

January 2008

To: Our Friends and Clients

From: Robert Bingham, CFA
SKY Investment Group LLC

Re: Fourth Quarter 2007 - Review and Outlook

“It’s becoming very moot as to whether we are in a recession. Companies are telling you, the bond market is telling you and consumers are telling you – it’s baked in.”

-Quincy Krosby, chief investment strategist at The Hartford

Despite the stock market’s volatility and the fireworks surrounding the meltdown in the non-conforming mortgage securities markets, the fourth quarter was fairly benign. The S&P 500 closed down 3.33%, the Dow Jones Industrials posted slightly worse returns falling 3.91% for the quarter and the tech-heavy NASDAQ Composite fell 1.62%.

For the full year, the S&P 500 closed up 5.49%, the Dow advanced 8.88% and the NASDAQ Composite rose 10.66%, all assuming reinvestment of dividends.

Bonds, in anticipation of future economic weakness and easing by the Federal Reserve, posted strong positive returns. The Merrill Lynch 1 – 12 Year Municipal Index returned +1.86% for the quarter or 4.98% for the year. On the taxable side, the Lehman Brothers Intermediate Government/Corporate Index returned 2.91% for the quarter, bringing total return for the year to 7.39%.

Needless to say, continuing worries by investors about the sustainability of U.S. economic growth has taken its toll on stock prices during the first few weeks of 2008. There has been much talk in the media about the likelihood of recession this year. While we agree that a slowdown, particularly in consumer spending, seems inevitable during 2008, the impact on S&P 500 corporate earnings will probably be more modest. Economic strength outside of the U.S. remains strong. U.S exporters are experiencing a renaissance as the impact of the weak dollar improves their competitiveness and drives sales of U.S. produced goods to international markets.

Further, as has been made apparent by the interest of non-U.S. investors in acquiring stakes in troubled U.S. banks, the dollar is cheap and makes U.S. direct investment attractive to foreign investors. As the year unfolds, we expect corporate earnings prospects to gradually improve, the dollar to strengthen, and more movement by foreign investors to acquire inexpensive, globally active, U.S.-based companies. S&P 500 earnings in the upcoming 3rd and 4th quarter should look particularly strong, as banks lap the massive write-offs related to

last year's dismal 3rd and 4th quarter hits and begin to once again reflect their underlying profitability.

As of this writing (1/21/08), the S&P 500 has corrected by 18% from its October '07 highs. It seems inevitable that the pundits will proclaim that we are in a bear market as the decline approaches 20% (the market's official definition of a bear market). Of course, this will be in hindsight, and we wouldn't be surprised if the markets bottom in the first quarter of 2008. Stock prices are extremely cheap relative to interest rates and earnings already, and so any further decline from here will only improve the stock market's attractiveness for value oriented investors.

2007 Commentary

While many factors drove the uneven performance of the financial markets during 2007, none was quite as dramatic or influential as the meltdown in the market for sub-prime mortgage securities. Just to review, sub-prime mortgages are home loans issued to homeowners with credit characteristics or borrowing needs unacceptable to the big government chartered lenders, Fannie Mae and Freddie Mac.

Difficulties in sub-prime mortgage markets have negatively impacted securities markets in several ways. First off, fewer types of mortgages are being offered because mortgage underwriters can not sell as easily the various mortgage offerings once provided. Capital markets have been spooked, and as a result, the ability to package and sell mortgages and other assets as securities has been sharply reduced. The most visible impact from this change is that fewer mortgages are being offered, fewer people now qualify for mortgages, fewer homes are being sold, and fewer construction projects are being initiated. Needless to say, these events slow the economy's growth rate directly through reduced construction, and indirectly, through reduced consumer, home-equity-based wealth and spending.

More concerning though, is the impact on the economy from the increasingly constricted capital markets. Wall Street has aggressively turned all types of loans into securities, from mortgages to car loans to credit card loans and large-scale leveraged buyouts. These securitizations have drawn money from around the world and financed growth in the U.S. economy over recent years, but may not in the months ahead. Importantly, much of this lending has taken place outside of the Federal Reserve's realm, i.e. in the securities markets. Consequently, Federal Reserve actions to stimulate economic activity will be less influential. It is likely much of the liquidity available for securitizations will not return to the market anytime soon. Instead, attitudes toward risk need to change before the securities markets once again fund economic growth. This adjustment will take time and is unlikely to return to the "Wild West" mentality prevailing at the beginning of 2007.

Those most affected by the curtailment in the pace of securitized lending are likely to be consumers and highly leveraged corporate borrowers. In contrast, firms which are self funding and have strong balance sheets, especially those not dependent on discretionary consumer spending, are likely to thrive. Consistent with this, globally-oriented, financially strong companies posted good returns in 2007. As our investment approach emphasizes these types of companies, our clients enjoyed good returns in 2007, despite the volatility.

2008 Outlook

While the first several weeks of 2008 have been difficult for equity investors, we expect the market's early weakness to give way to strength in the second half of the year. The Federal Reserve has been easing aggressively and some kind of fiscal stimulus package is likely too. Valuations of stocks, and in particular "Blue Chips," are very attractive relative to earnings, cash flow and interest rates. U.S. assets are cheap when measured by foreign currencies. Foreign investment should accelerate as foreign investors take advantage of our low prices.

Non-financial corporate earnings are likely to prove more resilient to domestic sluggishness because earnings growth is coming from overseas markets. Hewlett Packard is a case in point: 67% of sales come from outside the United States; or consider Applied Materials: 84% of sales come from outside of North America. Fears of domestic economic weakness have hit both stocks, but the actual impact of even a U.S. recession on results is likely to be manageable.

Another factor favoring a resumption of stock market growth in the second half of 2008 is a resumption of meaningful corporate profit growth. This is likely to come from several sources. First, financial companies will start to lap the poor results posted in the third and fourth quarters of 2007. As a result, S&P 500 profit growth is likely to be quite strong on a relative basis. Secondly, losses in the banking system have been front-end loaded because they are the result of markdowns in securities prices in anticipation of future loan losses. The securities markets are very efficient at marking assets to market (in this case securitized loans.) So the period in which losses are realized are front-end loaded and likely will pass quite quickly. This is in contrast to traditional banking where loans are marked down as they become non-performing. As a result, the correction cycle for the big banks has been compressed into months instead of years. Note too, that the actual losses may well be less than the market expects, especially if the Fed eases meaningfully or if loss mitigation activities are effective. If so, some of the securities may well be marked back up, releasing loss reserves and helping bank earnings in the future. Only time will tell, but our guess is that aggressive Federal Reserve action and loan workout activity will prevent the worst default fears from materializing.

Closing Comments

As Peter Perkins, managing editor of BCA Research's Global Investment Strategy (1/18/08) observes, "...history indicates that it is risky for investors to bet against the Fed." And while the U.S. Fed is behind the curve, Chairman Bernanke has been taking steps to catch up. And as Perkins points out, the European Central Bank's (ECB) "...uber-hawk Axel Weber indicated that inflation is only temporarily elevated," and "...with other members also taking a less hawkish tack, it appears the ECB recognizes the developing threats to economic growth." If the ECB starts to cut rates mid-year, it should take some of the pressure off the Fed to defend the U.S. Dollar and allow the Fed to cut rates to levels corresponding to bond market expectations. In such a climate, stock prices worldwide may perform nicely.

The recent panic in the markets has been caused by recessionary fears. Yet there is a difference between a recession and an economic slow down. If the economy muddles along with zero to one percent growth, corporate earnings will continue to grow. Certainly there will be deep pockets of weakness, and specifically in the housing sector. But the cheap dollar will support product sales which should lift corporate earnings and in turn strengthen prospects for a stronger second half of 2008.

All in all, we think that stocks are close to their bottoms for this current economic cycle and by mid-year should be poised to move higher. In contrast, high grade bonds and Treasuries are probably close to their cyclical highs and deserve great caution.

We welcome your questions and comments.

Stocks noted valued as of market close January 18, 2008:

Applied Materials Inc. AMAT 18.02

Hewlett-Packard HPQ 43.75

SKY Investment Group LLC
One Financial Plaza, Suite 2010
Hartford, CT 06103
(860) 761-9700
www.skyig.com