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Investment Review and Outlook

Investment Commentary January 2008

The major equity indexes notched their fifth straight year of gains in 2007. The S&P 500 rose 5.5%, the Dow gained 6.4%, while the Nasdaq was ahead by 9.8%. Large cap indexes outperformed small cap indexes for only the second time in eight years, and equity growth indexes outperformed their value counterparts. The Large Cap Russell 1000 Index gained 5.8% while the Russell 2000 Small Cap Index lost 1.6%. The Russell 1000 Growth Index was ahead by 11.8%, compared to the Russell 1000 Value Index which lost 0.2%.

During the last quarter of the year, all major domestic equity indexes declined, as increased worries about recession, Fed policy, and the spreading housing crisis sapped investor confidence. The S&P 500 lost 3.3%, the Dow was down by 4.5%, and the Nasdaq declined by 1.8%. The one bright spot among equity markets in the fourth quarter were the emerging markets, with the MSCI Emerging Markets Index gaining 2.9%, and 33.2% for the year.

The poor showing of value stocks last year was directly tied to the dismal performance of banks, brokerage, and housing stocks which have a meaningful representation in the value indexes. Collectively, these stocks were down 10% in the fourth quarter, and 50% for the year. In addition, going forward the heavy cyclical exposure in the value indexes could cause their performance to lag behind growth indexes in a weak economic environment..

High quality bonds were a standout in 2007. While most analysts, including ourselves, were more sanguine toward stocks than bonds in the beginning of last year, top-quality bond returns exceeded the gains of the major stock indexes. The Lehman Aggregate Bond Index rose 7% last year, and 10 year Treasury bonds gained 9.7%. Over one-half of these returns were generated in the fourth quarter in an investor flight to quality amid Federal Reserve rate cuts, fears about bank solvency, and demonstrably slower economic growth. Not all bond sectors fared as well, however. Bank and Brokerage bonds gained only 3.5% last year, and the bonds of homebuilders posted a 5.6% negative return. Investment-grade corporate bonds in general were only ahead 4.5%. Short term floating rate bond funds, which have been stellar performers over the past few years, increased only 1.1% as the adjustable-rate loans in these funds were marked down in price in an investor flight to quality.

The major surprise in the fixed income markets in 2007, however, was the disappointing returns of municipal bonds. Long term municipal bonds returned only about 2% last year. Most municipal bonds carry insurance via AAA-rated bond insurers such as Ambac and MBIA. Given their AAA ratings, such insurers guarantee the payment of interest and principal in the event of default. In essence, states and municipalities that do not have top credit ratings “rent” the AAA rating of the insurer, and thereby are able to attain lower financing costs.

These insurers came under fire in 2007 because of their other activities in insuring sub-prime mortgages. The losses in that business have threatened their AAA rating and endangered the insurance backing of over a trillion dollars in municipal bonds. As a result, investors sold municipal bonds and their prices fell. The major rating agencies have now affirmed the AAA ratings as the insurers have sought additional capital to strengthen their balance sheets. However, the rise in investor apprehension over credit quality led to a modest 2.3% return for long-term California municipal bonds in

2007. Given the steep decline in yields on Treasury securities last year, long-term municipal bond yields are now nearly equal to those on long term Treasuries. This happens very seldom, and when such occurrences happened in the past (most recently in the early 1990's), municipal bonds subsequently posted outsized returns. That is our expectation for 2008.

We believe we are entering the latter stages of a five year bull market, and the early stages of an economic slowdown, but not a recession. During such transition phases (similar to 1984-1985 and 1995) in the past, the stock market underwent corrections which created new leaders for the next market upleg that can last several months to a couple of years. The leading sectors of the 2007 market advance (energy, industrial materials, and technology) are losing favor, and last year's laggards are now gaining relative strength – consumer staples, healthcare, and non-bank financials. This process typically produces heightened volatility in the overall market, and violent daily movements.

The important thing to keep in mind is that rarely do stock market tops coincide with aggressive Fed easing (happening now), below average stock valuations (price earnings ratios of 16 compared to an average of 18), 3% market interest rates, and rapid increases in liquidity. The fear of recession is well-publicized and well-recognized by the Fed and other policymakers, as is the awareness of the need to “do something.” These factors are usually very market friendly. It is unlikely that a recession itself would have much impact on the overall markets, as they are forward-looking, and are now in the throes of valuing the prospects for the second half of the year. The equity markets are clearly in transition on this question, adding to volatility.

As of now, our work still has not pointed to the onset of a bear market, though some of our indicators have been close. Technical indicators of market momentum are nearly in bearish territory, and recent selling panics have driven equity prices lower as analysts' jump on the recession theme. The Fed has recently been awakened to the urgent need for further steps to lower interest rates, and that should occur in the first quarter with the Federal funds rate likely to be in the 3-3¼% range by the end of March. Just as important, the global nature of the current mortgage and housing meltdown suggests coordinated central bank action to lower interest rates and restore investor confidence that the monetary authorities are not behind the curve. These actions should set the stage for a reacceleration of U.S. economic growth in the second half of 2008, and more optimism for the trend of corporate profits going into late this year and 2009. Under such circumstances in the past, stock prices have typically advanced.

Election years have produced positive equity market returns about 70% of the time since 1888. During these even-numbered fourth years, markets are usually volatile and produce modest or negative returns early in the year, and positive returns in the second half. It appears that market action so far in 2008 is following the script.



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