

THE MARKET OBSERVER

FEBRUARY 2008

After recovering from its August selloff to reach new highs in October, stocks (as measured by the S&P 500) declined over 3% during the fourth quarter, finishing the year with an overall advance of 5.5%. Continued credit, housing and recession-related fears spurred further declines during January, pushing prices down 19% from their October highs to new intra-day lows on January 23. The next eight days brought a sharp, 10% recovery, leaving the index down 6.1% for the year through the end of January.

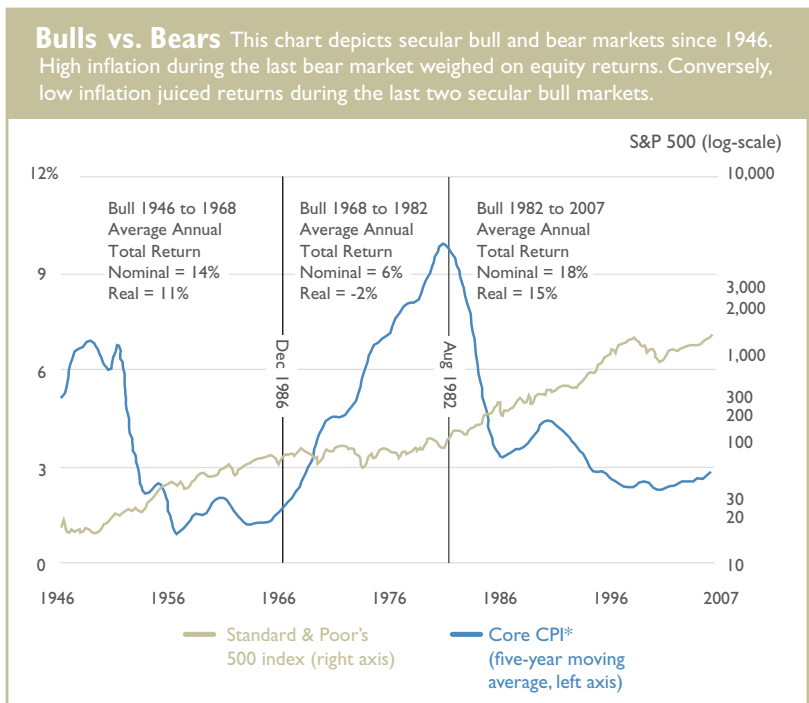
Reductions by the Federal Open Market Committee of the Fed Funds rate to 3% from 4.5% seem to have calmed the markets, at least in the short run. The markets, in addition, appear to be discounting additional cuts in this rate to at least 2.5%. Many forecasters believe we are already in a recession and are trying to get a handle on just how much of a decline in corporate profits we might see in 2008 to in turn get a feel for where stock prices might

find support in the event of further declines from here.

An important factor to remember is that the advances in corporate profits and stock prices we have seen since 1982 have been fostered to a large degree by an environment characterized by low inflation.

that “persistent tame inflation remains the key factor underpinning positive equity-class returns” going forward.

Bill Gross of PIMCO points out in the 1/14/08 *Barron's Round Table* that the current downturn is not the norm where excess inventories need



Source: Citi Global Wealth Management, Bloomberg, Ibbotson and FactSet as of 12 December 2007 *Headline CPI prior to 1963

Jeff Applegate goes on to conclude in a Citigroup January 2008 *Investment Outlook*

to be worked off. Rather, the contraction of the “shadow banking” system, where loans

Loss Recognition & Capital Raising: Sovereign Wealth Funds			
Firm	Estimated Loss	Estimated Capital Raised	Source of New Capital
UBS AG	\$14.4 Billion	\$11.5 Billion	Govt. of Singapore and Unidentified Mid Eastern Investors
Citigroup, Inc.	15.8	7.5	Abu Dhabi Investment Authority
Merril Lynch & Company, Inc.	7.9	6.6	Temasek Holdings (Singapore) and Davis Selected Advisors
Morgan Stanley	9.4	5.0	China Investment Corp
Barclays PLC	2.7	5.0	China Development Bank and Temasek Holdings
Bear Stearns Companies, Inc.	2.6	1.0	Citic Securities Co. (China)

Sovereign Wealth Funds have been primary sources of new capital. They were created by governments of countries that have accumulated large amounts of excess dollars through export activities and as producers of natural resources. One benefit of Sovereign Wealth Funds should be their truly long-term investment horizons.

Source: 2007 Cleary Gull Investment Management Services

Macro Environment: January 2008	
Positives	Negatives
Economic growth continues in most non-US economies	Slowing economic growth in the US
Pro-active central banks: Federal Reserve; Bank of England; ECB; and BOJ	Consumer Credit/Housing concerns
Ex-financials, earnings growth remains resilient	Geopolitical risk
Healthy corporate balance sheets <ul style="list-style-type: none"> • Cash near record levels • Stock dividends, dividend increases • Financial institutions have raised new capital from sovereign wealth funds 	Inflation worries

Source: 2008 Lazard Asset Management, LLC

in, helping at least in part to fill this liquidity vacuum.

The table below from Lazard summarizes some of the positives and negatives of today's market landscape. Granted, emotions are high, but the news is not all bad. Prudent diversification as always, is critical, especially in light of current, heightened levels of volatility.

Another interesting point to remember, made by Abby Joseph Cohen (also in the *Barron's Roundtable*) is that stock prices today are roughly at where they were at the end of 1999, while US GDP is up 50% and corporate profits are up 75% since that time. At its peak in March 2000, the market was selling at a multiple of 28 times earnings while today (leaving some additional room for declining profits) it is selling around 16 times earnings, which is in the long-term range of what is considered fairly valued. While we may very well see further declines in stock prices going forward, appropriately dedicated and maintained equity allocations within a diversified portfolio will be well positioned, as they have in past recessionary periods, when the economy recovers.

were advanced by structured investment vehicles and other financial conduits without the maintenance of the 15% reserves banks normally hold against deposits, presents a unique credit-tightening situation which may well take a while to work its way through the system. In the meantime, Sovereign Wealth Funds have stepped

