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Caveat Emptor (Buyer Beware)
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"The nice part about being a pessimist is that you are constantly being either proven right or pleasantly surprised."

George Will

New Years, is a wonderful time; we celebrate the possibilities of new beginnings while completely ignoring the past. If this wasn't true how could you explain the sub-prime mess?

After some trying moments during the course of the year, the major indexes managed to close in positive territory. While there were times when the outcome was in doubt, for the year the Dow Industrials finished up 6.42%, after having peaked at 14,164 in October. The S&P 500 closed in positive territory also, up 3.52%, but down considerably from it's October high, due to the heavy weighting of financials. The NASDAQ rounding out the major domestic indexes, led with a gain of 7.94%, supported by strong returns in tech stocks such as Apple, Google, and RIM. [1]

While Emerging Markets continued to defy gravity (and fundamentals), led by familiar names such as China, Russia, and Brazil, the EAFE Index representing predominately companies in developed countries lagged, but still finished positive by 7.22%. [2] As we predicted, small caps as represented by the Russell 2000, finally underperformed large caps in the U.S. finishing down for the year hurt by a faltering economy and sub-prime concerns.

Within the indexes there were clear winners and losers. Energy, materials, utilities, and companies with significant revenues generated overseas performed well as a whole. Financial stocks including but not limited to money centered and regional banks, brokers, insurance companies, in fact almost anyone related to sub-prime were thrown to the wolves. Real estate and companies dependent on the housing market, specifically the builders and lenders, were given up for dead with no hope of recovery.

March provided a warning shot over the bow falling sharply on a correction in the Asian indexes only to rebound and climb to new highs by July. Unfortunately, by August sub-prime was a household name and though the Federal Reserve with a surprise fifty basis point cut in September attempted to put a floor under the market, the results were short-

[1] Source: Wall Street Journal
[2] Source: Wall Street Journal

lived. After peaking in October, the indexes have been on a roller coaster ride reacting to every economic data point with a distinct downward bias. Looking forward into the new year we anticipate continued volatility with the potential for more downside risk. However, even with such a bleak pronouncement, there will be opportunities for those who are patient and more importantly disciplined. As always, there are a number of key issues that we will be tracking, the health of the economy influenced by the continued decline of the housing market being the most important of these.

History is littered with financial bubbles, The Tulip Craze of the 1600's, The South Sea Company during the early 1700's, the Crash of 1929, and the Technology boom of the 1990's. In the area of real estate, the 1920's ushered in a speculative boom in Florida that as all bubbles do, eventually ended in tears. One thing all financial bubbles have had in common is clear warning signs of the pending collapse.

When common sense is replaced by greed and reasonable assumptions are extrapolated beyond reality, the only ingredient lacking in the making of a bubble will be a fresh infusion of cash. Were there warning signs in previous bubbles? Absolutely. At the time of the Florida real estate bubble of the 20's, one-third of the population in Miami were realtors and swampland was being exchanged for $1,000 an acre, a princely sum in those days.

It isn't hard to identify a financial bubble. In fact it isn't even difficult to recognize when a financial bubble is peaking. What is difficult is having the discipline and the moral fortitude to walk away from the party when everyone seems to be having such a good time and making so much money. We know that eventually the bubble will burst, but we always think that we can hold out a little bit longer and still get out in time. If only life was that simple.

The current real estate market is in the process of its own post bubble collapse. Prices have adjusted downward from their peak and in all likelihood will continue throughout 2008 and possibly into 2009. Inventory levels will continue to build until an inflection point is reached and sellers adjust their pricing to what the market will accept rather than what they would like. Some analysts forecast home prices could decline upwards of 20% from current levels before stabilizing. [3]

The direct affect of declining home prices will be a further contraction in consumer spending, which will in turn negatively impact the economic growth rate. Signs of weak spending are already evident in the lackluster holiday season and the increased credit card balances coupled with a growing number of late payments and defaults. Add in higher

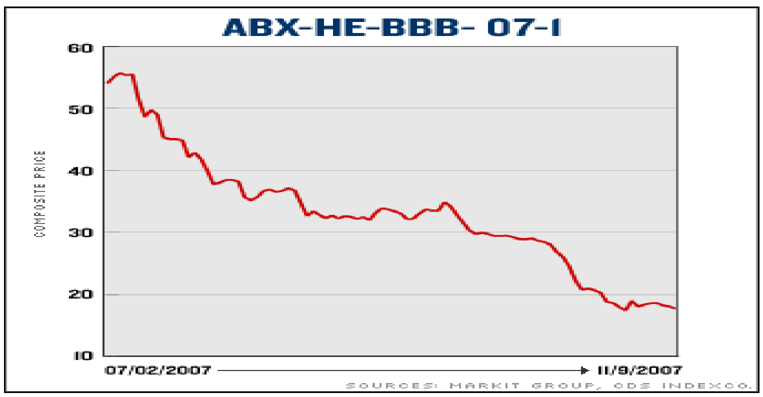
[3] Source: S&P Case-Shiller Home Price Index

energy costs, shrinking home equity, tighter lending standards, higher interest rates on revolving debt, and increased food costs and the deck is stacked against the consumer.

Whether the economy is dragged into a recession or is in fact already in one is immaterial in our view. What is more important is recognizing that the growth trend for the global economy will in all probability be down. As to the extent of the contraction we wouldn't even hazard a guess, but knowing the direction can help us to focus on the areas of the market to take advantage of and those to avoid.

One of the great unknowns at the moment is the sub-prime issue. To date financial institutions have written down $80 billion in sub-prime loans and some strategists believe that number could increase by another $250 billion. [4] The difficulty is no one really knows what the loans are worth. At present, these loans are in many cases being marked to models or as some Wall Street investors state "marked to myth". Until we begin to see a number of transactions occur in this space it will not be possible with any confidence to price the loans to the market.

The ABX-BBB Index tracks one area of the sub-prime loan market. While this does not necessarily reflect the actual values of the loan portfolios, it does provide an indication of the trend and insight into future values. As the chart to the right illustrates, a significant erosion of the sub-prime loan values has occurred in recent months with no sign of hitting bottom.



Our investment thesis for 2008 is relatively straightforward. Given the number of potential negative factors that could impact the global capital markets, we anticipate that the major financial indexes will experience a more significant correction than that of 2007. The decline will subsequently provide an opportunity for investors to commit new capital at more reasonable valuations. Prior to the decline, it may be prudent for investors to raise cash positions by reducing holdings that have either enjoyed significant gains or would be most vulnerable to a correction.

If our thesis holds true, we will take advantage of more attractive pricing in the equity markets to reinvest the cash position in industries and sectors that hopefully will

[4] Source: Goldman Sachs Research Report

represent strong long-term growth. As to specific companies, we will need to wait and determine the degree of the decline and the events surrounding any market correction before committing to actual names.

The following is a synopsis of the issues that could precipitate a market correction, but is by no means all inclusive:

- According to the S&P Case-Shiller Home Price Index, which measures the residential housing market, home prices fell 6.7% in October representing the largest percentage drop in the index's twenty-one year history eclipsing the prior record set in April of 1991. Unfortunately the news in the real estate market has been getting progressively worse since then. The inventory of available homes has continued to build even as housing prices have declined indicating that the housing market has not reached the inflection point where prices will stabilize and inventory levels will decrease.

- A build up in housing inventory will lead to a natural reduction in construction jobs at a time when employment is one of the only bright spots in the economy. In addition, the financial industry, specifically those areas tied to the mortgage market, will experience significant job loss.

- As the housing market continues to erode, the consumer's confidence is being impacted by the loss of value in their largest personal asset. Having lost the ability to borrow against their home, consumers are already indicating a predisposition to reign in spending as reflected by the lackluster holiday sales.

- The Federal Reserve has reported that debt levels rose 2.4% in October and stands at $2.49 trillion. Credit card accounts that were at least thirty days late increased by 26% to $17.3 billion in October. Foreclosures increased in November by 68% on a year over year basis according to Bloomberg. Even if the consumer is willing to continue spending, they may not have the capacity.

- While core inflation as reported by the government is contained, real inflation is not. Energy prices continue to escalate; with oil approaching a $100 a barrel and the revised trading range now between $70 to $100 per barrel. At the same time food inflation has increased dramatically due to global demand and ethanol production.

- Due to the impact of the sub-prime loans on the balance sheets of financial institutions, banks are tightening lending standards at a time when a large percentage of adjustable rate mortgages are about to reset. Even though the Federal Reserve has continued to reduce rates, the interest rate on both jumbo and

- Equity markets have been in an upward trend for five years, historically this would represent the exception not the norm. In addition, the S&P 500 Index now trades at 18.85 [5]times current earnings at a point when corporate earnings are slowing not accelerating. If the consumer does in fact reduce spending, corporate profits will decline further calling into question valuations and earning projections for the coming year.

- Geo-political risk should not be discounted as recent events in Pakistan clearly remind us. While energy prices reflect this to some degree, the overall market is much more sanguine preferring to ignore the potential impact to the capital markets if an event was to occur.

In short, while we are not predicting the end of the world, we are arguing for caution; as the title of our commentary succinctly states, "Caveat Emptor", Buyer Beware.

Sincerely,

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[5] Source: Wall Street Journal

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All indices are unmanaged and cannot be invested in directly. Past performance is no guarantee of future results. International investing involves special risks such as currency fluctuation and political instability.