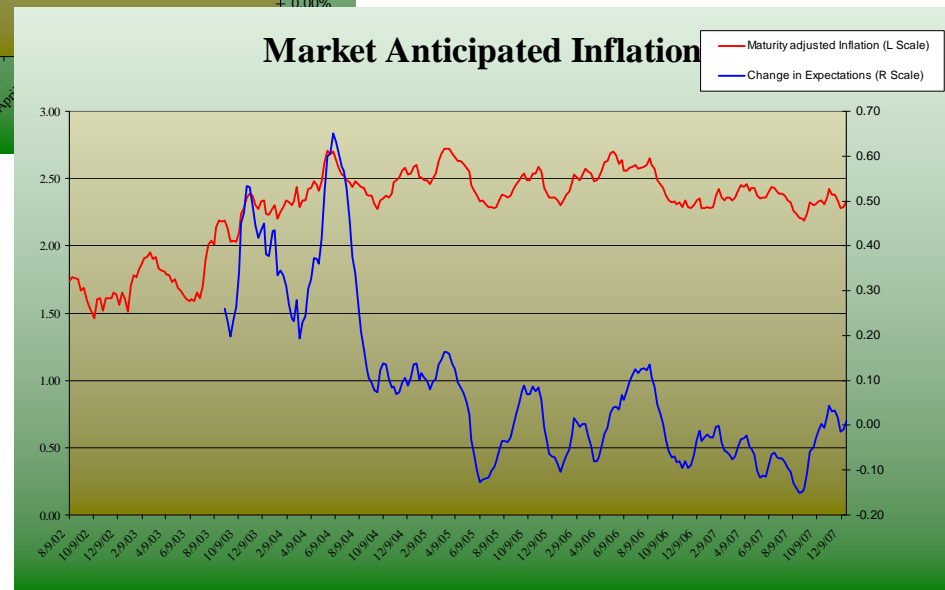
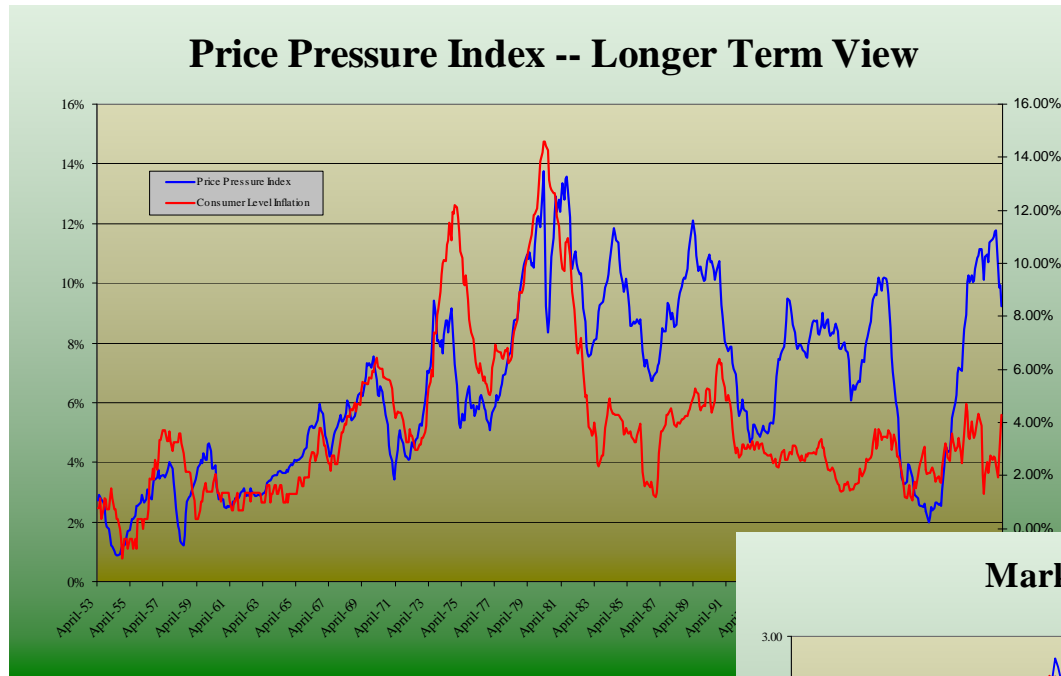
Beginning of 2007 CPI (yr / yr) = 2.02%

End of year = 4.29%



The annualized rate of inflation doubled in 2007 as commodities prices (especially energy) soared; note that CPI ex-food and energy remained slightly above 2.3% (but I have to eat and drive... how about you?).

Inflation - forecast



There still remains upward pressure on inflation according to our Price Pressure index (the decline is primarily due to lower interest rates).

However, the market has yet to acknowledge this pressure through the TIPS (10 year constant maturity used for analysis).

Employment - summary

Beginning of 2007 unemployment rate = 4.48%

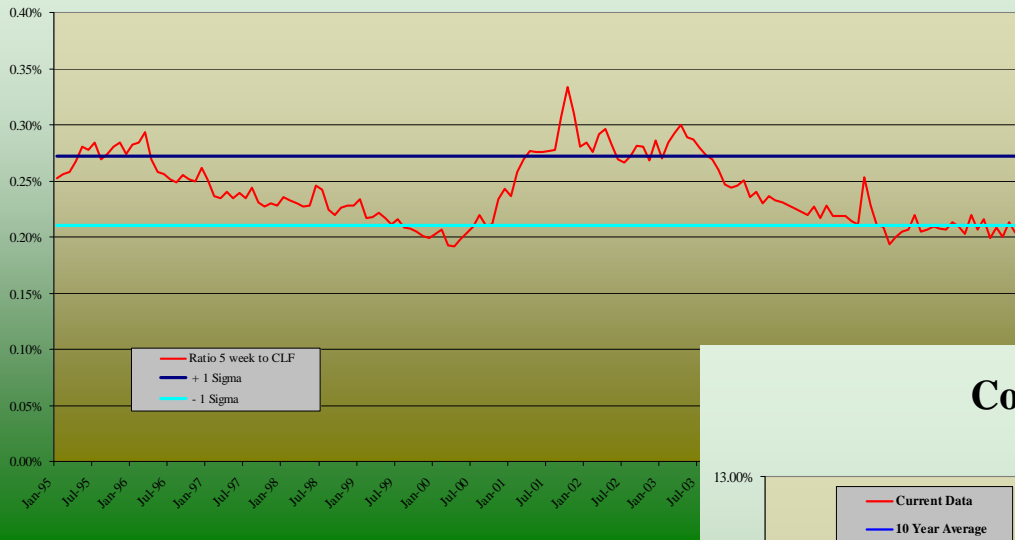
End of year = 4.66%



The present rate of 4.66% compares favorably with a 30 year average of 6.09%; these numbers continue to suggest a reasonably strong employment market.

Employment - forecast

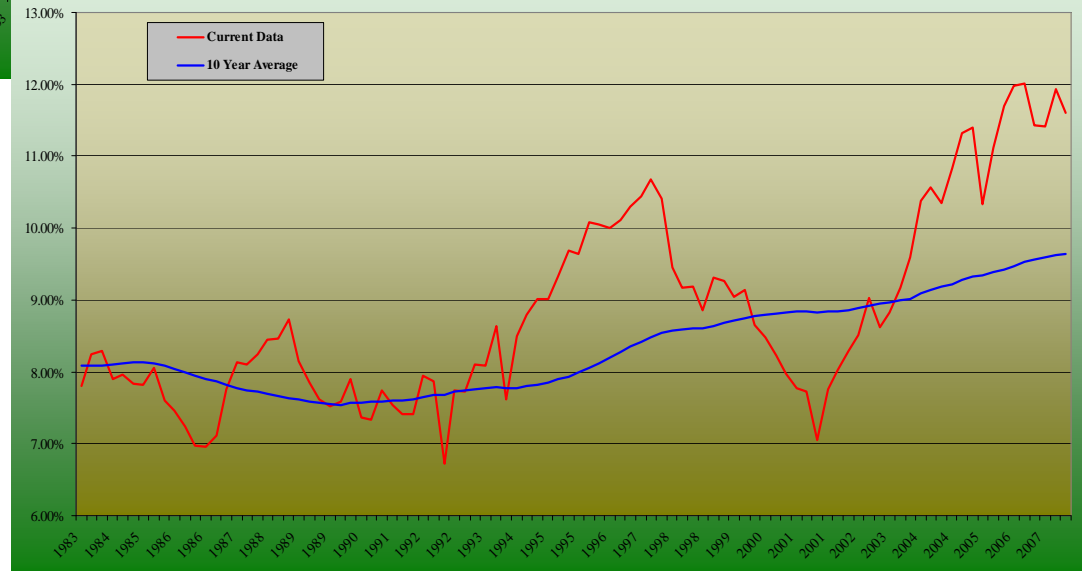
Initial Jobless Claims vs. Civilian Labor Force



Based on low unemployment and what we perceive to be reasonably tight labor conditions, employment will likely remain strong during 2008 (especially on a relative basis). This will feed back into the inflation numbers and supplement the upside pressure from commodity prices.

However, this employment prediction must be made with some caveats... We are experiencing sector recessions that can be vicious; if a worker's employment is in that sector, the job market will not look strong.

Corporate Profits as % of GDP



Interest rates - summary

Beginning of 2007 Federal funds rate = 5.25 %

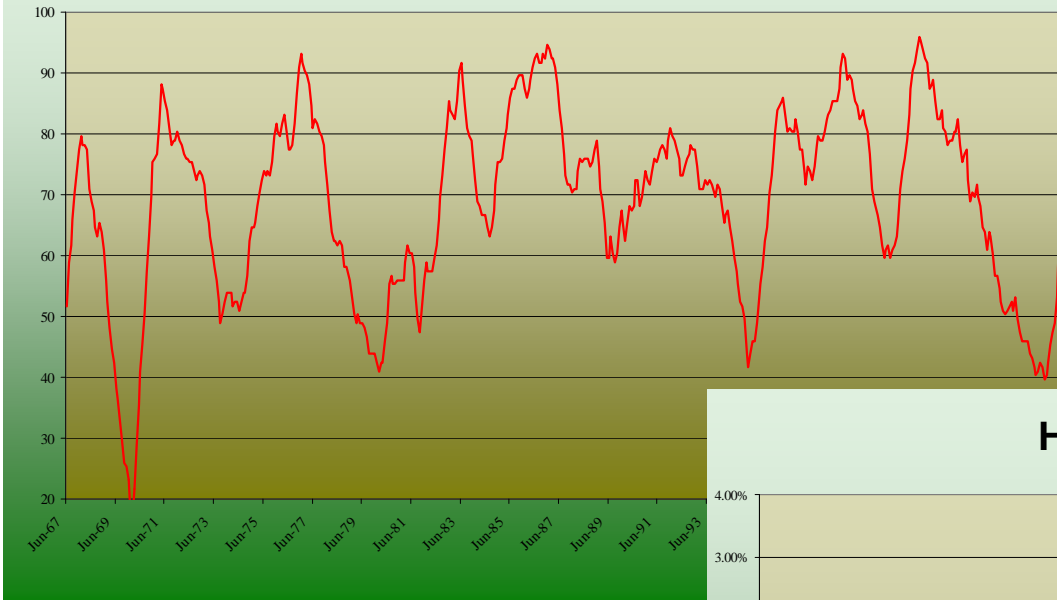
End of year = 4.25 %



After three rounds of lowering interest rates (and more anticipated by the market), the Fed funds rate currently stands at 4.25%. However, there is minimal real yield offered by interest rates when adjusted for inflation. Why would anyone save?

Interest rates - forecast

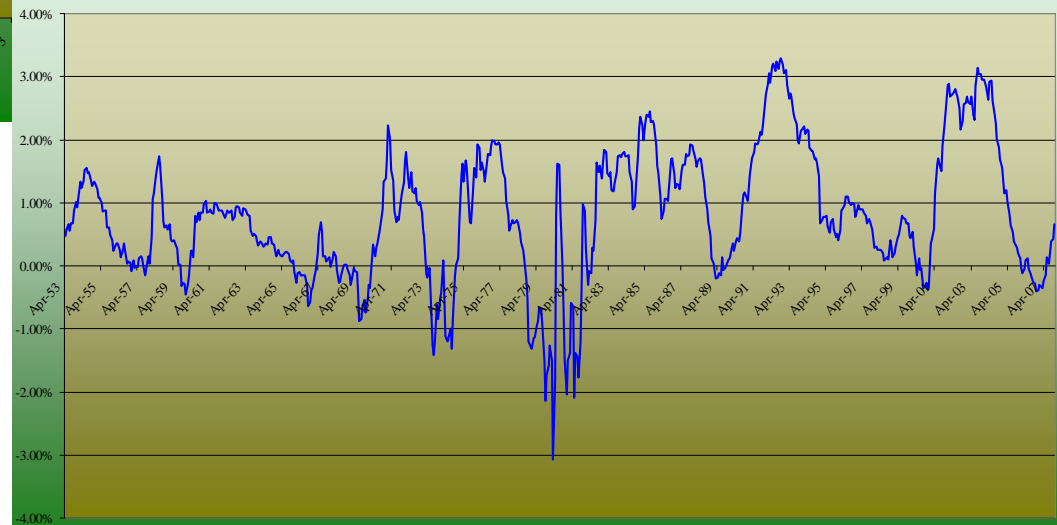
Monetary Conditions Index



Interest rates are not the only factor involved in monetary policy, but as can be seen by the above Monetary Conditions index, the Fed has become increasingly accommodative.

Short-term interest rate changes have, however, had minimal impact on longer-term rates as demonstrated by the Treasury yield curve.

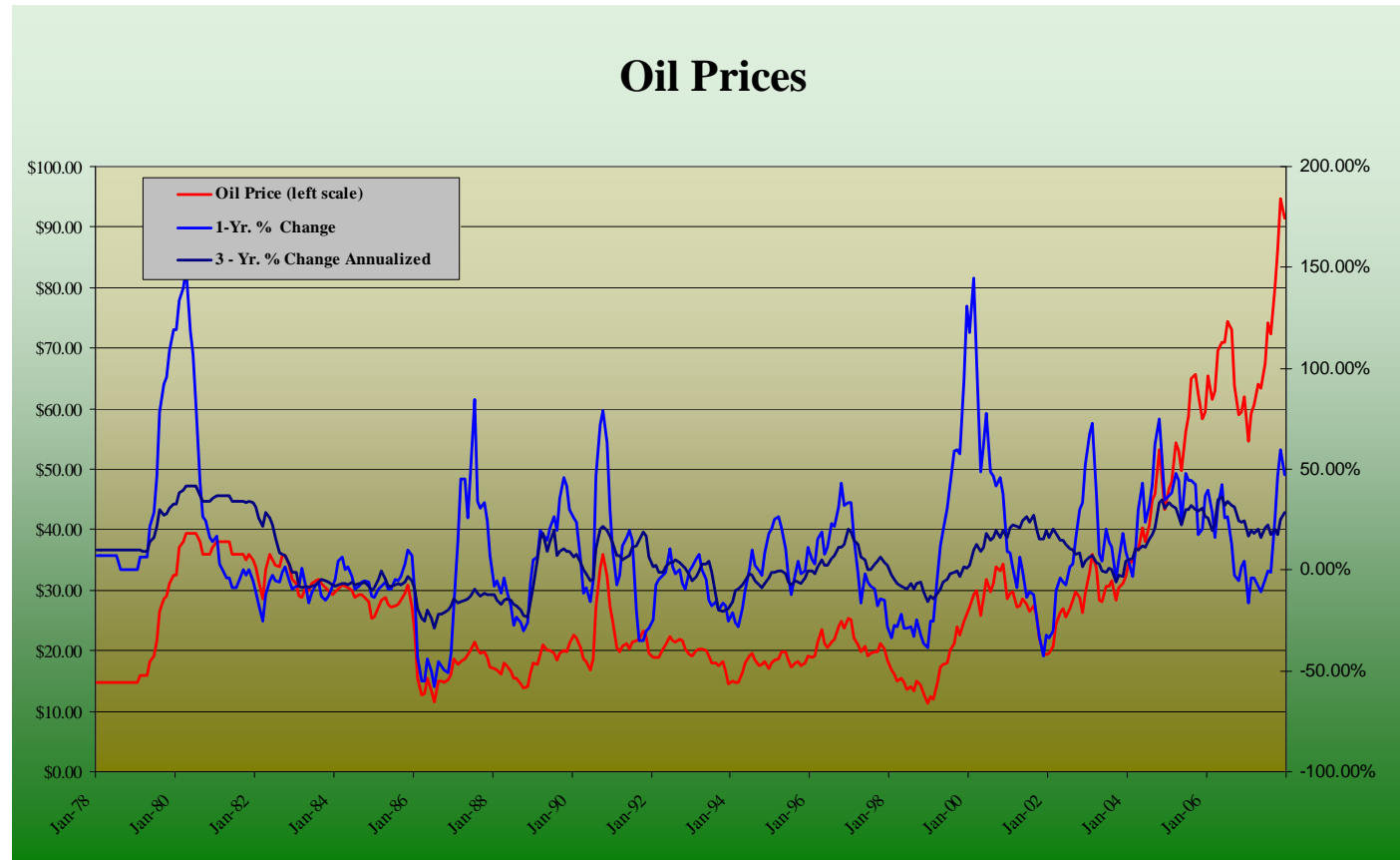
Historic Yield Curves



Oil - summary

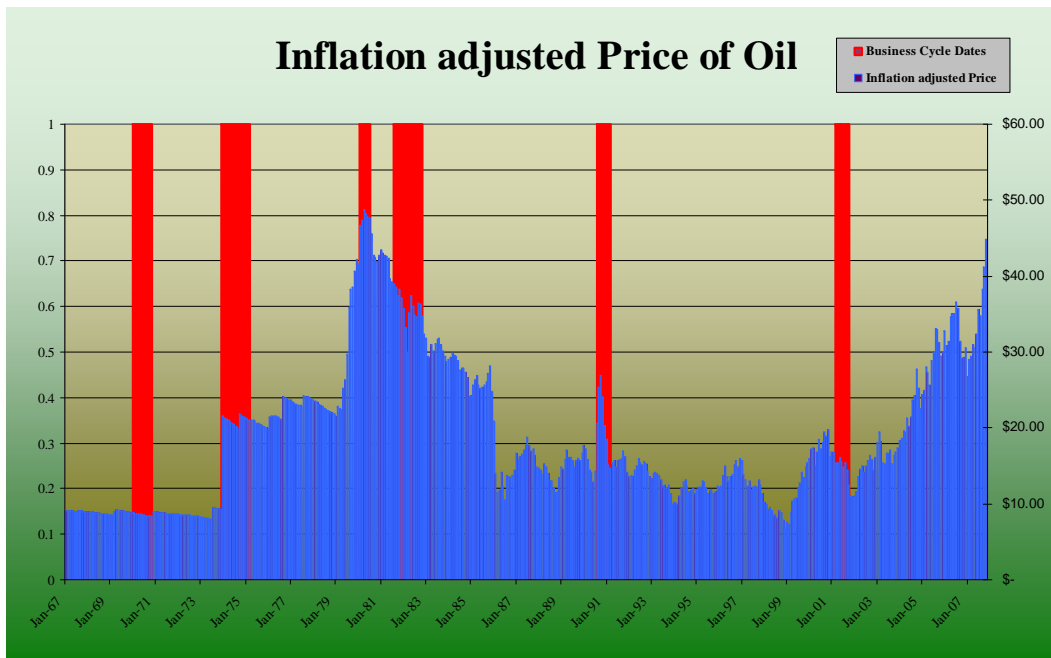
Beginning of 2007 barrel of WTI crude = \$62.03

End of year = \$91.37

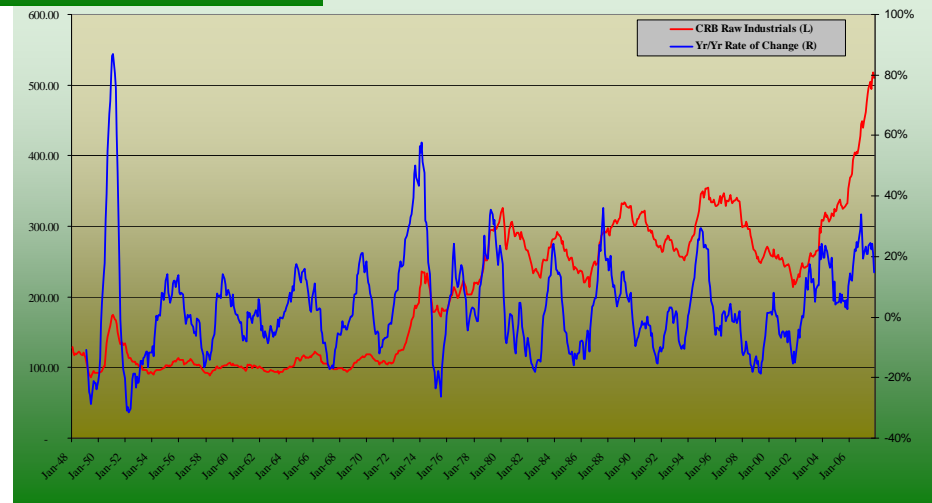


We think the natural price of oil under present market conditions should approximate the beginning of year price; much of the increase may be due to the monetization of the US \$ as investors seek inflation protection.

Oil - forecast



CRB Raw Industrials



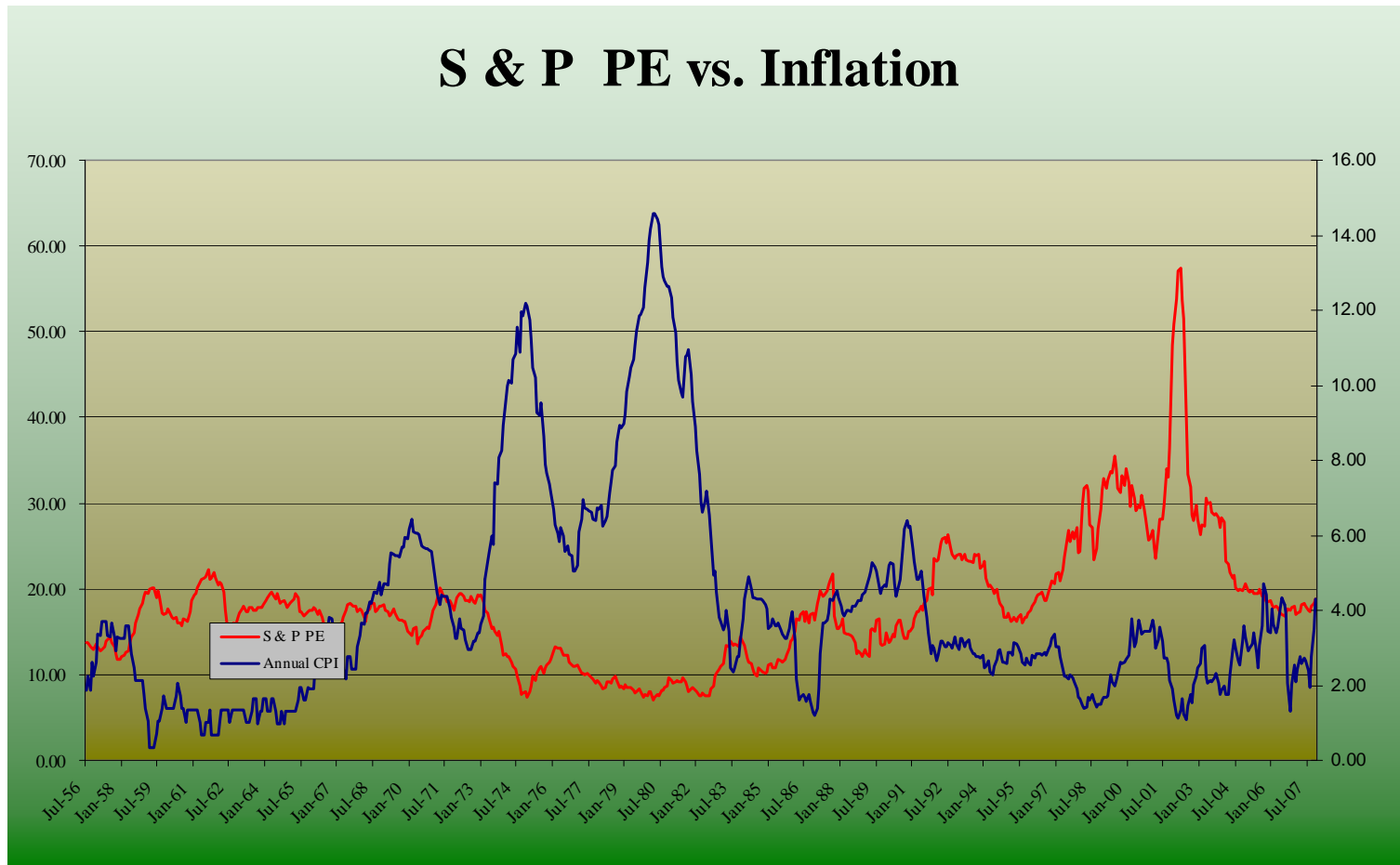
At present, the price of a barrel of oil is near an all-time high, even after adjusting for inflation.

But, all commodities have been increasing in price as the Fed's policies continue to cause dollar depreciation.

In summary...

- *E – Earnings are likely to be weaker as cost-containment measures have already been maximized, top-line growth is slowing and financials will be writing down losses*
- *I – Inflation is high and has the potential to grow higher (but, this strength has not yet been acknowledged by the market)*
- *E – Employment continues to provide additional upward pressure to inflation*
- *I – Interest rates are not the Fed's only tool, but they are reflective of an accommodative monetary policy*
- *O – Oil Prices feed into inflation, but are very volatile and can distort annualized measures (think post-Katrina); this indicator also impacts consumer sentiment in a way that others do not*

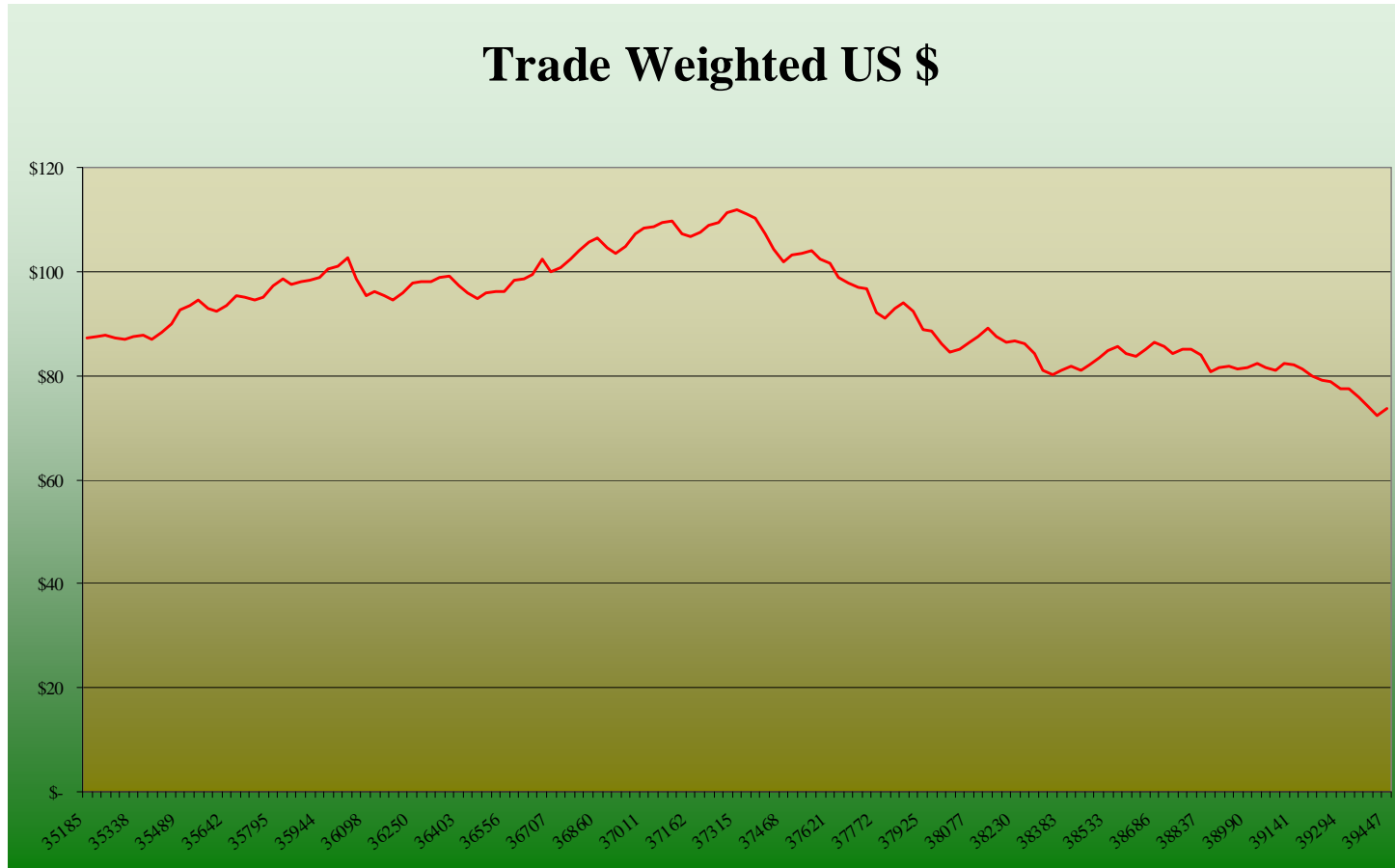
The conundrum...



Higher inflation results in a lower PE for the market. If earnings are declining, then the PE will be forced to contract ceteris paribus. If earnings are contracting, then Price is the part of this equation that will be forced to move.

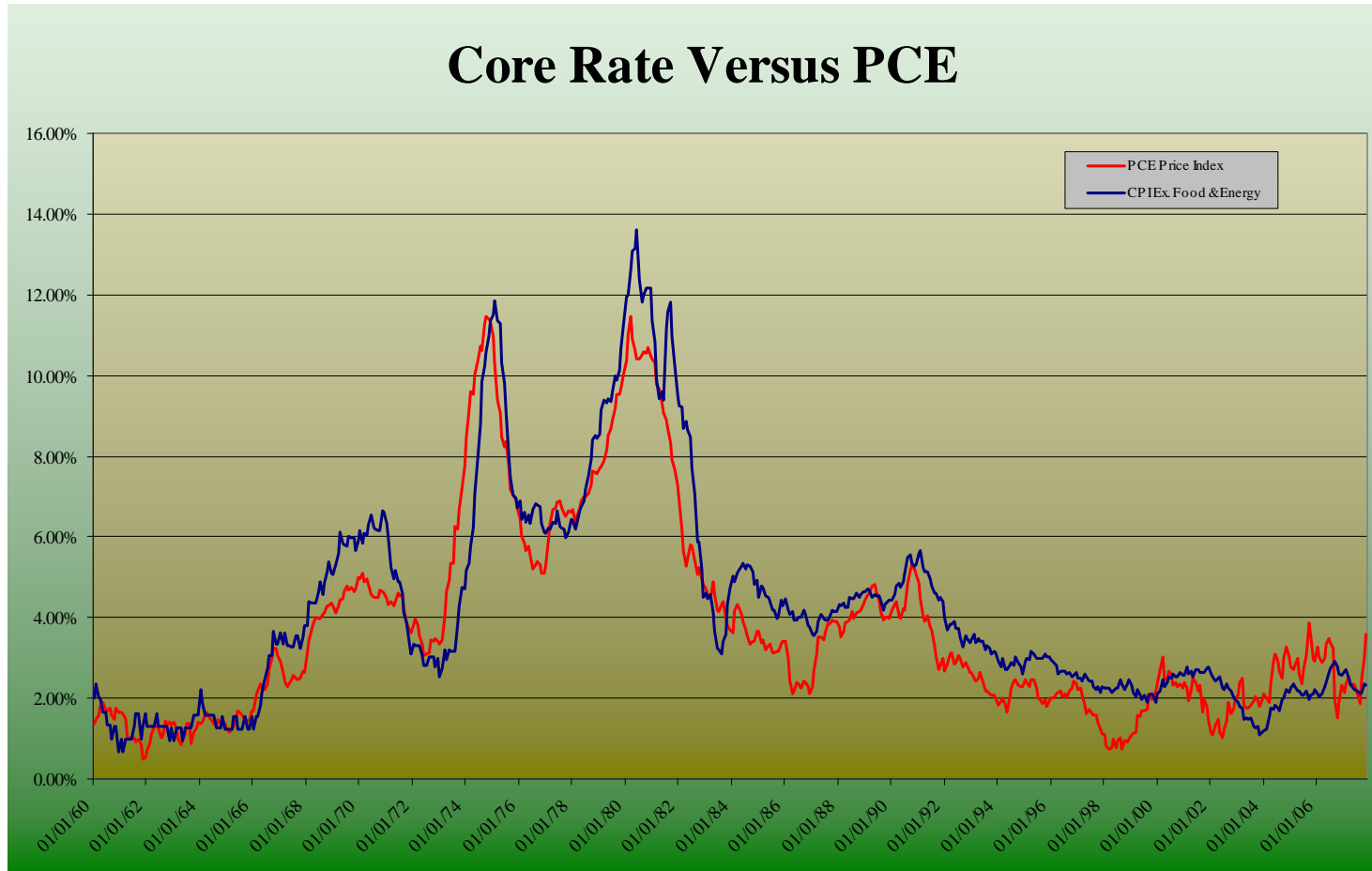
But, in a higher inflation world, things do not remain the same. The question is... how far will price contract with pressures both from inflation and earnings?

Other factors that have us concerned ...



Due in part to the Federal Reserve's monetary policy, the US \$ has weakened to its lowest point in 30 years relative to our trading partners. While we feel the \$ is somewhat over-sold in the near-term, there is cause for longer-term concern, especially a shock due to a rapidly falling dollar from oil price fluctuations or trade imbalances.

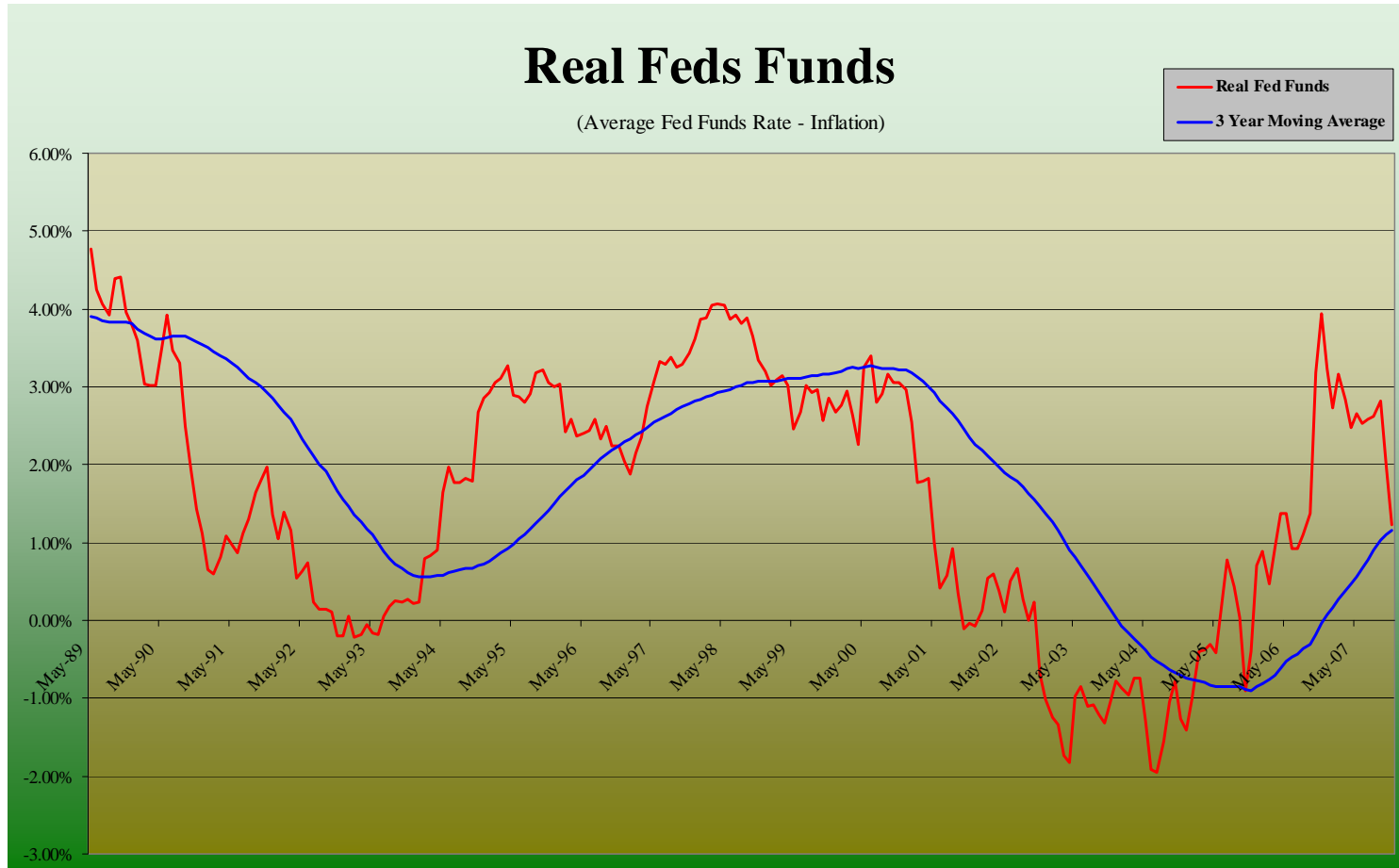
Other factors that have us concerned ...



A higher PCE reflects that inflation is indeed bleeding into incomes. We have long questioned the methodology for the measurement of inflation by CPI, so we watch PCE very closely.

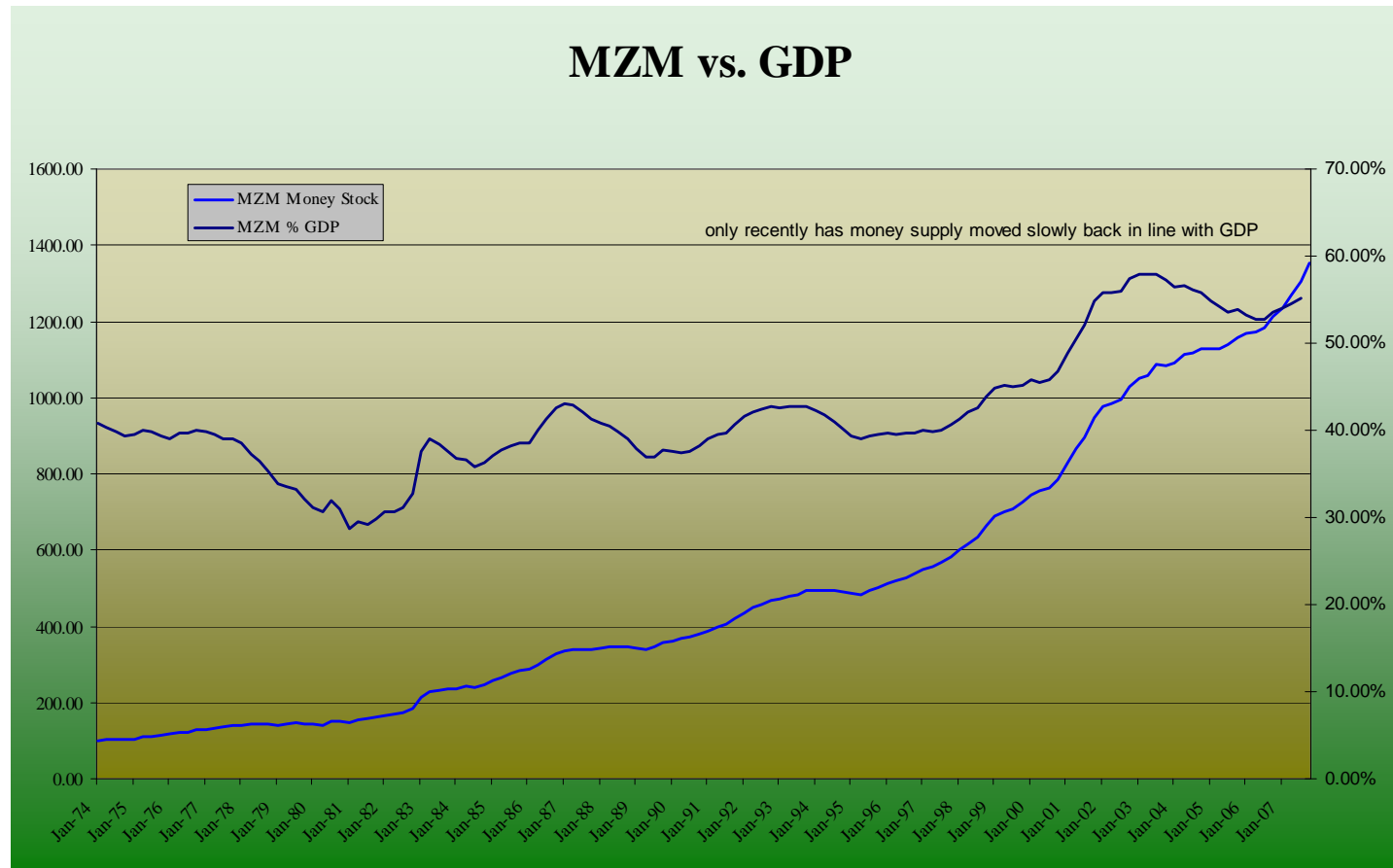
The biggest challenge here is inflation expectations. If they become much higher, that could trigger other events.

Other factors that have us concerned ...



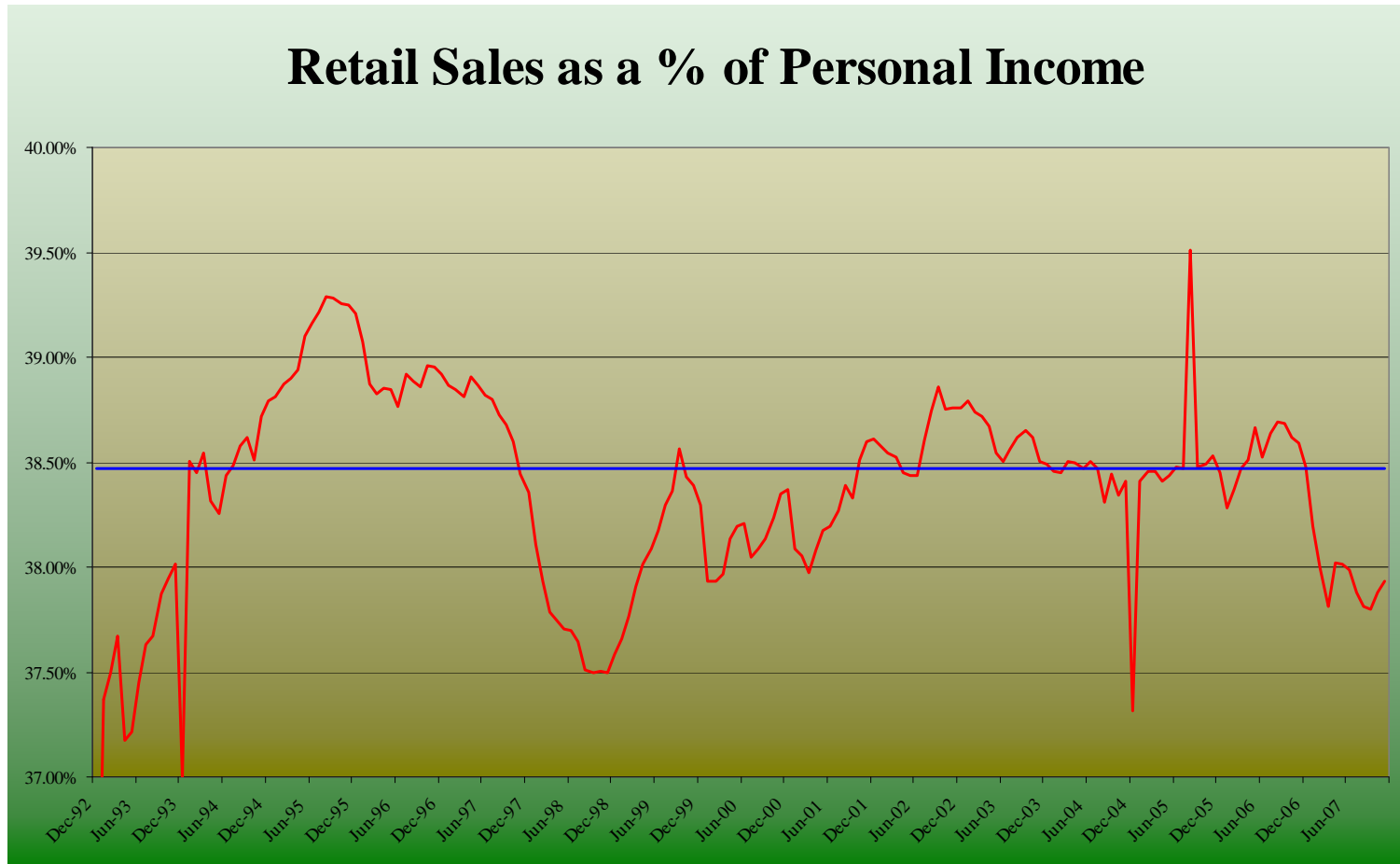
Higher inflation causes the real rate of interest to decline. Combine that with lower short-term rates, and the real rate of interest does not offer savers much benefit for “bailing out the system”. This could also result in lower investment from overseas, which is what has kept longer-term rates from increasing significantly.

Other factors that have us concerned ...



Money supply relative to GDP had been contracting just a few years ago, bringing this relationship back into parity. With recent Fed moves, money supply is substantially higher than it once was. While the stimulus may have been needed short-term, the US will have to “take its medicine” at some point or risk ceasing to be the world’s reserve currency.

Other factors that have us concerned ...



Retailers are already in recession, and company earnings are likely to follow (not just retail). Are we already in a recession, or can one be avoided? Can we be patient enough to let Fed policy work, or will we overdose on loose monetary policy? Will lower housing prices really tip us over?

Risks for 2008...

The global economy continues to hum along, but in the US the picture is decidedly more murky. Pressures from costs such as input prices and employment will likely pressure corporate earnings for the near-term. Monetary policy will not ease this concern as expansionary actions in an effort to stave off recession flow first into stores of value (since fiat money is less seen as such). It will also exacerbate employment costs as the competition for talent grows ever more stiff.

Complementing this pressure on earnings is the pressure that higher inflation places on the PE multiple for the marketplace.

While we may avoid an all-out recession, there are very challenging conditions that exist in several industries which leads us to believe that we may suffer from sector recessions that will be insulated from the greater economy (as much as is possible) by Fed action. Currently, banking and homebuilding are suffering immensely; retail (consumer discretionary) is not far behind. While the S & P 500 earned 5.48% during 2007, the financial sector was down over 20% and consumer discretionary down almost 15%.

Stagflation? Stagflation is a combination of a period of stagnant economic growth and ever increasing inflation. Traditional monetary policy answers do not necessarily work in this environment. We may be *forced* to take our medicine by the power of the global market since no one in power at home seems to be willing to make the tough decisions.

An unfortunate side effect of this might be expanded populism during an election year in the US.

Opportunities for 2008?

Firms with high international exposure

- portfolio of currencies
- less impact from stagnant domestic market and more from growing international regions

Think healthcare and technology.

Soft commodities

- consider foodstuffs (that have not yet soared in price) ~ as the developing world becomes more wealthy, their demand for more and better food will increase

- agricultural commodities ~ we recently returned from a research trip to the Mississippi Delta to learn more about cotton; we will provide details in an upcoming report

Capital Markets Expectations

Index	End of year 2007	Notes	Range	Forecast for 2008
S&P 500 Earnings	\$77.80	Negative earnings from financials will impact this.	\$65 - \$80	\$70
Inflation (all Urban)	4.29%	Consumers will feel the pain, but it won't reach a crisis point. Lower oil prices will help.	3.5% - 4.75%	4.05%
Employment	4.7%	Not as strong as past years; not as weak as anticipated by market pundits.	4.6% - 5.25%	4.9%
Fed Funds	4.25%	Two more small cuts is all the Fed can stand as they begin to consider the devaluation of the dollar (and their credibility on the world stage).	3.5%-4.25%	3.75%
Oil	\$91.37	Will continue to be seen as a store of value, but its price will begin to wane by the end of the year.	\$75 - \$125	\$85
S&P 500	\$1468.36	This will be a volatile year with a lot of buying opportunities on dips; the US economy muddles through its problems and is on better ground by end of the year.	\$1200 – \$1500	\$1400
Ten Year Treas.	4.10%	No calamities as foreign buying keeps this range-bound as the dollar rebounds in strength.	3.85%-4.5%	4.25%