The Oarsman Outlook

Fourth Quarter 2007

Growing worries that the real-estate slump could tip the U.S. economy into recession combined with renewed credit-market turbulence resulted in a negative fourth-quarter for most equity investments. Despite the yearend setback, however, 2007 went into the Wall Street annals as the fifth consecutive year of gains for U.S. stocks.

Among U.S. stocks, those in the Basic Materials, Consumer Staples, Energy and Technology sectors fared best in 2007. Lagging were stocks in the Consumer Cyclical, Financial Services and Health Care areas. Blue chips solidly outperformed smaller-company stocks, and “growth” bested “value” for the first time since 1999. Outside the U.S., strong results from European markets and lackluster results in Japan were both boosted by appreciating currencies. Emerging markets soared, paced by Hong-Kong-listed Chinese “H” Shares, which gained nearly 55% (following an 80% rise in 2006). Commodity-linked investments gained impressively (more than 20%), while commercial real-estate languished (down more than 15%) after a remarkable seven-year run.

Benchmark Performance – Equities

	Fourth Quarter 2007	Last Twelve Months
S&P 500 Index	-3.3%	+5.5%
Dow Jones Industrial Avg.	-3.9%	+8.9%
Large-Cap. Core Mutual Fund Avg. (Lipper)	-3.0%	+5.8%
Small-Cap Stocks (Russell 2000)	-4.6%	-1.6%
Non-U.S. Stocks (Dow Jones World ex-U.S.)	-1.6%	+14.4%

Benchmark Performance – Fixed Income

	Fourth Quarter 2007	Last Twelve Months
Intermediate-Term Taxable Fund Avg. (Lipper)	+3.0%	+7.0%
Intermediate-Term Muni Fund Avg. (Lipper)	+1.4%	+3.4%

Review of 2007

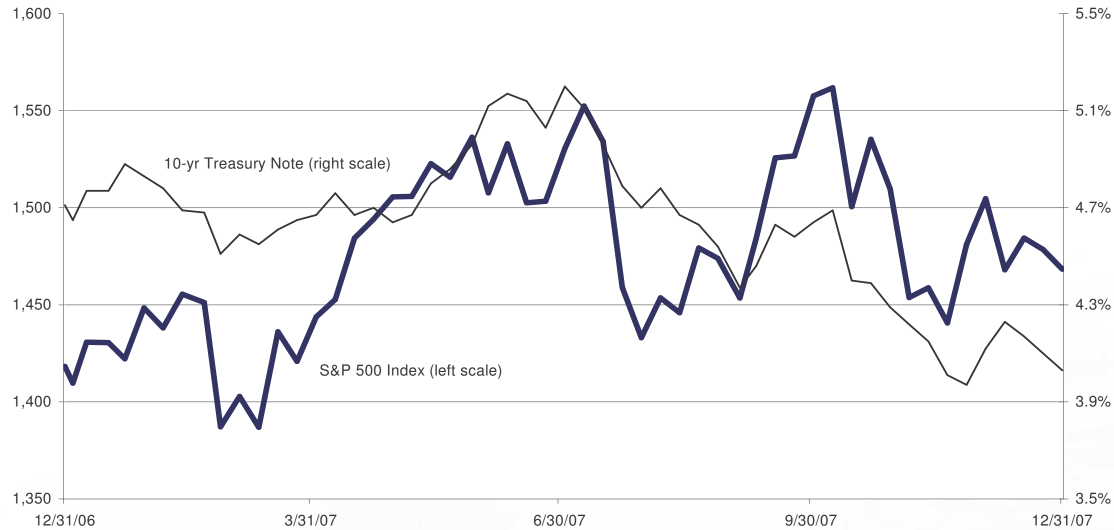
The year 2007 marked a turning point in the current economic/investment-market cycle. The period from early 2003 through 2006 was characterized by recovery of confidence and adjustment to new realities following the tech-stock bubble/bust, recession, terrorist attacks and the onset of two foreign wars. Following an ugly three-year bear market, stocks surged in 2003 and added more modest gains in each of the next three years. Meanwhile, real-estate values that had been rising steadily since 2002 kicked into high gear from 2004 through 2006.

Particularly noteworthy was the smooth, low-volatility nature of both markets’ advance, propelled by historically low interest rates engineered by a Federal Reserve keen to avoid a deflationary spiral like that endured in Japan following a 1989-1990 stock-market and real-estate collapse. These conditions fostered growing confidence and willingness to assume debt on the part of both financial-market and real-estate investors, and probably had a hand in the strong advance of many equity- and commodity-oriented investments during the second half of 2006. Unfortunately, the same conditions also fueled the final stages of the real-estate bubble, and facilitated both the engineering and marketing of complex fixed-income and derivative investment products whose initials (CMOs, CDOs, SIVs) have become synonymous with the credit-market meltdown that has likely cost global financial institutions at least $500 billion.

Our colleagues at the bond-manager PIMCO, recalling the work of economist Hyman Minsky, have noted that the real-estate bubble and subsequent collapse were the near-inevitable outcome of the 2003-2006 investment milieu. Minsky's thesis boils down to the observation that financial-market stability eventually begets instability. Presented with a run of low volatility and low interest rates (i.e., stability), investors, who tend naively to extrapolate prevailing conditions far into the future, respond by assuming increasing amounts of debt. Before long, investments are being made whose viability depends on the ability to "roll-over" short-term debt under something resembling currently available conditions. Such "speculative finance" aptly describes adjustable-rate mortgages (ARMs), which are beneficial so long as they can be refinanced under attractive terms before they "reset" to not-so-attractive terms. Given more time, burgeoning confidence (and greed) leads to leveraged investments viable only assuming a further rise in the price of the underlying asset. This "Ponzi finance" stage perfectly anticipates "negative-amortization" mortgages, which allow homeowners to borrow each month a portion of their (presumably ever-growing) equity to make interest payments they could not otherwise afford.

With real-estate markets increasingly supported by "speculative" and "Ponzi" mortgages, the stage was set for a spectacular collapse. Exactly what finally tripped the market is hard to say – perhaps no more than the combination of rising interest rates (recall that the Federal Reserve was gradually ratcheting up rates through 2005 and early 2006) and the sheer height to which prices had risen. But once prices stopped rising, "Ponzi" mortgages were immediately untenable. As this became clear, lenders suddenly became more cautious and the mortgage-securities market began to seize up. The resulting higher borrowing costs and, more important, tighter lending standards called into question the ability to refinance the much more numerous "speculative" ARMs, which, in turn, exacerbated the mortgage-market turmoil. Soon, terms were deteriorating for all kinds of loans, even "plain-vanilla," 30-year, fully-amortizing notes to qualified borrowers, removing potential buyers from the market while lowering the prices remaining buyers were willing (or able) to pay. Most observers expect this "negative-feedback-loop" to continue pressuring house prices (and credit markets) through a good part of 2008.

S&P 500 Index Price and 10-year Treasury Note Yield



<u>Outlook for 2008</u>

While never crystal clear, the economic/financial-market outlook is arguably murkier than at any time since just before the invasion of Iraq in early 2003. The housing downturn, which promises to be the worst since the Depression, threatens to tip the U.S. economy into recession: some economists believe this has already occurred; the consensus is that the likelihood is at least one-chance-in-three. Meanwhile, credit markets are experiencing the worst dislocation since the 1998 collapse of the Long-Term Capital Management hedge fund, restricting the liquidity essential to the functioning of the financial sector and damping confidence across corporate America. These predominantly domestic problems have rippled across the oceans thanks in part to the ever-increasing “globalization” of industry and, especially, finance: growth prospects in both Europe and Japan have been ratcheted downward and the question on everyone’s lips is whether emerging markets (e.g., China, Brazil, India) can “decouple” from slowing developed economies and continue their torrid growth of recent years.

We don’t believe the housing slump alone will be sufficient to cause recession. Economists estimate – imprecisely but with much rigor – that a dollar of lost real-estate equity translates into a reduction of current spending of between five and ten cents. That is, if your $250,000 house is suddenly worth $225,000, all else equal, you might curtail your annual spending by around $1,500. *In otherwise normal times*, however, that notional belt-tightening is more than offset by rising income, appreciating financial assets and/or tapping additional sources of credit, resulting in perhaps a slowing of spending, but not an outright decline.

The question, of course, is: are these “otherwise normal times?” So far, despite a year of falling house prices and five-plus months of credit-market turmoil, the broad economy has continued to support a reasonable rate of job creation and wage growth, both of which are <u>much</u> stronger influences on consumer spending than are real-estate (or stock market) prices. Worryingly, however, recent statistics – including holiday-sales figures, durable-goods orders, and purchasing-managers’ and employment surveys – suggest that growth is flagging. Declining bond yields and a faltering stock market seem to provide corroboration.

In this highly uncertain environment, we would expect the Federal Reserve to act decisively. The *sine qua non* with regard to supporting the broad economy (and consumer spending), it seems to us, is to restore the normal functioning of the financial sector and prevent a lingering credit crunch from further undermining broader corporate-sector confidence. A secondary goal ought to be to help offset the deflationary impact of declining real-estate values.

The Fed's actions to date (lowering overnight interest rates by one percentage point and facilitating borrowing by member banks) and, to a greater degree, its public pronouncements have indicated a surprising degree of caution, apparently out of concern for stoking inflation and perhaps also a disinclination to be seen as "bailing out Wall Street." We believe this caution is misplaced. Despite near-$100/barrel oil and surging food prices, there is little if any evidence of the kind of wage-price spiral necessary to turn rising prices for some goods into generalized inflation. In fact, measured core inflation has been in a <u>declining</u> pattern for a year or more, and inflation-expectation signals from the bond market suggest investors think it will stay that way. Moreover, global economic growth is clearly slowing, easing demand-side pressures on both goods and labor costs. Finally, the real-estate slump and credit crunch are both distinctly deflationary impacts. We believe you will hear less and less about inflation as 2008 unfolds.

We are hopeful – and increasingly confident – that early-year economic statistics like the weak employment report for December will soon convince central bank officials that the downside risks to growth clearly outweigh any threat posed by inflation. We expect overnight rates to fall hard and fast during the first half of the year, and would not be surprised to see additional innovative efforts to restore confidence in the financial sector. These actions would provide a powerful liquidity "tide" to buoy the intrinsic value of all investments, including not just real-estate, stocks and bonds, but, importantly, business investments in both labor and capital. Combined with the stimulative impact of a weak dollar and still-healthy demand from key export markets, that tide could well be sufficient not only to avert recession, but also to create a powerful stock-market rally later in the year (just as the Fed's actions in late 1998 fueled the tech-stock blow-off that climaxed in 1999 and early 2000).