

## **POLITICAL, ECONOMIC AND CAPITAL MARKETS REVIEW & OUTLOOK FOR 2008**

### *Summary*

- Globalization remains the primary underlying political and economic trend, but problems associated with it that emerged in 2007 will continue in 2008.
- Lack of strong global leadership will create political instability.
- Economic growth will moderate, but continue, as the global economy disengages from that of the U.S.
- Capital markets will be turbulent in 2008.
- Volatility and uncertainty will create risks, but also opportunities, in the markets in 2008.

### *Political Commentary*

For several years now, the focus of our annual political, economic and capital market analysis has been on globalization. In 2007 we witnessed the continuation of that trend, particularly with regard to economic growth and development of the capital markets. We are mindful of the problems concerning persistent poverty around the world. Nevertheless, we believe that the current level and extent of global economic prosperity is unprecedented in human history, and that the United States has stood at the forefront of this movement.

In 2007, however, we witnessed problems associated with globalization. In the political arena, these problems mostly pertain to the failure of global political structures to keep pace with economic growth. The most obvious manifestation is the lack of strong and effective leadership from the United Nations and our other supranational organizations.

In addition, due to weakness in U.S. political leadership, the balance of power is shifting from the United States in favor of other countries around the world. The economies of China, India and other nations have been growing rapidly, while the U.S. has been dissipating its resources. For years the U.S. has been mired in military actions in Iraq and Afghanistan. The United States has also been struggling with ongoing massive trade and budget deficits. Most recently its entire financial structure has been jeopardized by excessive mortgage lending to borrowers with marginal credit worthiness.

Another result of the weakness in U.S. political leadership is that it has led to the strengthening of dictatorships and other authoritarian regimes during the past year, including in Russia, Iran, Venezuela and elsewhere around the world.

In 2008, in our view, this lack of strong and effective leadership will continue. We do not currently see forces at play that will strengthen the United Nations or other global political structures. We believe any near term resolution to the military conflicts in the Middle East are unlikely. In addition, we believe that the United States will continue to lose stature in relation to the rest of the world due to ongoing military engagements, negative sentiment with regard to domestic subprime mortgage financing and a protracted presidential election with no clear front runners.

The result will be encouragement for other countries to continue to increase their independence from U.S. leadership. However, there will be no clear direction with regard to the balance amongst the emerging global powers. This will result in increasing instability, represented by barriers to free trade; friction over access to tightening energy supplies; new military conflicts; and difficulty in addressing critical global issues of environment and terrorism.

Also, as affluence in foreign countries increases, particularly in China, we expect that there will be greater desire of citizens within those countries for more political freedom over the next several years. Initially, we expect this trend will be only marginally disruptive, but that it will begin to be evident in 2008. This will enhance a climate of political instability.

In conclusion, we believe that the positive trends of globalization we have seen over the past several years will continue – but that problems associated with those trends will also persist into the New Year. We think that the lack of evolution of global political structures to accommodate economic development will increase the visibility of those problems. We believe that the current trend of diminishing power of the U.S. over the rest of the world will continue. In our view, as in the past, we think this failure of political leadership on the global stage and within the U.S. will be insufficient to derail the global economy. But it will hamper economic growth and increase turbulence in the capital markets.

### ***Economic Review and Outlook***

In 2007, we observed robust global economic growth. Growth was widespread among both developed and emerging economies, with a number of them growing by more than four percent. However, in addition to growth, we also observed the emergence of two threats to the global economy: (1) weakness in the U.S. economy, which could impede global economic growth; and (2) a developing credit squeeze, that could undermine the global financial structure.

With regard to the U.S., we see a faltering economy at the end of 2007. The U.S. consumer is struggling with a number of pressures, including a declining housing market, higher interest rates on adjustable rate mortgages, restricted access to debt and higher energy prices. We think these pressures on consumer spending will lead to significantly lower economic growth in the U.S. in 2008. In addition, despite sluggish demand for goods and services by consumers, we see signs that inflation has begun to seep into the economy. Rising inflation will limit the Federal Reserve's ability to lower key short-term interest rates to help alleviate economic slowdown. Despite these headwinds, we believe that the U.S. economy will skirt a recession in 2008, partially as a result of strong exports, but that it will be lethargic.

We anticipate slowing U.S. economic growth will have a negative impact on the global economy. A weak U.S. dollar and a slowing U.S. economy limits U.S. demand for foreign imports. However, we see a gradual disengagement of the world economy from its dependence on U.S. economic strength. The U.S. share of world imports has now declined to 14%, while trade between countries excluding the U.S. continues to expand. Emerging markets, such as China, Brazil and India, now contribute half of worldwide GDP growth. The growing strength of these markets will likely continue. Growing demand for goods and services by residents within these markets supplements the external demand for emerging markets' products and services. Moreover, many emerging markets have strengthened their foundations through economic reforms, reduced government budget deficits and large foreign exchange reserves. This strong financial footing should enable them to better negotiate weak periods. We think that the strength of the global economy will offset U.S. economic weakness over the coming year.

The other concern we have regarding the global economy is that the credit squeeze that originated with rising defaults on subprime mortgages within the U.S. threatens the global financial structure. Although loan defaults are occurring within the U.S., both U.S. and foreign investors hold securities backed by these mortgages. The impact of the defaults on lenders and investors is global. The risk is that a restriction on the availability of credit will lead consumers and businesses to significantly cut back spending.

We believe there is risk that these credit problems will have a substantial impact on the world economy. Although most of the problems related to subprime mortgages have been recognized, they will take time to work through the financial system. Credit problems may surface in other sectors of the financial markets, as well, such as with leveraged buyout debt. Also, the current credit squeeze involves loans that banks have removed from their balance sheets, packaged into investment securities and sold to entities outside the regulation of central banks. Given the global nature of the credit squeeze, we see the Federal Reserve working with other central banks around the world to restore order in the financial markets. We are uncertain, however, if the tools and methods they currently have at hand will be adequate to resolve the problems.

Nevertheless, despite the threat to the global financial structure that this credit squeeze may have, we believe this is primarily a monetary phenomenon that will have limited negative bearing on economic growth in 2008. We believe that the global economy remains fundamentally sound and will continue to grow moderately, as it gradually disengages from dependence on U.S. growth and as emerging economies remain strong.

### ***Capital Markets Review & Outlook***

In 2007, the markets provided overall favorable returns for investors. Total return on the S&P 500 stock index was 5.5%, although discrepancy between sectors was wide. Foreign stock markets, particularly emerging markets, had high returns. Returns on fixed income securities were reasonable, with the yield curve reverting to a more traditional upward slope. Return on the Lehman Brothers Aggregate Bond Index was 7%. Higher quality bonds out-performed lower quality bonds as credit spreads widened.

However, during the latter half of 2007, we began to see increasing volatility in the markets as defaults on subprime mortgages in the U.S. began to reverberate throughout the global financial structure. Global equity markets retreated from highs for the year achieved last fall. Interest rates on U.S. Treasury securities ended the year near their lows, but interest rates on corporate bonds and municipal bonds increased significantly. Returns on foreign bonds were volatile. Yield spreads widened as the U.S. Dollar fell sharply then rebounded against foreign currencies. Commodity prices were high, due in part to fears of inflation. Oil prices have reached an all-time high of \$100 per barrel. Volatility increased significantly in all securities markets.

In this environment and looking out into 2008, our view is that this volatility will continue and that 2008 will be a year of turbulence.

We believe that most of the subprime story has now been recognized – although the impacts of it will unfold throughout 2008 and beyond. The equity markets will likely continue to be buffeted by that saga. Furthermore, other weaknesses in the global financial structure that are not yet widely perceived may create ongoing instability in the markets. These potential problems lie in the area of debt financing for leveraged buyouts and private equity transactions, similar to the subprime mortgage scenario we witnessed in 2007.

Another significant area of uncertainty and risk is the response of monetary and other political entities to the current and potential economic crises. In our view, the global leaders currently in charge in the monetary area are highly competent and have been skillfully guiding us through the current crisis. Still, if major problems continue to arise and conditions deteriorate further, the authorities may be overwhelmed by unprecedented situations. In addition, despite the competence of monetary authorities, they may be undermined by protectionism, trade wars or other actions taken by political leaders who may be well meaning, but misguided, or whose interests may differ from those of global financial stability.

Aside from the risks noted above, we anticipate another growing concern for investors. In the face of prospective defaults on mortgages and corporate buyout financing, monetary authorities have aggressively provided liquidity to the markets in the short term. Over the longer term, we believe, they will recognize that coordinated reductions in short term interest rates globally will facilitate resolution to the crises. In this regard, then, investments in cash and high grade fixed income securities – traditionally seen as conservative investments – bear hidden longer term risks of inflation. At the same time, ownership of productive assets and other equity securities provide significant wealth protection and enhancement to investors who are able to withstand the short term tumultuousness.

These are major risks that we see overhanging the investment markets for 2008. On the positive side, we take note of the extraordinary resiliency of the financial markets over the past several decades in the face of repeated crises. The crash of 1987 is now a small blip on a strong climb of equity market values. We have witnessed a crash in the equity markets in the late 1990's, followed by a meltdown in the U.S. technology sector at the beginning of this decade. These events were devastating – but they were soon followed by strong market recoveries. We have anticipated global market crises for several years – yet we have also anticipated swift market recovery.

Another important positive factor is the fundamental strength of the global economy. While monetary authorities may be challenged in the short term to maintain functional financial systems, we think these problems are technical in nature. As the world economy continues to grow, society will develop the political and economic structures to accommodate the growth. This growth will be reflected in beneficial investment market returns. Our long term outlook remains solidly favorable.

### *Summary & Strategy for 2008*

In our view, the investment markets will be turbulent in 2008. As discussed above, we believe that the lack of strong leadership will create political instability. The global economy is fundamentally sound, but there are risks due to stresses in the global financial structure. These political and economic factors will exacerbate uncertainty in the capital markets. We anticipate that the volatility we experienced in the markets at the end of 2007 will continue in the New Year as markets swing widely in both positive and negative directions over the course of the year, with no clear overall trend. This will be unsettling for investors and will enhance aversion to risk. At the same time, it will entail challenges, but also opportunities, for investors.

In this environment, our strategy will remain similar to that we pursued in 2007. A strong global perspective is the core of our investment strategy. We will maintain broad diversification among a wide variety of investment securities. Regarding fixed income, we plan to emphasize holdings with relatively short maturities. Regarding equities, at the start of 2008 we will underweight stocks and hold cash balances somewhat above target allocations. In the face of market weakness, we will look for opportunities to strategically add to stock holdings. We expect to place emphasis on high quality, dividend paying multinational companies. In addition, due to their high dividends and reasonable valuations, we have renewed interest in real estate investment trusts (REITs). Finally, we will continue to look for individual stock selections that offer profitable long-term growth opportunities for the benefit of our clients.

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2 January 2008

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