

**Looking To 2008:
Higher Prices, Lower Interest Rates
Selectively Higher Stock Market**

As 2007 draws to a close, one would think that securities markets are in a state of despair. In reality the overall stock market indexes as measured by Standard & Poor's 500 is still ahead although not by much as of this writing—two percent or so year to date.

While this is below the best level of the year it is still a positive return. From the way some people have reacted one would have thought there had been a replay of 1929.

For some financial and homebuilding investments the 1929 analogy is apt. After years of loosening standards for extending credit, the inevitable losses appear with the predictable results. Data on such over-extension of credit is usually obvious only after the fact. This makes predicting such consequences easy in principle but difficult in terms of timing. It is this timing issue that causes those who can see such debacles coming under-perform before the fact while those who don't see them coming under-perform afterwards.

Still, aside from financial and housing issues this has not been an especially rough stock market. The problem has been the magnitude of the financial stocks' role in the market's overall rise in the past five years. After the dot-com bust in 2000, aggressive reductions in interest rates by the Federal Reserve permitted the economy to skate over what could have been a serious recession. Outside of Silicon Valley there were few areas affected by the collapse in tech spending. Consumers responded to lower interest rates by buying housing and any number of other items on credit. This, along with rising government spending on both the war and health care, made the recession of 2000-2002 a non-event for the American consumer.

This time around the roles are reversed. Government spending is still a driver along with exports and capital goods. Interest rates are again declining. However because the terms of credit are being raised consumers are feeling worse than the overall economy. The issue is whether we can skate through this economic rough patch as well as we did seven years ago.

So far the answer looks promising. Consumer spending is holding up reasonably well, showing the disconnect between how consumers feel and what they do. There is overcapacity in consumer-related industries, from retail to housing to banking, but these excesses will be worked off over time. On the other side of the ledger, the falling dollar has led to a broad increase in American competitiveness abroad. This will help to provide the demand necessary to move the economy forward. Government spending continues to roll along.

Thus the stock market leadership for 2008 will be companies that cater to foreign markets and companies domiciled abroad. It is an article of faith that no matter what the US economy does in 2008 the international economy will do better. While the connection between the US and foreign economies is still there it is not as binding as even five years ago. As more people improve their economic circumstances in other lands the demand for goods will grow far faster than in mature countries such as the US. Add to this the fact that a weaker dollar makes foreign profits worth more in US dollars after the currency conversion, and the focus on international markets becomes almost compelling.

But not too compelling. Many such markets are miniscule compared to the US economy. European markets can accommodate international capital flows. Less developed countries have a more difficult time of it. In some cases foreign stocks are rising simply because American mutual funds are chasing them. When the tide is reversed the stocks will decline sharply. This will be a repeat of what happened in foreign stock investing in the 1990s.

Among commodities, energy is the most compelling case. Even here one must be circumspect. While coal and natural gas deposits are in fairly stable hands, oil production is another matter. Most of the remaining oil fields to be discovered are under miles of water claimed by countries that do not have a history of stability. Far safer to invest in the extraction industries rather than the companies who allude to controlling the oil deposits when in many cases they do not.

Other commodities are a mixed bag. The history of commodity cycles is for prices to rise and fall on supply rather than demand. As new mines are opened later in the decade their scale will test the ability of the markets to absorb the output.

Overall the US economy has a good shot at slightly positive GDP growth in 2008. It will be a transition year, where many of the leaders of the past half decade will be replaced with sectors that have done less well. So long as credit is available the domestic economy should move forward. Foreign economies should have an easier time of it. However, one should remember that stock markets are anticipatory mechanisms. There is nothing to stop a stock market from rising in anticipation of a stronger economy. Thus the current state of the economy is almost secondary when it comes to equity investing.

The Economy

Economic activity is better than most people feel. GDP numbers for the fourth quarter look to come in around three percent, down from around four percent in the third quarter but still a respectable number.

The scope of the “housing crisis” is over-stated. Something like two million households are caught up in the problems of loan re-pricing, etc. with another million properties in this category that were purchased for speculation (i.e. flipping) or second homes and not primary occupation. This is out of about 160 million households in the US.

Where the impact is concentrated is in the securities of a handful of Wall Street firms who packaged the associated mortgages for resale as well as the firms both domestically and abroad who purchased the securities for investment. This would tend to suggest that the problem of residential real estate will solve itself over time as excess inventory is absorbed and more conventional mortgages are written.

Interest Rates

Since August the Federal Reserve has lowered interest rates by a full percentage point. The consensus seems to be that rates will fall another percentage point in 2008 before bottoming out.

Lower interest rates have two consequences. For the banking system it reduced the cost of lending, which is at least partly passed on to borrowers. This encourages the assumption of credit by qualified borrowers. For investors lower interest rates force investors to take incremental risks as the returns on cash will decline to levels at or below the inflation rate. In this manner lower rates support the financial markets.

Inflation

An era of low inflation is coming to an end. High food prices are merely the latest evidence of inflation, joining higher energy and labor costs.

Look for inflation to reach 4-5 percent in 2008, up from 3-4 percent this year. This will be the second year in a row of increasing inflation.

The Stock Market

Over the past five years the stock market has gone up between seven and eight percent per year depending on the index. This is in line with the historical trend of stocks in general outperforming inflation by about four percent per year.

While 2007 is not over yet, it would appear that there is widespread disappointment that stocks have not done better than average this year. Like the parents in the mystical town of Lake Wobegon, investors want all their years to be above average.

What works against the average investor is the desire to constantly change investments in response to every new information input. Not only is this expensive, it is also counterproductive for most investors. The vast majority of the investment media sanctions such conduct since it plays into the hands of those who underwrite the enterprises that generate the information. Thus whereby investors now measure their holdings in terms of weeks or months held, they once measured them in terms of years.

Thus for most investors superior investment returns depend on both a long-term time horizon and a multi-year basis for evaluation. Most people lack both the perspective and the patience. This is unfortunate.

In terms of the overall stock market, 2008 should see a year of average overall returns of 7-8 percent. Financial stocks should at some point do well if the right stock is chosen. The same can be said for exporters, health care and energy. Consumer stocks will likely under-perform. An exception will be those stocks so beaten down in the current market they will spring back for a good short-term gain.

Warren M. Barnett, CFA
December 20, 2007

© 2007 Barnett & Company