

Financial Markets Update January 2008

We have been concerned about America's finances for several years. It appears that others are now becoming aware of the problems at hand.

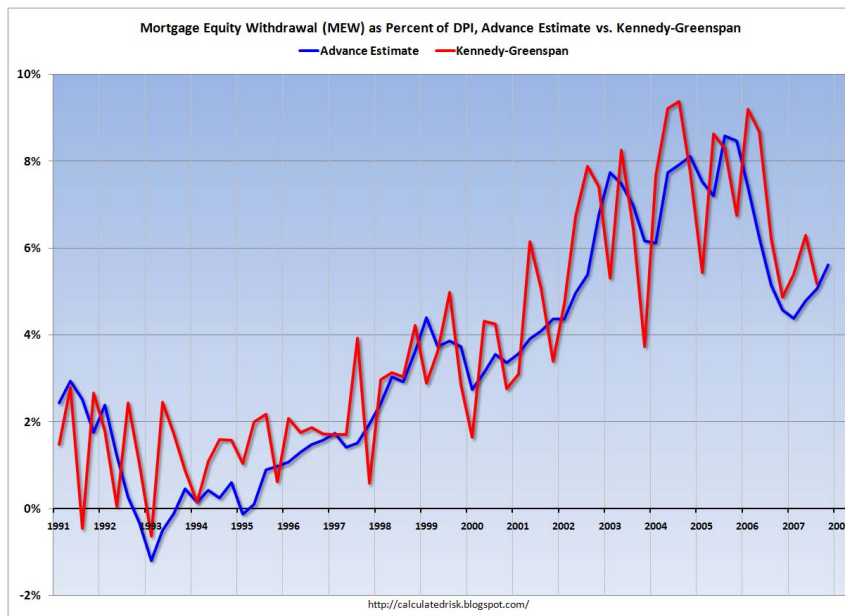
The financial markets are in a tizzy. To some extent, this does not impact the real economy. What happens on Wall Street, stays on Wall Street. There is talk of a credit crunch, but from what we see, credit is still readily available to individuals. It may be tighter than before but it is still loose by historical standards.

The woes of the financial companies are not over. They have had to take some losses as values of securities have plummeted but other parts of their portfolios don't have the same accounting rules and they will take losses over time as loans go bad. The mortgage gravy train is over and it will take some time to replace that profit center with another. Our guess is that firms will start to focus on helping retirees manage their IRAs and other retirement assets. The answer, by the way, to any telemarketers who call is "No, thank you - I do not need help rolling over my 401(k)."

In the meantime, keep your eyes out for the fortunes of the bond insurers(MBIA, Ambac). Their demise will cause another wave of financial market gyrations. The bond insurers moved away from their core business of insuring municipal bonds, perhaps the best business on the planet, to insuring complex mortgage backed securities, perhaps the stupidest business on the planet. Cleaning up the mess from their almost inevitable failure will be... messy.

The real problem is not the financial institutions, however. The problem is us. A wide swathe of American families are living lives they cannot afford. As a country, we are consuming more than we are making. It is only through the "generosity" of foreign governments and others overseas who have been buying all the debt we have generated that this has been able to continue. The unprecedented ability and willingness of households to extract money from their home equity has masked the basic insolvency of many Americans.

During 2004-2006, 8% of American's spending was financed by taking money out of their houses. This number would account for virtually all economic growth recorded in this country over that period.



The mortgage withdrawals have tapered off somewhat but are still way above sustainable levels and credit card balances have rocketed as people have less equity to take out but still are nowhere close to making ends meet.

The government is doing its best to keep the party going. The

specific mission of the Federal Reserve is to avoid recessions at almost any cost.

This policy, while it seems like a good idea, is fundamentally flawed, analogous to the problems that arose with forest fire suppression policies.

For decades, all fires were fought. Overtime, underbrush (i.e. kindling) built up and people starting building homes in zones known to be at risk of fire. The probability of huge fires increased and the damage inflicted by them was more severe.

Now, we understand that smaller fires help with fire control and lead to healthier forests in the same way that the risk of real loss is what helps maintain discipline in the extension of credit and encourages people to save money.

It is possible that lowering rates to virtually zero and sending out rebate checks may delay the day of reckoning but America's financial situation just gets more challenging as we get closer to 2017, the year that the impact of retiring Baby Boomers starts to outweigh the impact of Boomers still in their peak earning years.

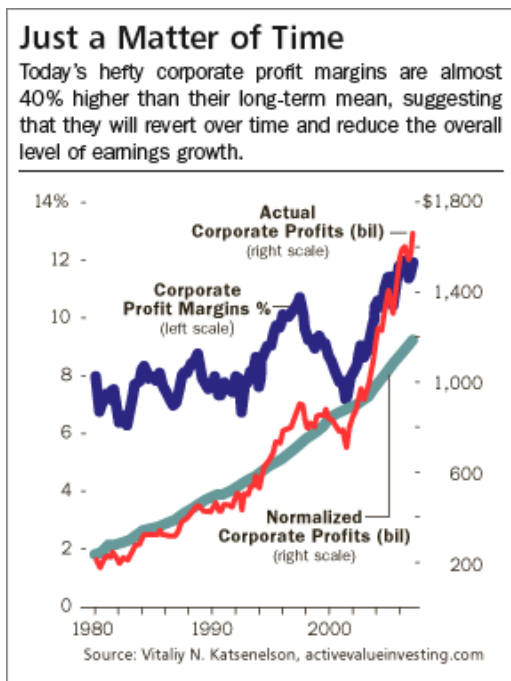
In the meantime, what does all this mean for your investment portfolios?

Not that much, as current portfolios already reflect our bias away from domestic US markets and towards those abroad.

While the US is facing the consequences of abysmal and reckless economic policy, most of the world is enjoying solid growth on the back of strong economic fundamentals. With certain exceptions, other countries are saving and investing responsibly and even have a lot of room to increase consumption. China is happening for real this time and while growth may suffer relatively because of problems in the US, real growth will still be impressive. Other countries are in a similar position.

Valuations for global equity markets look reasonable.

Japan appears cheap for the first time since I finished elementary school. Emerging markets, even after their tremendous run, still look attractive given growth prospects and valuations.



Even the US is, on balance, not nearly as expensive as it was only a couple of months ago. We still would consider it pricey as profit margins appear unsustainably high, but it is not at bubble levels. Ten year returns should be modest but we have little to no insight over shorter term results.

Bond yields are microscopic which makes them generally unattractive in retirement portfolios. Inflation linked bonds remain our fixed income instrument of choice and we are looking at guaranteed income funds within 401(k)s as a higher yielding low risk investment.

We continue to maintain high risk levels within retirement accounts, although we incorporated some fixed income element into almost all portfolios last year. Given our generally aggressive stance in investing the retirement holdings of those still in the middle of their working lives, this reflected caution about price levels in the face of an imminent housing crisis. So far, so good.

Commercial real estate (office buildings, apartments buildings, retail space)

outside of the US is one bright spot. Valuations are extremely attractive and rents overseas are likely to increase substantially. Within the US, real estate is still expensive.

Volatile markets can be the cause of anxiety but they also bring opportunity for those who can move past the fear and continue to focus on hard nosed analysis. We have already come across a couple of investments that we think offer the potential for outstanding returns and there will be many more like them over the next couple of years. Some may be asset classes that get hit in a general wave of panic, some may be individual equities and some may be real estate investments down the street from your house. We encourage you to continue to save money, keep your eyes open and remain patient. What is happening now is still probably closer to the beginning than the end.

We cannot predict with any certainty, however, the precise course that events will take in the US. We will venture to say those with money to invest should not fear turbulence as that is what creates investment opportunities.

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