

# THE BUTTONWOOD



Fourth Quarter 2007



On May 17, 1792, twenty-four merchants gathered under a buttonwood tree at 68 Wall Street.

There they signed the *Buttonwood Agreement*, creating the first investment community, which later evolved into the New York Stock Exchange.

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## What Could 2008 Bring for Investments?

By Kevin VandenBerg, MBA, LIFA

While no one has a crystal ball that accurately predicts the future for investment markets, it's always a good idea to constantly revisit the financial market environment at different times during the year. Since we are at the beginning of the year, it seems like an opportune time to discuss possible market themes or investment trends for the coming year.

There is little doubt that 2008 brings several factors to the forefront with regard to investment markets: Sub-Prime and Credit Crunch issues, Federal Reserve Policy moves (interest rates), Geo-Political concerns (assassination in Pakistan), slowing U.S. economic growth (recession?), slowing domestic company earnings growth (single digit), the rise of emerging markets influence (China, India, Brazil, Mexico, Russia), commodity price increases (inflation) and the 2008 Presidential Election (no clear cut candidates). Needless to say, there are several factors that could influence the financial markets this year. And these are the things we currently know about let alone the things that will come to the forefront during the year.

Although the economy is slowing, the Fed is doing its best by cutting interest rates and increasing liquidity in order to provide as much cushion in the markets as possible. The tug of war taking place between the Fed's accommodative policies and the ills of the economy (slower consumer spending, housing crisis, credit crunch) will most likely see victories on both sides, but at different times during the year. During the first half, it would not be surprising to see a slightly negative reading on GDP growth as we continue to see weakness throughout the economy. Over the past 50 years major upticks in the unemployment rate (as we've seen

recently) have led the US economy into recession. More specifically, whenever the 12-month change in the unemployment rate has been 0.5% or greater the economy followed into recession. Currently, the 12 month change in the unemployment rate is 0.6%, signaling recession is on the way. However, during the second half (and probably last quarter) of the coming year, the Federal Reserve's rate cuts will most likely work their way through the system to produce much better growth. This will most likely produce an uptick in company earnings and stock prices at the same time. Definitely, a tale of two distinct halves.

A major catalyst for the financial markets will be clarity of the 2008 Presidential election. As we become clearer on the candidates and the eventual winner, we should see a more positive stance within the markets. It's not exactly the case that the market will focus on whether the winner is a Republican or a Democrat, rather, that there is clarity in the outcome and a clear definition of the policies to come in 2009 and beyond. The market deals with bad news better than uncertainty, and at this point, the race for the Presidency is quite indeterminable. The quicker we can see resolution of this factor, the more positivity for the markets.

Lastly, the continued emergence of international markets and the resulting inflationary factors felt in the United States will most likely take greater shape in the year ahead. Indeed, 2007 will likely be regarded as an inflexion point for the US—the year of accepting the notion that inflation cannot remain low in the face of worldwide economic growth. The emergence of China and India, as well as industrialized growth in other emerging nations, has brought about inflation

# What Could 2008 Bring for Investments - Continued

By Kevin Vandenberg, MBA, LIFA

## Year to date performance and yield for various benchmarks

S&P 500 (large cap)	5.49%
S&P 400 (mid cap)	7.98%
S&P 600 (small cap)	-0.30%
EAFE (Int'l Developed)	11.17%
EAFE (Int'l Emerging Mkt)	36.48%
Dow Jones Industrials	8.89%
Treasury Yield (2-year)	3.12%
Treasury Yield (5-year)	3.49%
Treasury Yield (10-year)	4.10%
Treasury Yield (30-year)	4.53%

*Have you been in recently to review your portfolio? If not, please contact us to schedule a meeting.*

(here in the United States) of at least 4%, if not more. Although that may not seem like a very high number, it is markedly higher than the average 3% figure experienced over the last 80 years. A further complication of the current state of inflation is the fact that the Federal Reserve must keep yields/interest rates low (actually lower than inflation) in order to keep the economy afloat. Today, T-bills yield roughly 3%, therefore, with 4% inflation, investors seeking the absolute security of T-bills will actually be losing money on a real return basis (-1% after inflation). It has been quite some time that the difference between the inflation rate and T-bill yields was 1% or more, and the reappearance of this phenomenon tells us that inflation has gained the upper hand.

The price of oil and gold are major indications of inflation fears. Both are at historic highs although gold was close to its current level in 1980 as a result of two short-lived events (oil prices spiked with the Iran/Iraq war and there was an attempt to corner the silver market). However, both of present day highs are not a result of short term issues, rather a result of underlying economic fundamentals that are unlikely to disappear anytime soon. After all, oil is a finite resource and several major oil fields are becoming more and more taxed as they become older. As a result it is taking far more effort to pump the same amount of oil from these fields on a regular basis, and in some instances, the oil yield is falling at an increasing rate. Additionally, the emerging economies of China and India, et al., will continue to demand more oil, which will continue driving the price higher. Gold, on the other hand, is now being sought after as a form of hard currency, or safety, in times of economic turbulence—whether that is hyperinflation or severe recession. Gold may even be emerging as a “third currency” behind the dollar and the euro.

What does all of this mean with regard to investing for 2008? Here are some thoughts:

1) We continue to favor large cap stocks over small cap stocks as the economy slows. Additionally, we prefer growth stocks to value as these, too, tend to outperform in the

latter stages of the economic cycle. Although we may slightly overweight the large cap and growth sectors, we continue to believe in proper asset allocation and diversification among all of our core categories as a disciplined approach to investing. Slight overweights may be prudent, but vast overweights can be careless or irresponsible.

2) We continue to believe in commodities and precious metals as investment hedges in portfolios due to the aforementioned outlook with regard to inflation. These investments will serve to offset the erosion in purchasing power as a result of higher food, energy and related commodity price increases.

3) We believe increased international exposure to the tune of 25-30% of the overall equity portfolio is also prudent. After all, the United States is only 42% of the world market cap and has a much slower expected GDP (economic) growth rate going forward. China, India, Brazil, Mexico and Russia are just a few of the countries that should experience growth that is two to five times that of the US in the next few years. While the volatility of these markets may cause some anxiety over the short term, we believe the long term returns in these countries/markets will be far worth it. Diversification, however, is of paramount importance and should not be ignored.

4) Lastly, investors with 50% or more of their overall portfolios in fixed income securities should consider shifting 10% from fixed income to equities in order to fend off the effects of inflation. Equities have an historic growth rate (last 80 years) that is nearly twice that of fixed income (10.3% vs. 5.4%) and can help offset rising costs of food, energy and other commodities. We believe inflation and higher prices are not temporary, but rather a longer term theme due to the increased demand for commodities on a global scale.

All of the above items should be considered, but the following pre-requisites to investing should be underscored: patience, discipline, fundamental research and a long term investment horizon. These are paramount to successful investing and long term results that meet or exceed common benchmarks and expectations.