2007

2007 could be summed up by many words, but I am choosing volatility. For the first time in four years the markets experienced a high amount of volatility in daily movements. We saw a significant change in market leadership, with the exception of the international markets. The housing market is experiencing a correction that hasn't been seen in 50 years. While the financial sector is swimming in turbulent waters as questions remain not only about liquidity, but solvency.

It was a tail of two halves. The market started the year off slowly before finding it's legs and driving the Dow Jones Industrial Average and S&P500 to new all-time highs. The second half was marked by multiple 10% corrections before finishing negative. However, looking at the final number of the major US market averages you would have thought it was an uneventful year.

Index	2007 Return
Dow Jones Industrial Average	6.4%
S&P 500	3.5%
NASDAQ	9.8%
Wilshire 5000	3.9%
Russell 2000	-2.7
Value Line	-3.8

2007 was anything but uneventful:

- As we began 2007 the major investment themes were: Small Companies, Value Style, Non-US (International). The year started slowly.

-In February the DJIA corrected 6% in response to the one day 10% decline in the Chinese market. The major concern was the unwinding of the carry trade.

-In July the S&P 500 hit a new all-time high at 1556. The sub-prime mortgage market began talking about rising delinquencies. Concern started about a potential credit crunch.

-By mid August the S&P 500 corrected 12% from the peak in July. The Federal Reserve acknowledged the housing slow down and cut the discount rate, the overnight rate charged to banks. Market leadership began to shift as multi-year trends were beginning to change. Small Companies and Value stocks had given the leadership baton to Large Company and Growth stocks. International stocks continued to outperform.

-In mid-September the Federal Reserve cut the Federal Funds rate by ½%. This was the first cut in rates in four years. Fed Chairman Bernanke said that the Fed was prepared to go further if necessary.

-By early October the S&P 500 rallied to a new all-time high at 1,565 on the news that the Fed was on guard and ready to act. However, third-quarter corporate earning began and we got our first look at the losses being taken by the financial sector. By the end of October the Fed cut rates for the second time this year, by ¼%.

-This time the market was overly optimistic, and the S&P 500 corrected by 11%. By the end of November the S&P 500 was negative for the year, while the DJIA was up 2%.

-The Fed cut rates a third time in December. The market stabilized, but moved little in what is usually a good month. The Stock Traders Almanac publishes many historical numbers, including the Santa Claus Rally and the First Five Days. The Santa Claus rally is the last five trading days of 2007 and first two of 2008. Santa brought us some coal this year as the final return was -2.5%.

There are some concerns and themes that we carry into 2008. First is the credit crunch, housing slowdown, financial crisis (whatever you want to call it). While I would say that the market overreacts about most things, this concern is valid. The financial industry has lost billions of dollars on declining loan values in 2007, and is expected to continue announcing write-downs into the foreseeable future. Many are scrambling to find cash infusions to remain fully capitalized.

The dollar continued to decline against most other currencies. The US Dollar Index fell 8% in 2007, and more against individual countries. While a declining currency is good for exporting, we are feeling some of the consequences at home. Most commodities enjoyed a good year.

Commodity	2007
Crude Oil	49%
Gold	31%
Corn	17%
Silver	15%
Copper	6%

Oil has briefly touched $100 per barrel in early 2008. If the Fed continues to lower interest rates it will put more pressure on the dollar.

There is more chatter about a potential recession. If you really listen to most prognostication they really say the chances for a recession are rising. No question the economy is slowing. The definition of a recession is back-to-back quarters of negative GDP growth. As of the third quarter, the last available data, we have not had one quarter of negative growth yet. We had a number of troubling economic data reports in December including a negative number for the November ISM Manufacturing Index, the last employment report announcing that unemployment rose to 5%, and the mentioned rise in commodity prices. A few major Wall Street firms in early 2008 have called for a recession. However, Fed Chairman Bernanke said the Fed is not predicting one.

International markets continued their relative outperformance of the US market aided by the declining dollar. Below we rank country performance in US dollar terms for 2007.

Country	US dollars	Local currency
Brazil	71%	43%
Malaysia	45%	35%
Hong Kong	45%	45%
Thailand	39%	30%
Indonesia	39%	45%
World Index	8%	

The top returns continue to be emerging markets followed by developed countries as measured by the world index. We are left with a question, did emerging market stocks go up or did our dollar go down? Something to keep track of is the fact that international stocks under-performed the US in the 4th quarter.

There was a wide variation in returns when looking at sector performance.

Industry Index (no particular order)	Symbol	2007
Broker/Dealer	XBD	-14%
Bank	BKX	-25%
REIT	RMZ	-20%
Housing	HGX	-39%
Utility	UTY	15%
Retail	RLX	-18%
Airline	XAL	-41%
Chemical	CEX	24%
Semiconductor	SOX	-13%
Networking	NWX	3%
Internet	DOT	14%
Healthcare	HMO	16%
Biotech	BTK	4%
Pharmaceutical	DRG	-2%
Consumer	CMR	6%
Defense	DFX	2%
Oil Services	OSX	51%
Natural Gas	XNG	30%

The start to 2008 has been rocky. The first five days of the New Year were down -5.3%, so much for that indicator. The Fed meets again at the end of the month and is expected to cut rates by either ¼% or ½%. The market doesn't go in either direction continuously, so in the words of JP Morgan the market will go up and down. The only person who will accurately predict what happens in 2008 will boldly make their prediction in December 2008 while looking through the rearview mirror. It appears that the one thing we can count on is volatility.

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