

January 17, 2008

Dear Valued Investor:

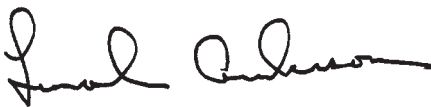
The media is now worried about recession. Doom and gloom is everywhere, and the stock market is off to an awful start this year. The Dow is down 6.0% year to date, and the S&P 500 is down 6.5%. Some (the optimists!) are comparing the current "credit market crisis" with 1998, when we had emerging market debt defaults and a big hedge fund named "Long-Term Capital" blew up. Back then, the S&P 500, which had been showing big gains, dropped about as sharply as it has lately and then recovered for nearly two years as the "credit crisis" faded.

I understand the point being made and consider it to be legitimate, but I would go further. Back in 1998, some corporate CFO's were pumping up earnings, and earnings "quality" suffered. Today, I think companies are for the most part much more careful in their reporting, given new legislation. Back in 1998, companies and investors were punch drunk on the internet, and fiber optics cable was being laid everywhere. Today, I think investors are much more cautious, and generally, companies are very cost conscious. For example, back in 1998 payroll employment was growing at about 2.5%, versus 1% this year. In 1998, business capital spending rose 11% in real terms, versus 5% now. And inventory investment hit all-time record highs in both 1998 and 1999, versus a near record low (excluding recessions) today. So I see no excessive hiring or plant and equipment investment or inventory overhang that needs to be eliminated. Yes, we did have a huge overbuild in the housing market, but that correction is, in my opinion, largely complete. From the peak at the end of 2005, real residential investment has already dropped 24% – the biggest fall since the 29% seven quarter drop in the 1982 recession. Housing starts are already down 56% from their peak 23 months ago, the largest 23 month decline since 1975.

So I do not see the excesses that still "need" to be corrected with a recession. Also, back in 1998 the S&P 500 Price/Earnings Ratio (the P/E) was much higher. On trailing earnings the P/E on the S&P 500 was about 30, and on forward earnings estimates it was about 23. Today it is about 18.7 on a trailing earnings basis (with the big hit on financial earnings) and about 13.3 on forward earnings estimates. To me, the lower P/Es take a lot of risk out of the market. Also, back then the credit crisis took the plain vanilla AA corporate bond yield above 8% in 1999. Today the AA yield is about 5.2%. Back then, total U.S. non-financial corporate balance sheets liabilities (debt) exceeded financial assets by about \$1 trillion. Today, financial assets exceed liabilities by about \$1.4 trillion. So I see record low balance sheet risk for aggregate non-financial companies.

Finally, I think this time around we have the Federal Reserve (the Fed) headed in the right direction. Starting out in September, the Fed has cut the fed funds rate from 5.25% to 4.25% currently, and I expect another ½ percentage point cut this month. So I think we will avoid recession, but I sure would like to see lower oil prices and a rising dollar exchange rate. As always, please call your financial advisor with any questions or concerns.

Sincerely,



Lincoln Anderson
Managing Director, Chief Investment Officer

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