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A Look Back

If you went to sleep at the beginning of 2007 and woke up at the end, you'd think we had a pretty dull year in the financial markets. A 3.5% gain in the S&P 500 and a 2.4% loss in the Russell 2000 were not representative of the uncertainty and volatility that dominated the equity markets. Markets started the year the way they ended 2006, roaring upward, accumulating a near 20% gain in the 6 months that ended in March 2007. A scare in emerging markets led by the Chinese government's indications that it would do whatever was necessary to slow the Chinese economy before it overheats caused our first market correction in 3 years as we lost ~7% in just a few days in March. Almost as quickly as the fall, markets recovered and were setting new all-time highs by July. The credit crisis of August treated us to a gut-wrenching 10% decline, followed by new all-time highs again in September. As 2007 closed and 2008 began, we appeared to be heading back to toward a test of those August lows on fears of a slowing economy that is potentially headed into recession. So far in 2008, that's exactly what the market has given us, declining more than 5% in the first week of trading.

While the U.S. stock market gets most of the attention from the press, other asset classes fared far better in 2007. Emerging market stocks gained 36%. Commodities gained 16%, led by huge gains in energy due to the spike in the price of oil. Foreign developed market stocks gained 11% and the U.S. bond market returned 7%. Notable on the downside was the performance of high yield U.S. bonds (+2%) and REITs (-18%), both of which are currently excluded from the PWA model portfolios.

Current Macroeconomic View

In our opinion, there are seven key noteworthy points in the current macroeconomic environment:

1) Housing – As of November, the number of new home sold for 2007 are down 32% and existing home sales are down 20% from where they were a year ago. The actual decline in home prices has been much more moderate, currently ~3% lower than they were a year ago. But, because prices are not falling, buyers are not stepping into the market, leading to the 10.3 month supply of houses on the market as of the end of November. With foreclosures near record levels, and adjustable mortgage resets not set to peak until mid-2008, it's unlikely that housing sales and housing prices have bottomed. We forecast further declines for the housing market through most of 2008 and potentially into early 2009 before a turnaround.

2) Credit Crisis – related to the housing declines, due to the increase in subprime mortgage defaults, many financial institutions are faced with billions in losses for what amounts to a mispricing of debt throughout the housing bubble. These losses pressure the banking system and its ability to offer credit for new mortgages, small business loans, and other facilities that stimulate economic growth. We anticipate that the work of the Federal Reserve will alleviate this pressure on the economy, but that new credit standards will nonetheless remove some of the liquidity that existed for the last few years, and therefore remove a portion of the fuel for growth..

3) Commodity Prices – Traditional fuels aren't the only commodities on the rise anymore. With oil near $100 / barrel and gasoline over $3 / gallon, the surge into alternative energies like ethanol has raised demand for corn, sugar, and other consumables pushing up their prices. This passes through to markets which rely on agriculture as animal feed, pushing up their costs and ultimately the prices of meat, dairy, and other products. This ultimately makes doing business more expensive, and makes living more expensive for the U.S. consumer. While oil prices will probably stabilize and not jump too far over $100 / barrel over the short-term, other commodity prices will remain high through 2008 having an overall negative effect on the economy.

4) US Consumer – U.S. consumer spending has held up reasonably well so far. Preliminary December retail sales show a 2-3% increase over the previous year and other indicators show that the consumer, albeit at the expense of savings, continues to spend. However, we believe the consumer will eventually slow, partially because of the housing downturn and partially because of an impending slowdown in job growth in early/mid

2008. Fed cuts should stimulate the economy enough over the next 6-9 months to minimize this effect into 2009.

5) US Dollar – The dollar plunged in 2007 to lows never before seen in the 30+ years that it has been tracked against a basket of foreign currencies. While the weak dollar certainly makes a vacation to Europe a lot more expensive, it actually stimulates the demand for US goods, services, and assets by foreigners since the price of anything in U.S. dollars seems cheap when purchased with foreign currency. While it's unlikely that the dollar will snap back to it's pre-2007 levels, we also feel another precipitous decline is unlikely in 2008. At current levels, the weak dollar should have a positive impact on the economy and stimulate further exports as well as put a floor under the price of U.S. businesses (and eventually real estate) as foreign bargain hunters will step in if prices get cheaper.

6) Global Growth – For the majority of the world, growth is still strong and is expected to remain strong. In emerging markets like China, growth is so strong that the government is taking an active role in trying to slow the economy down before inflation spikes. In developed non-US markets, both US and non-US businesses continue to report positive guidance, indicating no major slowdowns in global business or the global consumer. While this will not impact the US economy per se, a diversified portfolio of investments that includes non-US markets will benefit from this growth.

7) US Interest Rates – The Federal Reserve is in the midst of a rate cutting cycle that will stimulate economic activity in an attempt to offset the decline in the housing sector. While cutting rates will likely not help those who have resetting adjustable mortgages they can't afford, it will relieve pressure (albeit slowly) from the beleaguered financial sector, and ultimately set up the survivors for what should be a major bull market in finance in the coming years. We believe the Fed will continue to cut rates into mid-2008, stopped at or near a 3% Fed Funds target. These cuts will have a positive effect on the US economy over the medium term.

The above analysis leads us to believe that the economy will slow in early 2008, likely bottoming in mid / late part of the year when financial pressures have eased and interest rate cuts have had time to feed into the market. Barring a catastrophic event, we believe the latter part of 2008 will begin a turnaround in the US economy, which should be seen by financial markets in advance, giving a potentially undervalued market a boost by mid year.

Financial Markets

Stocks

US Stocks have begun 2008 significantly on the downside, sliding 5% over the first week of the year. While the cautiousness about the US economy and high energy/commodity prices continue to weigh on the markets, it is important to note that stocks, historically speaking, are not overly expensive. In fact, the S&P 500, inflation adjusted, is now 25% below where it was at it's peak in 2000! Granted, we started from an overvalued position in 2000, but that's 7+ years of no stock market growth as the economy expanded and profits grew. So, a short or even medium term economic downturn should not be able to pressure stocks too far from where they are today.

The price/earnings ratio for the S&P 500 and for the Vanguard Total US market ETF is approximately 15, which is close to the historical average. While we expect that earnings forecasts will come down for Q1 and Q2 of 2008, potentially putting some continued pressure on the market, because valuation is not out of line now, we feel it is unlikely that we'll experience more than another minor correction. Because we're looking for minor downside over the short-term, but upside over the medium and long-term, investments that are currently being built for medium and long-term goals are in a good position. In fact, as long as clients continue to add to their accounts (retirement and non-retirement), the lower market provides an excellent opportunity to buy more shares at a lower price, which will lead to bigger gains when the market begins to move up again. For shorter-term, fixed timeline goals, client funds are in more conservative positions and should not be affected by the market downturn.

Foreign stocks have outperformed US stocks and will probably continue to do so in early 2008. While we don't try to predict specific markets or time entry and exits to and from those markets, client portfolios are diversified such that their asset allocation includes foreign stocks. Since foreign and US stocks are not perfectly correlated, having a mix will reduce the volatility of your portfolio since they are unlikely to fall or rise in perfect proportion over time. The price to earnings ratio on the total non-US stock market is about 14, and we continue to view the asset class attractive.

Bonds

Bond prices rose in 2007 as investors fled to safer waters when the stock market grew choppy, inflation fears eased, and the future of the US economy began to look grim. In fact, bonds returned more than stocks in 2007, with the aggregate bond market returning 7% to investors. Because of their attractiveness in times when the stock market is unattractive, bonds offer fantastic diversification opportunities. Not only do they pay monthly interest, but they tend to move up in value when stocks move down.

The aggregate bond market yield 4.76% as of the end of December (based on 12/31 price and December's interest payment). At that rate, since it has minimal default risk and adds diversification to stock portfolios, we continue to favor bonds to cash and to include them in all but our most aggressive model portfolio. Additionally, we have been excluding high-yield (junk) bonds from our models for the time being. At some point in 2008 as the economy begins to turn around and the credit crisis is resolved, we will add them back to our model portfolios.

Commodities

Commodity prices have soared over the last few years. Everything from metals, to energy, to agriculture has seen a price rise, partially due to strong global growth (demand for these commodities), and partially due to the falling US dollar (if the dollar buys less, the commodity costs more in dollar terms). We maintain an approximate 5% allocation toward commodities in all but our most aggressive model portfolio to attempt to offset some of these higher costs that clients face, and as a way of diversifying the portfolio overall. In recent weeks, we shifted client commodity positions out of a precious metals fund and into a broader commodity fund for all clients, believing that the broader fund offers more diversification. For 2008, we believe oil prices will stabilize, but that other energy prices as well as metals and agriculture may still have room to run.

Real Estate

US real estate experienced a horrific year in 2007 and we believe it will only get worse for much of 2008. While the housing market will likely not bottom until at least late 2008, we expect that housing related stocks will bottom prior to that in anticipation of the turnaround. We did not include a specific US REIT fund in model portfolios for 2007 and continue to exclude them. We anticipate that REITs, homebuilders, and other real estate investments will be attractive at some point in 2008. At that time, we will modify client portfolios to include that asset class.

Foreign real estate faired somewhat better, though foreign REITs still lost 3% in 2007. We believe they will continue to outperform US REITs and due to their 4% dividend yield and diversification potential, we continue to include them in model portfolios.

Targeted Investments

While targeted investments may differ depending on client goals, risk tolerance, and exposure to particular sectors / industries in their ordinary life, there are a few themes we're currently interested in for 2008 that are worth noting:

- Financial Sector – Down 21% in 2007 and down 30% from their highs, the credit crisis and subprime meltdown has obliterated financial institutions. Some of these institutions will not survive. But, the ones that do survive will be well positioned with less competition and a positive interest rate environment. There will likely be a time in 2008 when we will take a position in financials.
- Homebuilders – Similar to the financials, homebuilders have been beaten down (-48% in 2007). When the housing market begins to show signs of life, these stocks will rebound as they are significantly undervalued now given long-term potential.
- Shorts – The downturn in the stock market brings opportunities to short particular stocks or sectors in non-retirement accounts. We always consider short positions to be (betting that stocks will go down instead of us) short-term in nature and generally avoid them because winning positions will generate

short-term capital gains in non-tax advantaged accounts, and are not allowed in tax-advantaged accounts. Still, we may begin using occasional short positions in 2008 to hedge a falling market.

- Refiners – You may have noticed that as oil climbed to $100 / barrel, gasoline has held pretty steady. This has resulted in reduced profit margins for refiners, who buy oil, refine it, and sell the gasoline. The difference between the price of oil and gasoline (known as the crack spread) fluctuates over time and we believe it is bottoming. Pure play refiners should benefit as the crack spread expands and as such, we've begun to take small positions in some portfolios in that area. Owning refiners is also beneficial because their price will go up as you begin to spend more on gasoline because the price at the pump went up. There is something very satisfying about paying for gasoline with profits from energy companies.
- Tech and Telecom – The new wave of technology is everywhere and the growth in tech and telecom companies, especially in foreign markets, continues. We plan to take advantage of this with targeted investments in this area.
- Volatility – Market volatility has now become the norm. In some portfolios, where allowed, we may utilize this to our advantage with sophisticated options strategies.

Market Psychology

A quick point worth noting on market psychology. The sharp up-and-down in the markets tends to draw more market-timing traders in. These speculators attempt to profit from momentum by buying when the market is going up and selling when it's going down, creating even more of a whipsaw effect. For the inexperienced investor, it can be tempting to try to pick a top or a bottom in the market and profit from these wide swings. There are four issues with doing this. 1) You need to pick the right top to sell your investments and if you're wrong you risk missing the upside. 2) You need to pick the right bottom to buy back into your investments. 3) You need to pay taxes when you sell (assuming you have gains), which means you'll be unable to buy the same amount back later. 4) You pay commissions to your broker each time you make a trade.

Brokers will win with this strategy since they collect trading fees. Uncle Sam will win with this strategy since he collects taxes. A few individuals will win with this strategy if they pick the exit and entry points correctly. Everyone else will lose, and will experience much more long-term volatility than necessary. A much more successful strategy is to work with your advisor to outline your goals, the returns you need to achieve those goals, and implement an asset allocation that is designed to target that return over the timespan you need. You can't measure it over months, you won't get the exhilaration of a "winning trade", and it won't be as much fun to try. What you will get is enough money to fund your lifelong aspirations and that is much more meaningful than occasional short-term wins.

Conclusion / Looking Ahead

Short-term market predictions don't matter any more than short-term market movements. We've given you our thinking on how certain segments of the market will perform in this newsletter and we think that will provide a knowledge base to help you understand your portfolio in light of what you're hearing on TV, on the internet, and in the newspaper. In the end though, we believe that your overall asset allocation, designed to achieve your goals, is what matters, not the short-term performance of the market. We'll continue to review those goals and your path to success with you in 2008.

A few final words of advice… Don't let the ups and downs of the market worry you. Remember how this newsletter started. *If you went to sleep at the beginning of 2007 and woke up at the end, you'd think we had a pretty dull year in the financial markets*. Ask anyone who followed them day-to-day, and they'll tell you how much stress and angst the markets actually caused. When you look back on 2008 from 2009, which memory would you rather have when it comes to your finances, dull or stressful? Personal finance is the one place in life where dull is the great result. So let us do that worrying for you in 2008. And thanks again for your business.

Sincerely,
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President – Perpetual Wealth Advisors, L.L.C.