

Economic Conditions & Market Outlook

Watching the behavior of investors in the U.S equity markets during the first few weeks of January was somewhat reminiscent of the protective tactics advocated in the old elementary school 'Duck and Cover' Civil Defense films - hit the floor, crawl under the desk, hands on your head, and hope for the best. In fact, trying to find cover from dropping stocks has been about as futile as depending on that wooden desktop to protect you from falling nuclear bombs.

Stocks continued the slide from their October highs of last year. All of the major market indices have declined from their year end prices, with the Dow Jones Industrial Average slipping 4.96%, the Standard & Poor's 500 Index shedding 4.59%, and the NASDAQ sinking 8.01% as of January 11. The recent underperformance in stocks has been very broad-based, with eighty-eight of the ninety-nine industry sub-sectors in the U.S. Total Market logging negative returns for the period.

Suffice to say it was an inauspicious start for equities and the bearish pundits were quick to note that this was the worst kick off for a New Year since 1930. While we tend to view such historic stock market trivia as exactly that, it is clear that current investor confidence is somewhat shaken.

There are several reasons for this case of the jitters. Fallout from the sub-prime lending debacle and the ensuing credit crunch, as well as weakness in the nation's housing industry all continue to haunt the markets. Add to this list concerns about rising crude oil prices, falling U.S. dollar value, and an increasing number of private economists predicting a near-term economic recession. The end result is more than enough uncertainty to keep any economic Cassandra busy wringing their hands.

While we've regularly reinforced the fact that it is a mistake to assume the economy and the stock market always move in lockstep, the readjustment of market expectations to slowing economic growth often results in the type of price volatility recently observed. And economic growth has indeed slowed.

Federal Reserve Chairman Ben Bernanke's recent comments finally acknowledged that the "outlook for real activity in 2008 has worsened and the downside risks to growth have become more pronounced." Mr. Bernanke also noted that the Federal Reserve "stands ready to take substantive additional action as needed to support growth" and even telegraphed the strong possibility of a further easing of interest rates by as much as half a percent later in January. Of further note was his comment that the Federal Reserve is not currently forecasting an impending economic recession.

This last observation raises an issue. Speculating whether or not a recession is on the way has been a favored topic of late among the financial media and speaking-circuit economists alike and will likely continue to be so throughout the months ahead. While such discourse can be entertaining, we tend to view these debates as mere academic exercises. In our opinion, whether an economic slowdown is eventually labeled a 'recession' or not has little bearing on making effective portfolio management decisions today.

Why? There are several reasons. Most notable is that a recession is traditionally defined as two consecutive quarters of negative real economic growth or declining gross domestic product. Thus, recessionary periods are always identified in hindsight, after governmental data has been reviewed, released, revised, and re-released. As a result, this time lag eliminates any forward-looking benefit that possibly would be provided via early identification of an impending recession. Passively pondering whether this is or is not a recession is akin to sitting back and wondering whether your lifeboat that is rapidly taking on water is really going to sink. We prefer to start bailing regardless.

Second, the stock market's response to prior recessions has been anything but predictable, with varying degrees of market movement accompanying the last six U. S. recessions. Nasty market downturns plagued the most recent recession of 2001, as well as two others that occurred in the early 1970's. In each of these, stock prices plummeted before and during the recessionary period.

However, in the three other recessions between 1980 and 1991, stock prices had only modest pre-recession drops and actually *increased* during the recession itself. And while there was somewhat better correlation in the stock price movement occurring six months after each recession ended, i.e. a healthy recovery in stock prices, 2001's slowdown provided the exception with equities continuing to drop another -6.3%.

Finally, the individual underlying economic measures that may, or may not, eventually culminate in an actual recession, such as slowing growth, rising unemployment, reduced consumer spending, housing weakness, and inflationary concerns, all negatively impact near term market behavior and investor psychology. Proactively making adjustments in response to deteriorating fundamentals is simply prudent. With apologies to the economic purists, our view as a portfolio manager tends to be, 'if it walks like a duck, quacks like a duck, and swims like a duck, whether it really ends up *being* a duck is somewhat immaterial'.

Looking forward, it is probable the stock market will continue to behave in a very spastic fashion. Less-than-stellar economic data will likely be the norm through mid-year and question marks will continue to surround the 'real' damage inflicted on the financial sector via sub-prime lending woes. This lingering uncertainty only contributes to the confidence crisis currently reflected in wild day-to-day market gyrations.

As last quarter's corporate earnings continue to be released throughout the next several weeks, be prepared for more of the same market volatility. Stocks with better-than-expected earning news may likely see dampened upward price moves, while those stocks that do not meet already diminished investor earnings expectations run the risk of being sorely punished.

Some companies will use this opportunity to aggressively write off or re-price questionable balance sheet assets, thus preparing the foundation for future positive earnings growth. This can be a positive. But even with the potential benefit of 'taking all the medicine at once', the markets will likely remain skeptical that the 'patient' has completely healed. Part of this is because too many supposedly sophisticated companies and high-priced management teams had little to no idea as to their firm's full exposure to a potential sub-prime meltdown and then appeared less than forthright regarding the extent of the problem once they did. It will take awhile for investor confidence to fully recover.

And while we are definitely not in the camp that believes the Federal Reserve can fix all with a wave of the interest rate wand, the general perception that Mr. Bernanke and team have been awkward in their response to the problems to date has added to the current uneasiness.

Despite the market dropping well into correction territory from its October highs and increasingly attractive stock valuations appearing in certain sectors, it is still early for a wholesale return to equities. Lower corporate earnings will raise a stock's P/E Ratio, making what once was viewed as a bargain now seem overpriced. So while there will indeed be some real value opportunities; caution, selectivity, patience, and a defensive leaning are appropriate until the dust settles a bit.

Conversely, running in a panic for the market exit doors at this time seems unwarranted. Volatility has a flip side as well and, as unlikely as it may seem when following the ticker during recent weeks, stocks can rebound as quickly as they fall. Although we see no magic elixir in the offing that will immediately cure all current market ills, leaping out now with the anticipation of a perfectly timed reentry is a fool's game that invariably fails.

It is very likely that fear of the unknown has overblown some of the most worrisome market and economic concerns. We suspect that as the first half of the year progresses many of the storm clouds on the horizon will dissipate and the latter half of 2008 will fare much better. In fact, some of the recent dogs of the market could very well end up being darlings at year end.

Our Tactical Investment Stance

Roof Advisory Group's disciplined investment approach emphasizes adding value to client portfolios while controlling downside risk. Strategies include clearly defining investment policy ranges based on each client's specific investment objectives/risk tolerance, monitoring portfolio adherence to established benchmark parameters, and the ongoing evaluation of relative portfolio return.

Within this strategic context, the firm makes tactical shifts with changing market conditions to optimize client portfolio performance. While every client situation is unique, outlined below are a few of the tactics we are using in the current market:

- For the majority of clientele, ongoing market volatility had formally shifted our target portfolio weightings to ***one-step above minimum equity allocation*** earlier in January, with most portfolios actually being ***several percentage points below that mark*** to cushion against negative stock market moves. After formerly dropping to this position during last August in response to the credit and liquidity crisis, target portfolio allocations were raised to, if not slightly above, the ***mid-point*** equity position for much of the Fall. As stocks retreated later in 2007, equity exposure was again pared to well below ***mid-point*** equity level until the formal allocation change that was made earlier this month with additional equity reductions.

While selective buying opportunities will be pursued, a wholesale return to portfolio equity ***mid-point*** is unlikely to occur within the next sixty days.

- Diversification is always a priority in the firm's equity and fixed income portfolios, with that strategy demonstrating even more value than the norm in unstable market conditions. While the firm typically shuns making large over/under weighted industry sector bets, we are smart enough to step out of the way of falling objects. As a result, ***Financial Service sector stocks, particularly Banks, Brokerages and Investment Banking***, are currently well ***under benchmark level***, and have been so since mid-last Summer.

- Additionally, we have ***eliminated individual equities deemed most vulnerable*** to negative moves in the current market. Citigroup was sold well above current pricing levels in December 2007, with Lehman Brothers, J.P. Morgan, and other sensitive issues being sold mid-year 2007. Positions in ***companies with lowered earnings expectations have been pared***. The firm has ***not held any individual Home Building or Sub-Prime Lending stocks*** throughout the entire time period.

Some of these sales proceeds have been redeployed into select stocks in areas deemed less vulnerable to sub-prime credit issues and market volatility. These include ***Defense, Utilities, Energy, Technology***, and, for the first time in quite awhile, ***Pharmaceuticals***.

- Positions in certain value-oriented ***mutual funds with Financial Services exposure have been reduced***. Much of that had taken place in late summer 2007 but ***additional parings occurred earlier in January***.

- ***International and global exposure has continually increased*** and is maintained through investing in ***large-cap multinational firms*** that operate globally and the utilization of managers and/or exchange traded funds that ***focus on foreign investment opportunities in stable countries***. The target level for ***direct foreign exposure*** remains at the highest it has been in our firm's history.

- We have continued ***increasing the average duration in our fixed income portfolios*** as short-term interest rates have fallen, again creating ***some return premium for lengthening maturity***. Individual securities are always used for larger fixed income portfolios to control quality, maturity, and yield. Junk-rated bonds are never held and holdings ***with notably downgraded credit standings have been eliminated***.

Concentrations in short-term fixed income positions, particularly money market funds, will be ***higher than the norm near-term***. This is tactically beneficial in the current situation for two reasons: it reduces portfolio volatility and allows for rapid redeployment when the opportunity is presented.

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