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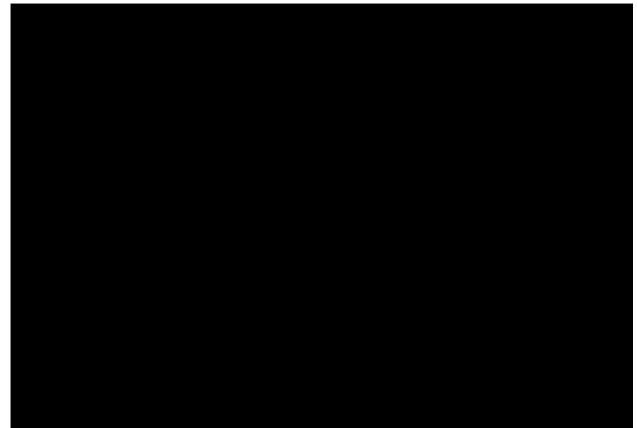
INVESTMENT COUNSEL

Quarterly Review and Outlook

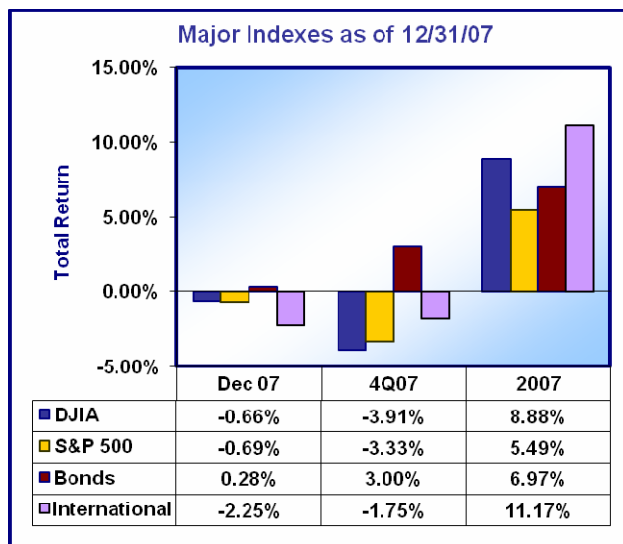
4th Quarter 2007

No Credit, Even Where Credit Is Due

The fourth quarter of 2007 turned out to mark the beginning of a long-delayed correction in the markets, as the threat of a liquidity crisis in the credit markets was exacerbated by mounting evidence of near-term economic weakness. The Federal Reserve Board began easing interest rates in September and offered up two more rate cuts in the fourth quarter; nevertheless, the US stock market declined in both November and December for the first time since 1974. By the time the giant lighted ball descended in Times Square, the broad S&P 500 had given up 3.3% for the quarter, finishing just 5.5% higher for all of 2007. All of the major stock indices lost ground during the final three months, and the Russell 2000 index of small cap stocks finished in the red for the entire year. Utilities, energy and consumer staples managed gains while every other sector lost



ground. Consumer cyclicals dropped 10.5%, and the financial sector took a pounding, off 15.0% for the quarter. Similarly, the high-yield bond sector gave ground in the period, with the Lehman High Yield Index down 1.3%. As we write this we have seen the selloff accelerate during the first two weeks of the New Year in response to deepening worries over the state of the economy, and have witnessed an unprecedented 1.25 percentage point rate cut by the Fed within an eight-day period, signaling concern on the part of the

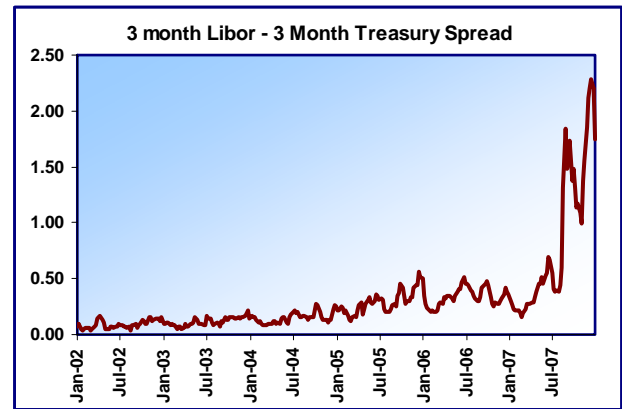


Quarterly Review and Outlook

central bank that the economy continues to face significant headwinds.

The bond market displayed every bit as much volatility during the fourth quarter as the stock market. The primary culprit was the acceleration of the meltdown in the sub-prime mortgage market and the attendant collapse of liquidity in the overall credit markets. We discussed in our last quarterly review the impact of the surge in mortgage defaults and how it was likely to ding the banks. Since then, the fourth quarter brought a massive wave of asset write-downs that sent the banks scrambling to raise additional capital, much of which came from so-called “sovereign wealth funds” (otherwise known as foreign governments). In response to the uncertainty in collateral values underlying loans, lenders generally became more “risk averse” as manifested by a substantial tightening of lending standards and an unwillingness on the part of institutions to lend to other institutions in view of the unknown risk of getting stiffed.

This subitaneous constriction of credit triggered the most acute liquidity crisis in the capital markets since the 1998 Long Term Capital Management collapse and perhaps even since the Great Depression, as evidenced by the sudden unavailability of loans even to creditworthy borrowers. In its own quintessentially understated way, the Federal Reserve noted that “Strains in financial markets have increased in recent weeks”, but the European markets made a more emphatic declaration via a spike in the 3-month London Eurodollar deposit rate (LIBOR) relative to the US Treasury bill, reflecting the diminished certainty of repayment on loans to any party other than Uncle Sam. This imbalance in the LIBOR



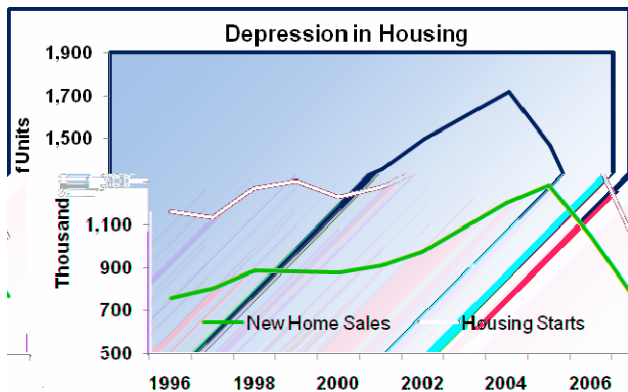
rate is significant to American borrowers since about 90% of adjustable mortgage rates in the US are pegged to the LIBOR rate. Furthermore, the expectation of weakness in economic growth going forward increased the anticipated risk of default on the part of bond issuers, further attenuating investor risk aversion.

This additional risk aversion showed up as a sudden increase in the risk premium, or the extra return required by lenders to convince them to make a loan (or buy a bond). The additional risk premium has directly impacted the high-yield bondholder, as the average “spread” or extra interest yield earned by the bondholder over the yield on the 10-year US Treasury bond has soared from 2.4 percentage points last summer to nearly 7 percentage points today. The tangible effect has been a sharp decline in the prices of the bonds.

Equity markets also reacted negatively to the massive write-downs, particularly in the financial sector as large banks dropped one bomb after another and the total value of asset write-downs approached the \$80 billion mark. Stocks also retreated in response to the threat of substantial economic weakness ahead. The contraction in the housing market finally spread its

Quarterly Review and Outlook

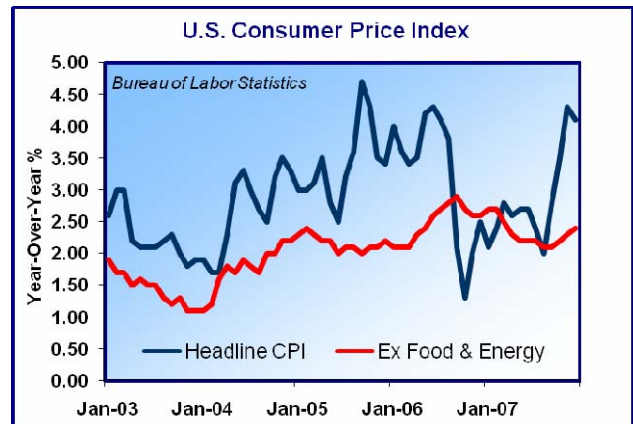
tentacles across the greater economic landscape, taking its toll on employment and dampening GDP growth. 2007 proved to be the worst year for home builders in a generation. New home sales for the year plummeted 26% from the level of 2006, and December sales were off a jaw-dropping 41% versus December of 2006. Home builders experienced fourth quarter cancellation rates as high as 55%, and at year end the inventory of unsold homes stood at nearly 10 months' worth of sales.



The unemployment rate reversed a five-year decline and moved up from 4.6% in mid-summer to 5.0% by December. Meanwhile, GDP slowed to a crawl, growing only 0.6% in the fourth quarter as the impact of the real estate slump, higher energy and food prices, and declining portfolio values finally convinced consumers to reduce their spending and companies to rein in their capital investment. Economic forecasters surveyed by the Federal Reserve have taken down their predictions for 2008 growth; they are calling for a 1.9% annual growth rate for the first half of the year, which likely will prove to be too optimistic in view of the comments issued after the last Fed Board meeting. A reasonable estimate of GDP growth for 2008 is between 1% and 2% for the year, with the first and second quarters flat or down. The likelihood of a recession

in the technical sense is considerably higher, although the prospects for a severe and long-lived downturn do not seem great.

The Fed's attempts to treat the anemia in growth are complicated by the specter of accentuated inflationary pressures creeping in due to food, energy and transportation cost increases. The headline CPI exceeded 4% on an annualized basis for the first time since 2006, and the core rate (excluding food and energy costs) continues to exceed the Fed's preferred target rate of 2%. Continued cuts in the Fed Funds rate aimed at halting the slide in economic growth also carry the risk of further eroding the value of the dollar and feeding the inflation beast. The central bank is in a pickle, but has chosen to err on the side of growth, essentially saying it will tackle the resultant price instability down the road.



Considering the nearly unprecedented upheavals in the credit and housing markets, the US economy has managed to show remarkable resilience. Although there may well be more market volatility ahead, there will inevitably be opportunities as well.

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