



STRATEGIC FINANCIAL
MANAGEMENT GROUP



Investment Strategies & Insights

4th Quarter 2007

The Rearview Mirror

Before we look forward to the new year, it is always valuable to take a quick look over our shoulder to 2007 since the trends of last year set the stage for 2008. In order to measure the impact of the financial world on our culture today, we have to look no further than the American Dialect Society. Every year this group selects words that have become common place and taken on significance during the year. For 2007, the second runner-up was "Green" and the first runner-up was "Facebook"...words that reflect the discourse over environmental concerns as well as the continued footprint that the internet is leaving on our societal landscape. But the winner for 2007 was "Subprime", which according to the American Dialect Society, "signifies the public's concern for a deepening mortgage crisis".

We would concur that the most significant event in the financial world last year was the revelation of the breadth and the scope of the use of high-risk investment vehicles tied to subprime mortgages with little or no public awareness. The risk that was added to the financial markets by the use of these complex investments by the banks, brokerage firms, and the hedge funds to generate higher returns is now being seen by the massive losses that most of these companies are reporting as write-downs against their earnings.

The fallout from this fiasco was the CEO's of Citigroup, Merrill Lynch, Bear Sterns, and others were fired as losses due to the subprime meltdown totaled over \$200 billion...so far. However, the resilience of the markets was demonstrated as the broad stock market was up almost 5.5% for the year in the face of the turmoil in the credit markets and the deceleration of corporate earnings for most U.S. companies.

On The Horizon For 2008

Initially, the market will focus on the actions of the Federal Reserve and whether they will aggressively drop interest rates in an attempt to reflate the economy and provide the necessary liquidity to help a banking system that has been battered by losses. Mr. Bernanke is obviously concerned, based upon recent comments, but the question remains if rate cuts will have the desired impact other than provide a possible "relief rally" in stock prices as investors often applaud any action viewed as positive.

Many people have focused on the need for liquidity in the banking system so that banks will be motivated to lend. We have seen Citibank receive \$7.5 billion from Abu Dhabi's sovereign wealth fund to shore up their capital. But upon closer examination, it does not appear that the banks are lending...even to each other. This is partially due to higher lending standards being imposed by government authorities, but this cannot account for it all alone.

Even though liquidity is important, it is not the only solution. As Ned Davis Research has said, "Liquidity is a coward...it runs away at the first sign of trouble." Until the extent of the losses due to the subprime structured investments within the financial industry are fully known, banks are going to be more concerned with their capital structure than in loaning money. Additionally, with the slowdown in corporate earnings, many companies are scaling back capital spending and trying to build up their balance sheets as the economy slows. Having liquidity and spending it are entirely different issues. It remains to be seen if the Fed can coordinate its policies with the recovery of confidence in the financial industry and create the needed capital flows to stimulate an economy that is already slowing.

**"Take calculated risks.
That is quite different
from being rash."**

George S. Patton

SUMMARY:

Subprime dominated the financial world in '07 as the fallout reached the boardrooms of Citi, Merrill, & others.

The Fed is attempting to increase liquidity to stimulate lending but banks are more concerned about preserving capital at present.

Both interest rates and inflation should decline in '08 as the economy slows.

Economic indicators show that the impact of declining housing prices and tighter credit is taking its toll as retail sales disappointed in December.

The outlook by CEO's for capital spending is not encouraging as corporate America is keeping their coffers full.

Time will tell if lower interest rates, a Congressional stimulus package, and continued foreign investment will be sufficient to jumpstart the economy.

Investment Strategies & Insights is mailed quarterly to our clients and friends. The intent of this publication is to share some of our most interesting views and research.



Inside the Economy

Inflation and Interest Rates

- After moderating for much of the year, inflation measures increased sharply in the 4th quarter.
- The Consumer Price Index (CPI) rose 4.4% for the year, due primarily to rising food and energy prices.
- The expectation for 2008 is that inflation will decline as the U.S. economy slows.
- The Fed will have to react to a slumping housing market, a weakening economy, and problems in the credit market by lowering interest rates.

Economic Output and Direction

- The leading economic indicators have continued their decline and indicate sluggish growth for the first half of 2008.
- The hope is that the Federal Reserve will be able to jump-start the economy by increasing liquidity for borrowing and lowering rates.
- If the housing markets bottom and banks can put the subprime problems behind them and get back to lending, then a slow down is all that we may have.
- We appear to be at an inflexion point where if the Fed's actions are considered to be too little and too late...the risk of recession rises substantially.

Business and Consumer Indicators

- Even though the decline in the dollar has made U.S. manufactured goods more competitive globally, the index that measures this segment of the economy just dropped into negative territory.
- In addition, the previous bright spot of a low unemployment rate jumped from 4.7% to 5%...surprising many economists.
- With this added pressure on the consumer, retail sales fell in December more than expected.
- Declining confidence is also evident in the business community as the measure of CEO's outlook for business conditions reached the lowest level in seven years.
- Weak confidence by those making decisions on capital spending does not bode well for corporate America coming to the rescue and stimulating economic growth.

Inside The Markets

The Stock Markets

- U.S. stocks declined in the 4th quarter as problems with the money center banks and brokerage firms unsettled the markets.
- Adding to the pressure was the second consecutive quarter of declining earnings growth.
- Some hold out hope that stocks will only suffer a correction in 2008 due to the fact that valuations have not reached the excessive levels seen in 2000 before the last bear market.
- International stocks continued to outperform domestic companies, spurred on by tremendous inflows of dollars from U.S. investors.
- The long-term global economic trends should continue, but volatility should increase if the U.S. economy slows and China is successful in slowing their rapid growth.

The Bond Markets

- Bond prices continued to rally due to declining interest rates as the bond market began to price in the slowing U.S. economy, expecting more rate cuts from the Federal Reserve.
- Additional downward pressure on bond yields will be seen as the uncertainties in the equity markets drive investors to the safety of Treasury bonds.
- The dollar remains lower against other currencies, but could rally against the Euro.
- Allocations to foreign bonds will be maintained as a hedge against the weak dollar with concentration in the Asia Pacific area.

Commodities / Alternatives

- Oil reached \$100 per barrel but has now pulled back to the low 90's.
- Much of the upward pressure on oil prices is due to speculators and the falling dollar.
- Other commodity prices have pulled back from their lofty levels but should remain strong if global demand surges again in the last half of 2008.
- Until the impact of the Fed's attempt to reflate the economy is seen in commodity prices, we will use caution and only add to positions on pullbacks in prices.



For the first time since 2001, the “R word”... recession...has become a part of the discussions about the direction of the economy. The problem with recessions is that by the time the people charged with the responsibility of determining if we are in one...it’s over. As a result, we believe that it is more important to look at the weight of the evidence and attempt to measure the impact on the direction of the financial markets.

When we look from the top down at the economy, the current outlook is not very bright. The broadest measure of our economic output is Gross Domestic Product (GDP) and it is projected to decline this year, especially in the first half. The initial catalyst for the decline was the residential housing market and it has continued to deteriorate. Despite slowing construction, the supply of unsold homes has continued to increase as prices have fallen. This has led to rising foreclosures that revealed the problems in the credit markets as high-risk mortgage packages began to unravel creating massive losses for banks and brokerage firms.

When examining the weight of the evidence, the most difficult things to measure are those that cannot be seen. The new Fed chairman, Ben Benanke, has attempted to make transparency a hallmark of his new regime. It is ironic that among our leading financial institutions, the lack of disclosure, not financial transparency, has been on the rise. The combination of a more transparent Fed policy and opaque financial markets has created a dangerous mix that has led to many financial excesses. When the Fed, and other regulatory agencies, failed to put into place disclosure requirements, market participants began to devise new ways to camouflage risks and create additional excessive credit.

Consequently, it is now apparent the monetary authorities did not know when a full-blown credit bubble was upon us...only when it bursts. The standard response to this type of crisis is to infuse new funds. This provides short-term relief, but in the long run, it does not repair the problem, and in effect, it enables those that created the issue. Under the previous chairman, Alan Greenspan, the Fed’s approach was that of economic libertarian.... let the markets decide winners and losers. But when this approach created excesses, Mr. Greenspan’s solution was to bail out the losers since the system that was created was now based upon the doctrine of too-big-too-fail.

This approach is not only evident with the large banks, but it can also be seen in the government’s proposals to bail out homeowners that entered into mortgages they cannot pay and houses they cannot afford. Easy monetary policy without consequences can only continue with the full disclosure of all financial participants to the risk that have been created in the credit markets.

The financial markets have apparently come the place that any news is being viewed as bad news. But there are good things that are in place that can accelerate a turnaround and get the economy back on pace once again. Even though we have seen unemployment rise recently, personal income remains strong providing a cushion for short-term financial bumps along the way. Moving to the corporate arena, most U.S. companies are on solid footing with plenty of cash and reduced debt from historic levels. In addition, there are sectors of the economy that are experiencing healthy growth, such as health care, defense, aerospace, and agriculture.

With the Federal Reserve indicating a willingness to act aggressively in lowering interest rates and the government now looking at economic stimulus packages, both monetary and fiscal policy is very accommodating. If foreign investment in the U.S. remains strong and the global economy continues to grow, the needed capital for growth may come from outside our borders. We believe that it is too early to tell what the outcome will be.... slowdown or recession.... bull or bear market. Until the weight of the evidence tips in a definite direction, we will be increasingly defensive in the portfolios.

Best regards,

Craig Greenway

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