

# Rocky Mountain News

## 2008 market outlook

By Rocky Mountain News finance editor David Milstead  
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Tuesday's Rocky will have a much-abbreviated survey of local investment pros looking ahead at the markets in 2008. Here's the unexpurgated version:

Our panelists:

**Michael Serota**, Senior Vice President of Advanced Wealth Management of Raymond James & Associates Inc.

**Jeff Tjornehoj**, Senior Research Analyst, Lipper - A Reuters Company

**Fred Taylor**, Principal, Northstar Investment Advisors, LLC

**Greg Evans**, vice president of investments/branch manager at the Millstone Evans Group of Raymond James & Associates

**Christopher P. Bloomstran**, President and Chief Investment Officer; Semper Augustus Investments Group

**Craig Callahan**, Founder and President, ICON Advisers

**David A. Peterson**, Registered Principal, Peak Capital Investment Services, LLC

**Gregory Anderson**, CEO of GRAnderson Wealth Management Group

**John Goltermann**, Vice President, Director of Research, Obermeyer Asset Management

**Barbara Walchli**, Portfolio Manager, Aquila Rocky Mountain Equity Fund

**Jeff M. Wilson**, President, Wilson Advisory Group, LLC

**Al Woodward**, The Woodward Wealth Management Group

**Jerry Paul**, Portfolio Manager, Quixote Capital Management, LLC

### ***2008: What are the chances of a recession?***

Michael Serota: Personally I believe that a true recession has less than a 25% chance. What we might have is what is known as a "Growth Recession" where growth slows to maybe 1.50%-2.00% per quarter.

Jeff Tjornehoj: The chances of a recession grow slimmer as businesses downshift in expectation of a recession. Right now, I see limited excesses in most sectors—housing certainly is one of them and that mismatch of supply and demand will continue to unwind next year.

Fred Taylor: At this point in time I would venture the odds of a mild recession in 2008 to be 50-50. Certainly the Federal Reserve is hedging its bets by only cutting the Fed Funds and Discount Rates by twenty five basis points at their December meeting. The Fed is confronted with the problem of weighing the

negative impacts of higher inflation versus weaker consumer spending and the burgeoning credit crisis. By definition a recession means two negative quarters of GDP growth which could happen in 2008 but in an election year and with the White House doing everything in their power to keep the economy out of a recession it may not happen. However, by looking at the dismal performance of banking, housing, and consumer discretionary stocks this year we may already be in a recession?

Greg Evans: The chances are smaller than a lot of people are now predicting. I would put it in the less than 30 percent range. There will be pockets of pain and individual stories of demise, but consumer net-worth (assets - liabilities) is at an all time high of \$58 trillion - compared to \$29 trillion in 1996.

Chris Bloomstran: The odds of a recession in 2008 are quite significant. The U.S. consumer, bearing an unsustainable level of debt, is clearly slowing consumption. A deep recession necessarily should have transpired following the bursting of the technology-fed stock market bubble from 2000 through 2002. As it was, Greenspan's Federal Reserve bailed out the consumer with historically low interest rates - which drove housing to its own bubble. With housing prices declining nationally for the first time since the 1930's, and with corporate profits headed lower, the consumer is tapped out. We may find out we are already in a recession.

Craig Callahan: No one knows the answer to that question, not even the Fed. Rather than trying to predict the unpredictable, we focus on numbers. At ICON, we utilize a bottom-up value approach, and economic forecasting is not part of our investment process. That said, we believe the Fed is acting in a responsible manner to try to prevent a recession.

David Peterson: I believe the chances of a recession are slim. Corporate earnings continue to grow, and the consumer remains quite active. Holiday sales, while not robust, increased from the previous year, in spite of the downturn in the housing market. Final GDP for the third quarter was quite strong showing the economy grew at a 4.9 percent clip, and although a slowdown from this lofty number is to be expected, I do not believe a recession is likely.

Gregory Anderson: The better question might be, what are the chances of an extended and severe recession? Based on current economic news and the Fed's continued attempt to engineer a soft landing, all the signs point to a recession. But any recession in 2008 should be mild, with an excellent chance for a quick turnaround.

John Goltermann: The chances of a recession are low, in our view, because a) the labor market is likely to remain tight as a result of a declining birth rate and a growing global economy; b) a weak dollar means that there won't be a collapse

in corporate revenues; and c) inventory levels are fairly low and a recession is usually associated with an inventory work-off of some sort.

Barbara Walchli: The economy is decelerating towards slow, even no growth but we see the risk of a recession below 50%. The lower dollar is making our goods and services very competitive on a global basis. Currencies stimulate demand with a lagged effect, so we are likely to see rising international demand for our goods and services over the next twelve to eighteen months. Tourism and the hotel/resort industries in Colorado are also likely to benefit as we see more foreign visitors.

Jeff Wilson: We are already in one. It won't be "announced" until 2009, however.

Al Woodward: Man has always sought to know the future. Modern man is no exception. The stars we gaze upon now are numbers, statistical trends and global sentiment. A recession in 2008 is extremely unlikely. (See: Federal Reserve and Bloomberg for economic data) We are walking a tightrope to be sure. There are fears. However we should reprimand ourselves when our fears become Pavlovian. 2008 promises to be sunny with occasional light showers.

Jerry Paul: At least 90%, we are probably in it and don't know yet. The problems in credit and housing make it nearly unavoidable.

***One argument for gains in the stock market in the coming year is that the market as a whole seems reasonably priced, based on forward P/Es. But what if the "E" forecasts in the P/E are wrong?***

Michael Serota: If earnings forecasts are incorrect, and they are high, we can be in for a tumultuous and volatile year, but I don't think that it will be more volatile than what we witnessed in 2007.

Fred Taylor: Buying stocks based on historic PE ratios will be extremely difficult in 2008 particularly in the financial, housing, and retail sectors. If the economy does go into a recession then the task of calculating accurate earnings will be chasing a moving target. However, if there is no recession in 2008 because the credit crisis gets resolved, consumers keep spending, and Americans keep their jobs the stock market could really surprise everyone on the upside. Those stocks hurt the most in 2007 anticipating a recession could be the best performers in 2008 if one does not actually occur.

Greg Evans: Forward earnings on the S&P 500 is about \$103 for an earnings yield of 6.9 percent - based on the December 21 closing price of 1,484. If you cut earnings by 10 percent to \$92.70, the earnings yield is 6.25 percent. A 20 percent reduction generates earnings of \$82.40 and an earnings yield of 5.55 percent. All of these yields are still much higher than the 10 year Treasury bond yield of 4 percent. Bottom line, U.S. stocks are very attractively priced.

Chris Bloomstran: The "E" is wrong -- at least it is unsustainably high by historical standards. The market is typically pretty prescient, applying low P/E multiples to peak profits (thus anticipating the eventual decline in profitability) and high P/E's to depressed earnings (anticipating a coming expansion in margins). 2007 saw the second highest level of corporate profit margins, exceeded by those in 1929, so a very low P/E multiple should be applied. Profits need to fall some 30 percent to reach a more normalized level. Hence, if the current "reasonable" P/E merely remains unchanged, stocks need to fall roughly 30 percent to be fairly valued. Of interest, in 1929 profits began a titanic descent from their peak and stocks dropped 89 percent in three years.

Craig Callahan: Some investors focus on year-over-year earnings comparisons. We do not. We compute intrinsic value and do not use P/E or other simplistic ratios. We measure domestic stocks prices as about 23% below our estimate of intrinsic value as of Dec. 21, 2007. We are, therefore, bullish.

David Peterson: If earnings do not measure up with expectations, stocks will likely fall on the disappointment. However, any drop should be limited, because current P/E ratios are modest. More importantly though, I do not believe the "E" is wrong. In the week prior to the Christmas holiday, several technology companies reported robust earnings. My belief is that this will continue.

Gregory Anderson: Earnings have been stronger than usual, due in part to increased sales in the international markets. There does not appear to be any slow-down in foreign markets in the foreseeable future, unless the dollar makes a miraculous recovery.

John Goltermann: This is our big worry. Corporations face higher costs going forward and a large component of "E" in the stock market were from past (sometimes fictitious) profits booked by finance or financial services businesses, whose assets are now being written down. Both of those factors are likely to prove published earnings estimates too optimistic.

Barbara Walchli: The S&P 500 is currently selling at 16X forward earnings and normally would sell at 18X forward earnings given our current level of interest rates. The U.S stock market is already discounting a slow-down in earnings. For companies whose earnings hold up, you could see some price earnings multiple expansion in 2008.

Jeff Wilson: The last few years of earnings have been "juiced" by accommodative taxation, cheap money, and plenty of debt. Taxes will likely go up. Even though interest rates are going down, the availability and terms are much less favorable, so earnings will be going lower for the foreseeable future.

Al Woodward: What if earnings fall? What indeed. The important point to remember as we go forward is that earnings are strong compared to stock prices.

Consider blue chips like Wells Fargo, Chevron and Merrill Lynch for example. All as of Christmas of '07 have P/E ratios well below 15. In other words, earnings say the stuff is undervalued as it is.

***What is the biggest risk factor for 2008 - the U.S. dollar, the housing market, the price of oil, or something else?***

Michael Serota: The economy is no doubt the biggest factor in 2008. The Fed's forecast reinforces the view that growth is likely sluggish in 2008, tightening credit conditions and the high degree of uncertainty in the outlook. The credit situation is worsening, and there is definitely a flight for quality.

Jeff Tjernehoj: Inflation. We're in a credit market correction, not a cyclical decline, and if the Fed moves too aggressively to placate lenders that made too many bad loans easy money will spur inflation.

Fred Taylor: The biggest risk to the stock market would be the failure of a large multinational bank like Citigroup and if interest rate cuts by the Federal Reserve did nothing to prevent a liquidity panic on Wall Street and around the world. Another risk would be a return to a 1970's stagflation economy where the US suffers rising inflation due to an incredibly weak dollar, higher energy/commodity prices, and foreigners selling their US Treasury bonds at rapidly falling prices. At the same time this phenomenon is occurring, housing prices continue to fall, which causes the American consumer to stop spending which in turn forces companies to lay off workers. This combination would be the worst of all possible domino effects.

Greg Evans: The biggest risk is what is not yet known and priced into the market. Undoubtedly, I would say a terrorist attack is at the top of the list.

Chris Bloomstran: Drawing on the previous answer, the biggest risk factor for stocks in 2008 is a significant decline in corporate profits. Nearly all Wall Street pundits forecast high single-digit growth in earnings for the companies in the Standard & Poor's 500. We believe earnings will actually decline this year and need to fall roughly 30 percent to reach a more normal level. Profits at financial companies comprise the largest slug of earnings. With the financials, profits have already turned down and stand to fall materially this year. Ditto earnings for the major integrated oil companies, where profits are huge but are down for the last quarter. Big oil is finding it difficult to replace reserves. P/E multiples have been the lowest for financial and for energy companies. Hence, the rest of the market is that much more expensive. The stock market is not ready for a big decline in earnings.

Craig Callahan: The stock market has been on a better-than-average advance the last five years. Many investors who worried about oil, housing, war and other news events have missed out on the impressive market advance. Our valuation

readings have been a good guide to stay invested. Currently, those readings suggest stock prices need to advance about 23% to reach our estimate of fair value. We go by our valuation guide and do not guess about events.

David Peterson: I believe the biggest risk factor for 2008 is the election—not which party will ultimately gain control of the Whitehouse or the legislative branches, but the election itself. The media constantly focuses on the negatives of the candidates, their past indiscretions, their misstatements, etc., that regardless of which party wins, the negative feelings generated by the election will no doubt play a role in investor confidence.

Gregory Anderson: The biggest risk factor is that consumers might start worrying about risk factors. The consumer has to have signs of stronger purchasing power on all fronts, but especially in the areas of housing and oil. Any indications of stronger purchasing power will further stimulate the economy.

John Goltermann: For investors, there are numerous opportunities, but many potential landmines. In our view, inflation is likely to be the biggest risk factor going forward and will negatively impact those portfolios that are not positioned properly for it.

Barbara Walchli: Financial companies are very self-absorbed with a new accounting rule, FASB 157, and the impact from having to mark Level 3 assets to market. Previously, these assets have been marked “to model.” Financial companies are writing down these assets and having to look for more capital. The biggest risk is that the banks or financial companies pull back on lending or raise lending standards too high and hurt other companies and industries in the process.

Jeff Wilson: The economy will have to suffer for a couple of years with sub-par or no growth as the debt crisis blows over, and the housing bubble deflates. They kind of go hand in hand.

Al Woodward: The single biggest risk we face as a nation is our debt. Our national debt sits at \$9.1 trillion. U.S. Consumer revolving debt sits at \$928 billion (US). Compare this with Australia’s \$40 billion (AUD). Like Romeo, we are poised to be Fortune’s fool. The subprime shock is only a symptom. If and when our debt goes bad, the stock market crashes. Yes, it is really that simple. At times debt is appropriate. However a nation cannot build its fortunes on borrowed money. Whoever builds a house with borrowed money is actually building his own tomb.

***Is it too late to get on the international-funds train?***

Michael Serota: I do believe that the international theme is strong, and as we move to more global economy it will be a continuing theme. It is not too late to be in the international markets, but stay diversified, do not look for the next "China."

Jeff Tjornehoj: No. The (Morgan Stanley Capital International Europe, Australasia, and Far East) index has only diverged from the S&P 500 (in terms of direction) three times since 1976. While it has outperformed in each of the past six years, I still see enough global liquidity to keep equities favorable both at home and abroad next year.

Fred Taylor: International investing has greatly benefited from the imploding US dollar over the last two years. In the short term, I don't see this changing so having international stocks in a portfolio certainly makes sense but investors should only buy the best foreign large cap multinational companies with exposure to the emerging markets around the globe. I still think China, India, and Latin American economies will continue to grow in 2008; however, the real question today is, have their stock markets already priced this in?

Greg Evans: There is still money to be made in the international markets, but nothing like we have seen over the last 5 years. Investors need to make sure their manager has a good sense of what the intrinsic values of the stocks in the portfolio are worth and that the stock prices are below those values. A number of emerging markets have done very well the last couple of years and some of those could perform poorly going forward.

Chris Bloomstran: The train has already left the station. International stock markets have outperformed U.S. markets since the March 2000 market peak. Emerging markets have performed exceedingly well, with stock prices growing much faster than the underlying economies and companies. Fund investors, who famously invest in the rear-view mirror, are generally late to the party. Technology and momentum funds drew the vast preponderance of mutual fund investments late in the bull market during 1999 and in early 2000. At the peak, Janus drew nearly half of all of the money going into mutual funds! We all know about the ensuing train wreck. Now -- and for the past two years -- emerging market funds are garnering nearly all the flows. For the first time ever, the P/E in emerging markets is higher than in the industrialized world. Investors are wagering on a risk-free higher rate of growth abroad. Now is not the right time to make that expensive bet.

Craig Callahan: Over the last five years, the gains in international stocks have been even better than in the U.S. International stocks were better bargains; prices had further to go to catch intrinsic value. Now, however, that valuation advantage is gone. We are equally bullish on international and domestic stocks.

David Peterson: I believe a portion of everyone's portfolio should be invested internationally. However, I would not jump on the international bandwagon at this

juncture. On a year-by-year basis, international stocks have either been one of the top performing sectors or one of the worst. History suggests the end of the run may be in sight. In addition, I don't see the beaten down dollar getting much weaker, and this would be a negative for the international markets.

**Gregory Anderson: The international markets continue to show growth and we favor many of the Asian and some South American countries. We see continued opportunities with Exchange Traded Funds (ETFs) in China, India and Brazil.**

John Goltermann: Absolutely not. Companies domiciled abroad present some of the best investment opportunities in this environment because they are located within areas that have high savings rates, robust economies, strong foreign currency reserves and possess the two things the world needs...labor and tradable commodities.

Barbara Walchli: International investors are likely to face less favorable conditions going forward. Emerging markets have been on a tear and are approaching bubble status. International monetary authorities have been raising interest rates for several years and foreign economies are slowing. In addition, the dollar has declined so much, it could level out or move upward, giving international investors some headwind. Investors that wanted to increase international exposure could adopt a dollar cost averaging discipline – investing a small amount each month over a period of several years.

Jeff Wilson: Not if your time horizon is 10 or 20 years. For the near term, as the US economy slows down, most international markets will ultimately be affected, though with a 6- to 18-month delay.

Al Woodward: In a word, no, it is not too late to invest internationally. Evidence indicates quite the contrary. Remember growth trends extend beyond our own lifetime. The United States will likely go the way of former world powers like Great Britain. Meanwhile we should make room for “youngsters” like China and India. Shrewd investors know there is money to be made as those nations progress through their technological adolescence. For more information on the subject see “Rise of the Red Chips” by Jim Rogers.

***Suggest some sectors that will be winners in 2008 - and some that will lag.***

Michael Serota: Sectors I like in 2008 are health care, pharmaceuticals, longer term I like the major financial institutions that have been beaten down, although this will be a longer term hold. Again, stay diversified, maybe some exchange traded funds that you can purchase the entire sectors that you want to own.

Fred Taylor: Winners in the first half of 2008 will most likely be the best performers at the end of 2007 such as energy, technology, materials, and utility stocks. However, as a contrarian play, by the second half of the year it may make

sense to buy companies in the financial, consumer discretionary, and real estate sectors, which had the worst stocks in 2007. Six months from now this subprime/credit crisis may have been fully discounted by the stock market and there could be some positive earnings surprises with easier earnings comparisons going forward in 2009.

Greg Evans: Sectors that should perform well include technology, industrial and healthcare. Later in the year, look for financials and consumer discretionary to do well.

Chris Bloomstran: Many of the greatest investors approach the markets with a contrary mindset. Often the best place to deploy capital is in those sectors that have been out of favor. Look to sectors that have lagged. Opportunities abound in financials, though headwinds here are still strong. We have avoided trouble with financials by investing in less leveraged companies who internally generate cash. Companies like Berkshire Hathaway stand to benefit from others' misfortunes. Others are conservatively financed and are not being adversely impacted in the current environment. Some financial companies could also be disasters. Avoid those that are over-leveraged or are too dependent on others for capital. These will lag in 2008.

We would also look to sectors that would benefit from a change in the political dynamic. Generic drug manufacturers should win in a Democratic controlled Washington, as well as from the onslaught of branded drugs losing patent protection in the next few years. Many well-managed retailers have also seen their stock prices fall to attractive levels, despite the slowing consumer. As always, there are generally opportunities. Avoid trouble by sticking with good companies and trying to buy them on the cheap.

Craig Callahan: Some new sector and industry leadership emerged in 2007 such as Information Technology, which had lagged the last few years. Based on our methodology, we expect that market leadership to continue into 2008. Consumer Discretionary and Financials represent the best two sector bargains under our system, and our research suggests they may emerge as leaders sometime in 2008.

David Peterson: While the NASDAQ has outperformed the S&P 500 this year, that out performance was not to the degree I expected. Given the strong recent earnings from some of the technology bellwethers, I again expect the NASDAQ to outperform. As a bit of a contrarian though, I expect the oil industry to lag after strong gains in recent years—especially if the dollar gains some traction.

Gregory Anderson: Although the financial sector has retreated during 2007, this sector presents opportunities for 2008. We like the regional banks and commercial real estate investment trust specializing in apartments and

hospitality. The areas most likely to lag in 2008 include telecommunications, health care, and consumer staples.

John Goltermann: Sectors that support the world's continuing economic development will continue to outperform in the future, although the specific time frame is impossible to predict. Commodity production and resources located in politically secure areas will continue to increase in value. Many technology issues looks overvalued to us at present, so we are likely to avoid them for the foreseeable future.

Barbara Walchli: In the first half of the year we would see continued strength in health care, stable growth such as entertainment and information services and selected technology. In the second half we would see better performance coming from economically sensitive companies as the economy stabilizes. Weaker financial companies are likely to lag through much of 2008. Some of these companies used poor lending standards for the last three or four years, so it will take a while for some of the companies to deal with the resulting problems.

Jeff Wilson: Winners - Oil field services, refiners, alternative energy, telecom backbone. Losers - Housing, mortgage, financials, real estate, construction, commodities (other than gold and precious metals), Oakland Raiders

Al Woodward: Trying to pick the next breakout stock is slightly less complicated than trying to vote for the next American Idol. We tend to favor blue chips that are undervalued based on their fundamentals. An excellent long-term play is alternative energy. Financial stocks are suffering, but someone is going to pick up the pieces. Look for the strongest player to emerge and reap handsome rewards.

Uncertainty and opportunity are two sides of the same coin. Warren Buffet made his name on this principle. However unless you have a red phone on your desk that says "Oracle of Omaha" we encourage small investors to seek the benefits offered by actively managed accounts. Proactive in bull markets, defensive in bears, they offer a sophisticated solution to an age-old challenge.

Jerry Paul: Banks, a local one United Western has outstanding prospects given that they launched their community bank restructuring two years ago and have a relatively clean loan portfolio (I own it). For the most part, well-managed banks have more than priced in credit risks and problems.