



	<u>2007 Close</u>	<u>2007 Perf.</u>
Dow Jones Industrial Average:	13,264.82	↑6.4%
Standard & Poor's 500 Index:	1,469.36	↑3.5%
10-Year Treasury Yield:	4.033%	

Investment Outlook **December 31, 2007**

Dear Investors,

Happy New Year! I wish you all a happy and prosperous 2008. I would also like to thank you for your continued confidence in me to invest your assets during these volatile and uncertain times.

The fourth quarter of 2007 was a tough slog for the equity markets as investors grappled with several major challenges. Among them: massive write-offs by global financial institutions on their portfolios of mortgage-backed securities, rising energy prices—oil closed the year at nearly \$96 per barrel—and increasing evidence that both the manufacturing and consumer sectors in the U.S. are slowing. On top of this, the U.S. residential housing market shows no signs of nearing a bottom. Home prices are down significantly on a year-over-year basis and inventories of unsold homes continue to build. Given all that has happened the equity markets did surprisingly well, in my opinion. The S&P 500 Index declined 3.8% in the quarter but ended 2007 with a gain of 3.5%. The rest of the world did much better, with the Dow Jones World Index (ex U.S.) up a tidy 11.8% for the year. As one might have expected, during these trying times investors headed for the safety of U.S. Treasury securities, sending prices up and yields down. The 10-year Treasury note ended the year with a yield of 4.033%, near its low for the year despite unmistakable signs of inflation.

The global credit crunch that seized parts of the global bond and commercial paper markets in August has eased somewhat, but there are many corners of the market where securities do not trade and remain difficult to value. Banks, not knowing what lurks in the balance sheets of their counterparties, are reluctant to loan money to their peers or to their corporate and retail customers. This hesitation is causing a ripple-effect of credit tightening that is being felt through the financial sector and all the way to the wallet of the consumer. The easy money times that existed one year ago have evaporated, and the attendant consequences of this credit crunch for those who require cheap and available debt to do business (or to live) will likely be unpleasant.

The U.S. Federal Reserve has two objectives: to promote economic growth and to contain inflation. These are competing objectives that must be balanced with the blunt instrument of monetary (interest rate) policy. Normally economic growth and inflation move together: the higher the rate of economic growth, the more that inflationary pressures build. At the moment, however, the Fed is seeing both of these objectives lurch in the wrong direction. The U.S. economy is now decelerating while inflation appears to be rising. Economic data reported in December showed the Consumer

Price Index up 2.3% from a year ago—higher than expected—and wholesale prices up in November at the fastest rate in 34 years. Import prices also notched their largest monthly gain in 17 years. Thus, the Fed's ability to lower interest rates to stimulate growth is hindered because lower rates fuel such inflation. There is no easy solution to this problem.

Commodity prices are also helping to ignite inflation. The prices of oil, gold, and many other mineral and agricultural goods are at or near their all-time highs. The cause of these persistently high prices is the unrelenting demand from the developing world—particularly China and India. Previously these countries had much smaller economies relative to ours and had domestic needs that were too modest to seriously impact world energy and commodity prices. But now these huge developing countries will be helping to drive prices. Muted demand from the U.S. economy is—at least not yet—enough to dampen them. Thus, we are in essence importing inflation at a time when our domestic economy can least afford it. This noxious cocktail of circumstances could cause stagflation, a distasteful condition in which high inflation is combined with tepid (or no) economic growth. Our last bout of stagflation was in the 1970s, and the stock market did not enjoy it.

One positive for the U.S. economy—but certainly not for Americans traveling overseas—is the sharp drop the U.S. dollar has taken in the past few years. A cheaper dollar helps U.S. companies that export goods, but it makes imported goods more expensive. Thus, it can be part of the solution to our trade imbalance. A languishing greenback also makes the U.S. a more attractive place for foreigners to spend and to invest. Over the holidays, newspapers told of planeloads of Europeans making shopping trips to New York City to stock up on cheap American goods. Several large and troubled U.S. financial institutions also found willing investors in the Middle East and Asia. With domestic demand waning, foreigners are picking up some of the slack.

I expect that 2008 will be a year of many challenges, and I would not be surprised at all if the full year looks much like the last half of 2007: huge volatility coupled with little, if any, price appreciation for the broad stock market indexes. The global markets will be square in the center of a huge tug-of-war between a wallowing U.S. economy and persistently strong growth overseas. This will be the first big test for economies outside the U.S. to see if they can sustain their recent momentum and healthy capital markets while the largest economy in the world sits this dance out.

As usual, I welcome your comments and feedback.

Best Regards,

Peter

Peter C. Thoms, CFA
Orion Capital Management LLC
1330 Orange Ave. Suite 302
Coronado, CA 92118
Tel: 619-435-1701 Fax: 619-435-1706
www.orioncapitalmgmt.com