



Global Financial Markets Perspective Fourth Quarter 2007

Central Bank Coordination

Global financial markets remain strained due to weakness in the housing sector of the U.S. economy. As many as two million homes are in foreclosure and there is a growing housing inventory of unsold homes exceeding nine months. The economy is also under pressure from tightening credit, tougher lending standards, plunging housing starts (down 14% in December from year ago levels) and a dwindling number of construction-related jobs. The housing crisis is not limited to the United States as many European financial firms got involved in financing the real estate boom and the meltdown quickly spread abroad.

The most important aspect of this credit crisis was the response by central banks around the world. America's Federal Reserve, the Bank of England, the European Central Bank (ECB), the Bank of Canada and the Swiss National Bank, as well as Japan's and Sweden's central banks joined forces in a plan to ease the worldwide liquidity squeeze. To combat the shrinkage of liquidity caused by the mortgage crisis, central banks provided unlimited credit to avoid a serious malfunctioning of global financial systems. Other than the Fed's intervention in the stock market collapse of 1987 and the Thai currency crisis of 1998, we can't recall any other time of massive Fed intervention as a lender of last resort to avoid a financial catastrophe. Moreover, this coordinated effort signals a positive shift in the way central banks perceive themselves and their role in the banking and financial systems.

As 2007 ended, the credit crisis had not been resolved but both monetary and fiscal policies were focused on minimizing the impact of speculation. The domestic mortgage story will play an important role in the outlook for the U.S. economy in 2008 as it will be a causal factor in the government's actions. Stimulative fiscal policy coupled with lower interest rates would be favorable for U.S. financial markets.

In the past, when the U.S. economy sneezed, the global economy would catch a cold. Today, however, this idea may no longer be universally true. Mexican and Canadian economies have been closely correlated with what happens in the United States due to strong trade and investment ties. At the other extreme are countries such as China and Russia that appear to be much less reliant on U.S. demand to drive economic growth. The increasing integration of global financial markets means that few countries will be immune to the capital market volatility associated with problems in the U.S. credit markets. But we believe the stock markets of some countries will weather the storm better than others due to their adoption of capitalism, low tax rates and communications technology. We have been avid proponents of owning a large share of foreign equities in client portfolios. Moreover, our outlook for foreign stock markets is much rosier than that for domestic equities even though there will be times when these markets experience weakness.

There are a couple of reasons for this rosy foreign equity market outlook. The first is related to the recent performance of U.S. equities and the second is related to the evolution of the emerging market economies – most notably China and India.

Since the beginning of the bull market in early 2003, there has been a rally in U.S. equities that has produced above-average returns. Since December of 2002, the annual return of the S&P 500 index has been 12.8% – about 2.4% above the long-term return for large cap stocks. The small-cap Russell 2000 index gained 16.6% per year over the same period – about 4% over its long-term trend. Given this consistent outperformance, one might expect to see some consolidation of these gains.

By the middle of last year, the stage was set for some retracement of the bull-market. For the majority of investors, the most newsworthy item in 2007 was the subprime mortgage market collapse in the U.S. and the financial impact on institutions that utilized borrowed funds (otherwise known as financial leverage) to make money by manipulating this market. The global spread of this leveraged-mortgage market strategy had the expected impact: when the U.S. mortgage market imploded, there were similar problems among foreign financial institutions that had experimented with these products.

Residual risks to domestic equity markets are being carried over from 2007 -- the rising price of oil and gold – the latter a traditional hedge against rising inflation. The rise in the price of gold seems to be a reflection of overall price increases in commodities as opposed to stockpiling. The rise in the price of oil can be looked at in a positive way. The income of oil producers is skyrocketing and the Middle-East and Russia are becoming economic and financial powers due to this surge in wealth. Most investors have not recognized the fact that the dollars used to buy higher priced oil will be dollars that must come back to the U.S. in the form of increased demand for U.S. goods and services. The latest reports of double-digit growth in exports attest to this eventuality. Moreover, record oil prices are having a positive effect on the development and distribution of alternative forms of energy. So far the global economy does not seem to be suffering from these higher oil and gold prices.

Asia is a new world, one that reflects back on the regional order that existed before the Colonial Era. Imperial collapse, isolationism, invasion, civil war and communism are all behind China now. And what was once the richest country in the world is determined to regain its wealth. India is just as keen to be a rising star. China's determination to succeed and the lessons learned from past regional failures are keeping the economy on a trajectory to rival the U.S. in the not too distant future. The quality of Indian executive leadership is exceptional. It is not unreasonable to expect the same level of success that India's software and pharmaceutical companies have found in global markets. China and India are still in high-growth stages and will inevitably slow. But, China's and India's emergence as fully functioning economies has been very positive for Asia. While Europe and North America will continue to lead the world in numerous areas for the foreseeable future, Asia's equality has finally arrived.

More importantly, the Asia Pacific region took a big stride in 2007 towards establishing itself as a powerful economic force. China and India are emerging capitalist countries never before seen in past bull markets resulting in a banner year of economic growth. Populations were once the

curse of developing nations, but now size appears to be in style. There are two billion Chinese and Indian consumers who will, in theory, soon have a credit card and a brokerage account, thanks to the massive evolutionary leap of domestic financial systems and communication technology in the last five years. Confidence and consumption are strong across much of the region and most governments are in reasonable shape to help domestic demand if there was a slowdown.

Although 2008 is off to a rough start, we are less pessimistic than most market observers. The early January clamor in political circles was the need for an immediate tax cut and increased government spending to get the economy back on track. Similar to the Bush tax rate cuts of 2003, we will bet that if a meaningful cut is forthcoming, the market will turn positive quickly. Without such a tax rate cut, the economy will likely slow to a rate below its historic average – not a bad situation given booming economic growth for the past five years. The housing market will have to overcome the excess housing inventory created by misplaced optimism that housing demand could continue indefinitely. Many subprime lenders have replaced their CEOs and written off billions in bad loans. Companies like Countrywide Credit have recast thousands of subprime loans so that rates on those mortgages will not increase. The slowdown will also have a moderating effect on commodity prices as is usually the case when demand weakens. The bottom line is that the U.S. economy is due for a bit of a breather. As a result, 2008 should be a challenging year for equity markets—as was 2007, 2006...well, you know.

Our Summary Forecast:

- No recession in 2008, just sub-par growth averaging 2%
- Interest rates rise slightly reflecting inflation concerns
- Inflation staying in the 3-4% range
- Oil trades between \$80-\$100 per barrel
- Gold trades between \$800-\$900 per ounce
- No Oscar ceremony this year
- Surprise Super Bowl outcome

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