2007 a Volatile, Below-AverageYear – 2008 Should be Different

Annual Outlook: January 2008 It's that time of year when everyone is full of predictions, from politics to weather to you-name-it. In this Annual Outlook, we'll just comment on the stock and bond markets. As we do each January 1st, we'll show you what the stock market "gurus" are predicting and we'll also calculate our own estimated range for the S&P500 this year. By going through this annual ritual, we hope to better understand the current market environment and position our portfolios accordingly. Immodestly, we find our own predictions have been consistently good at predicting the stock market high for the year (last year we predicted an S&P500 high of 1,525 vs. actual at 1,565). As for bonds, we were closer than any of the "gurus" on interest rates with our forecast for 4.5% 10-year interest rates vs. their forecasts of 4.5% - 5.1% (they closed at 4.04%). Before we go through our annual process, let's briefly review the year just ended.

Looking back at 2007, it should be remembered as the Year of Volatility. Stock markets were very volatile with big up days followed by big down days. Back and forth. But in the end, it was only a modestly positive, below-average year. The S&P500 only gained 3.5% and the smaller-cap Russell 2000 lost 2.7%. International stock markets (EAFE Index) fared a bit better gaining 7.2%. Bonds returned about 5.4% while REITs got crushed losing 18.1%. It was a wild ride for such modest returns. One measure of volatility is "90%-days" where 90% of the daily volume is to the upside or downside. According to Lowry's Research, 90%-days are rare and over the last 50 years 90%-days have occurred just 4x / year on average. But in 2007 there were an amazing 23 90%-days, 9 up and 14 down. Now that's volatility! In our last year's forecast, we called for more volatility but truthfully not like this. We thought the volatility would come more in the form of up and down trends, not just daily whipsaws. The overall volatility for the year was only 14% from high to low, which is actually less volatile than average (about 20%). Looking ahead to 2008, our prediction is for more volatility again, but more in the way of trends that last several months at a time, and a high to low range of at least 20%.

Enough of looking backwards, let's march on. Each year at this time we go through the same 4-step process to come up with our predictions for the year ahead. By keeping the process the same, we can see what works and what doesn't. One thing we've learned is that the median prediction is rarely right, so we study the range and dispersion of the predictions carefully. Additionally, no single "guru" seems to be consistently right which is interesting given how much they're paid and the respect they command. Our 4-step process includes studying 3 surveys and then doing our own work to calculate a reasonable range for the stock market and our interest rate forecast. Let's walk you through the numbers and see what our work is showing for 2008.

Our first step is to consider the annual *Business Week* survey (1/4/08 – already in print) of leading market analysts. This year's survey only interviewed a dozen strategists and all but two are expecting the S&P500 to be higher at the end of 2008. That's an 85% bullish consensus and consistent with prior years. The way we use this survey is to look at the trend and dispersion of the estimates. What we find is an S&P500 year-end estimate ranging from 1,350 to 1,780. (Last year's range was 1,440 to 1,590). Since we're starting at 1,468, that equates to a wide range of -8.0% to 21.2%. That is much different than the tight range predicted last year. That means some of these are going to be terribly wrong! Reading through the interviews, what stands out is the differing opinions over whether we go into a recession (and thus down), or whether the worst is mostly behind us and a recovery (and thus up) is ahead. Again, there is no consensus. Either housing prices continue to slip, consumer

spending slows, and job losses continue, or the "sub-prime" mess of 2007 is contained to financial stocks and we've already seen the worst of it. We'll see. But what we glean from this report is that there is no consensus this year, and the most likely outcome is more volatility than 2007 as we sort it out.

The second survey we consider is the year-end survey from *Barron's.* This year *Barron's* asked 12 analysts to predict how the S&P500 Index and 10-year Treasury bond interest rate will close next year, 12/31/08. As always, they didn't ask for the volatility or range, just the year-end number which, admittedly, is hard to do. (We avoid this prediction trap by only offering a range). This survey is considered a bit more "elite" with a narrower field of better-known, and better-respected, analysts participating. None of the analysts are accurate year in and year out, but we've highlighted the top 3 from the last several years and give them a bit more weight for their 2008 year-end predictions. This is what they guessed:

Analyst	Firm	Top 3	S&P500 Prediction	10-year T-Bond %
Francois Trahan	ISI Group		1,750	4.00%
Jonathan Golub	Bear Stearns		1,700	5.00%
David Bianco	UBS Securities		1,700	4.00%
Abby Joseph Cohen	Goldman Sachs	2006	1,675	4.00%
Tobias Levkovich	Citigroup	2006, 2007	1,675	4.40%
Jonathan Morton	Credit Suisse		1,650	4.25%
Larry Adam	Deutsche Bank		1,640	4.75%
Ian Scott	Lehman Brothers		1,630	4.20%
Tom McManus	Banc of America	2005, 2007	1,625	5.00%
Thomas Lee	JP Morgan		1,590	5.00%
Abhijit Chakraberti	Morgan Stanley	2005, 2007	1,525	4.50%
Richard Bernstein	Merrill Lynch	2005	1,525	3.70%

While not quite the range of the *Business Week* survey, it is still a wide range and nearly as optimistic (1,750 vs. 1,780 high forecast of *Business Week*). Also, the range is wider than last year's forecast (225 points vs. 160 points last year). In 2006, the best forecasters differed significantly and last year, 2007, the best forecasters were huddled together. This year, we go back to the better analysts having significantly differing forecasts again. Lastly, the interest rate forecasts are also fairly wide this year, from 3.70% - 5.00%, compared to the narrow range of last year of 4.50% to 5.10%. Like the *Business Week* survey, our conclusion is that there is less consensus this year, and a wider range of growth forecasts from 3.4% to an optimistic 18.6%. Again, some of these analysts are going to be very wrong but the forecast for volatility seems to be consistent.

The third and final forecast that we look at annually is the *Value Line Investment Survey*. It has been ranked #1 for risk-adjusted returns for over 25 years according to The Hulbert Digest, a service that ranks newsletters. Among other things, *Value Line* publishes one proprietary number each week called the "Median Appreciation Potential" (MAP) that estimates the return potential over the next four years for the markets. A high number is bullish and a low number is bearish. In the past five years, the MAP has ranged from 40% (a recent market top on 5/05/06) to 115% (a market bottom on 10/09/02). Last year the number was a bearish 35% which proved to be fairly predictive of the sub-average year of 2007. Although improved, we remain a bit cautious as the "MAP" is currently at a fairly low 50% today. This survey seems to fit in the lower end of the range of both the *Business Week* survey and the *Barron's* survey, above. The *Value Line* "MAP" doesn't predict the fluctuations in the market, just that the next four-year return will be below average for a buy-and-hold investor. This isn't so

discouraging to us, however, as our strategy of trading the trends should allow us to beat the market overall. What the survey also tells us is that we are unlikely to be at the beginning of a new bull market rally.

Lastly, our 4th step is to go beyond the noise from the market "gurus" in the three surveys above, and do our own "old school" homework. We calculate our own range forecast for the S&P500 based on expected earnings and price/earnings multiples. Each year we look at the unbiased S&P website, www.spglobal.com, to look at earnings forecasts, both "operating" and "reported". While we have always taken their unbiased earnings forecasts as the best thinking of the day, this year we must digress. This year, we think the S&P earnings forecasts are simply too optimistic given the recent significant decline in earnings. Earnings in the 3Q of 2007 dropped significantly (-9.3% for operating and -29.4% for reported) primarily due to write downs and losses from the "sub-prime" crisis. And 4Q 2007 is expected to drop by another 5% - 9% year / year. And yet S&P is forecasting 9% - 15% earnings growth for 2008 and we're just not buying it nor are many of the analysts in the three surveys above. So we're adjusting the earnings forecast for 2008 to a more probable 4% - 5% range. To these earnings forecasts, we carefully estimate the year-ahead price/earnings multiple range based on current levels, interest rates, and historical averages. We start the year with the S&P500 trading at 19x trailing price/earnings ratio, which is a little high (not cheap) based on historical multiple ranges. Putting it all together, we calculate the following results as our own 2008 forecasts:

	2003	2004	2005	2006	2007 with 4Q estimates	2008 Est.
Operating Earnings	$54.69	$67.68	$76.89	$87.72	$88.13	$92.00
Reported Earnings	$48.74	$58.55	$69.69	$81.51	$76.62	$80.00
Op. Earn Multiple	14-20x	16-18x	15-17x	14-16x	15-18x	14-17x
Rep. Earn Multiple	17-25x	18-21x	16-18x	15-17x	18-20x	16-19x
S&P500 Range:	789-1109	1063-1213	1136-1268	1224-1427	1374-1565	1275-1550

To summarize, we forecast that the S&P500 will be in a 1,275 – 1,550 range for 2008, assuming that earnings improve about 4%. Our earnings forecast are based on our expectation of continued economic slowing at the beginning of the year followed by recovery in late 2008. Our 275-point range prediction equates to 21% from bottom to top which is significantly more than this year's 14% range. But as we stated earlier, we believe that volatility will increase again this year, and a 21% range is merely a return to a normal range for the S&P500, where the last 10 years range has been 12% - 51%.

Compared to most of the "gurus", above, we are a bit more bearish on stocks. As for bonds, our prediction for the 10-year US Treasury bond is 3.75% which makes us more bond bullish than the analysts, above. We've proven to be pretty accurate in prior years for the S&P500 "high" and on interest rates, and we have no reason to doubt our methodology this year. So watch for it, high of 1,550 and 3.75% 10-year interest rates. Regardless of our predictions, we have a discipline to protect and grow your money. We'll diversify and follow our trend indicators to keep you "in" each of the rising markets and "out" of the declining ones. Our biggest hope is that the rising volatility results in longer trends and less daily whipsaws. We're ready, now bring it on!