



Stanton & Castleton, Inc.

An independent firm

2008 Capital Markets Outlook

Towards the end of each year we meet several times to discuss our outlook for the coming year. We both will have reviewed several Capital Market Outlook publications from a number of respected investment houses including Raymond James. This along with our research of the global markets from both an economic and geo-political perspective helps us establish our expectations for the coming year.

Our objective is to establish an outline for how we believe the markets may behave and identify what we see as the major risks to investments across all market segments. We do not pretend to be able to predict what will happen in the future, rather we want to establish confidence that the portfolios we recommend are positioned to benefit from positive market environments and are helping to reduce risk exposure through diverse asset allocation and manager selection during negative market periods.

The following is our 2008 Capital Markets Outlook:

Inflation & the Federal Reserve:

YEAR	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEP	OCT	NOV	DEC	AVE
2007	2.08%	2.42%	2.78%	2.57%	2.69%	2.69%	2.36%	1.97%	2.76%	3.54%			
2006	3.99%	3.60%	3.36%	3.55%	4.17%	4.32%	4.15%	3.82%	2.06%	1.31%	1.97%	2.54%	3.24%
2005	2.97%	3.01%	3.15%	3.51%	2.80%	2.53%	3.17%	3.64%	4.69%	4.35%	3.46%	3.42%	3.39%
2004	1.93%	1.69%	1.74%	2.29%	3.05%	3.27%	2.99%	2.65%	2.54%	3.19%	3.52%	3.26%	2.68%
2003	2.60%	2.98%	3.02%	2.22%	2.06%	2.11%	2.11%	2.16%	2.32%	2.04%	1.77%	1.88%	2.27%
2002	1.14%	1.14%	1.48%	1.64%	1.18%	1.07%	1.46%	1.80%	1.51%	2.03%	2.20%	2.38%	1.59%
2001	3.73%	3.53%	2.92%	3.27%	3.62%	3.25%	2.72%	2.72%	2.65%	2.13%	1.90%	1.55%	2.83%
2000	2.74%	3.22%	3.76%	3.07%	3.19%	3.73%	3.66%	3.41%	3.45%	3.45%	3.45%	3.39%	3.38%
1999	1.67%	1.61%	1.73%	2.28%	2.09%	1.96%	2.14%	2.26%	2.63%	2.56%	2.62%	2.68%	2.19%
1998	1.57%	1.44%	1.37%	1.44%	1.69%	1.68%	1.68%	1.62%	1.49%	1.49%	1.55%	1.61%	1.55%
1997	3.04%	3.03%	2.76%	2.50%	2.23%	2.30%	2.23%	2.23%	2.15%	2.08%	1.83%	1.70%	2.34%
1996	2.73%	2.65%	2.84%	2.90%	2.89%	2.75%	2.95%	2.88%	3.00%	2.99%	3.26%	3.32%	2.93%

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Above are the inflation rates since 1996 as measured by the Consumer Price Index (source: inflationdata.com). As you can see inflation has remained fairly stable these past ten years. It is interesting to note that even with the decline in the US dollar and oil prices reaching nearly \$100 per barrel, we are trending slightly below 2005 & 2006 average annual rate. We can also see that if rates stay the same we will have had 3 years in a row of over 3% inflation. While not at an alarming rate, recent inflation trends have been up.

It appears the US economic growth has slowed from the effects of the sub-prime debt issues and record high oil prices. These two factors were the driving reasons behind the FED's decision to begin cutting interest rates in September of 2007. Our expectations are that the slowing economy will help lower overall demand and keep a lid on inflation for 2008.

The rate cuts should help stabilize the credit markets and provide the underpinnings for a second half 2008 economic rebound. We believe over the next few quarters markets will focus on dealing with and moving past the effects of the sub-prime loan issue. Over this time market returns may be restrained.

The Economy:

This past year has been increasingly volatile, however overall returns have been positive for most of the year. As of 11-27-2007, we are still positive for the S&P, Dow Jones Industrial Average and the NASDAQ Composite. We could experience our first negative year in the last five if we see continued selling in the US markets through December 2007, however overall returns have been reasonably stable. The FED's recent action to lower interest rates is recognition of our slowing economy and the recent fallout of the sub-prime loan market. These factors along with historical high prices for oil could lead to a slow start in 2008. In the past, rate cuts begin to have a noticeable effect on economic activity about six to nine months after the shift to an easing policy by the FED. If this plays out as in the past we could see growth establish a positive trend sometime after the 1st quarter of 2008.

Equity Valuations:

As discussed, we have seen erratic price movements through 2007 in most major equity markets. Establishing a reasonable valuation for equities is a bit of a moving target. As an economy slows so does the earnings and growth

for companies, so we could see lower stock prices as a result, however as of 9-30-2007 the S&P forward looking P/E ratio was 15.3, with a trailing P/E of 18. If we compare that to the market peak in March of 2000 the trailing P/E was 30.9, (Source: Standard & Poor's, First Call, Compustat, Factset, JPMorgan Asset Management) by comparison today's valuations do not seem out of line with the S&P 50 year historical, 1955 – 2005, median P/E of 17. (Source: Mark Panzner, Rabo Securities) Even if we factor in lower growth rates for 2008 the current market P/E does not appear to overvalue equities right now. This perspective gives us additional confidence in being able to weather any short term volatility the markets might experience over the near future.

Bond Markets:

Since the summer of 2007 we have seen dramatic declines in overall interest rates: 13 week T-Bill rates and the five year Treasury Note rates fell over 37% and the ten year Treasury Notes are down over 27%. This is the result of the Federal Reserves cutting the Fed Funds Rate by $\frac{3}{4}\%$ since September of 2007. These actions were a response to the crippling effects of the losses in the sub-prime loan market throughout world economies. This along with dramatically higher energy cost has slowed the US economy. In general high grade corporate, municipal and government bonds will benefit from rate cuts and we expect that to be the case for 2008. With the prospect of additional rate cuts, we favor short to intermediate maturities in the current environment.

Currency Markets:

We are truly a global market place entering 2008. Currency valuations play an increasingly important role in money flows worldwide and can have a dramatic impact on multinational companies' profits. We have seen the US dollar become the de-facto currency reserve for the world over the past 100 years. As we move toward a "borderless global economy" where the greatest growth is in countries outside the US (i.e. India, China) we may begin to see other stable currencies share/assume this status. This is why we have taken an increasing overall position investing in foreign markets. We believe adding multinational and foreign holdings will reduce overall risk and stabilize returns. What is clear to us is that the world is "becoming smaller" and the rapid expansion of the internet has forever changed how people, companies and countries do business. Information and shared intellectual innovation will effect global growth in ways we have not yet imagined.

Oil, Real Estate and the \$:

When we look forward in world markets and see the related geopolitical issues at play, our approach is to try and anticipate those events that could unexpectedly shape investment returns. We are well aware of what is in the headlines and so is everyone else. In our view, while these anticipated and discussed risks will have a real effect they will not “shock” the markets. Few people had anticipated the sub-prime loan risk prior to July of 2007. As we all saw its effect was dramatic, rapid and negative. It is the “Black Swan” event (In [Nassim Nicholas Taleb](#)'s definition, a **black swan** is a large-impact, hard-to-predict, and rare event beyond the realm of normal expectations.) that we try to imagin. One positive “Black Swan” would be if oil prices fell dramatically in 2008. This is not a widely held opinion, however the overall supply / demand situation has not changed much since the beginning of 2007, and yet the price of oil has nearly doubled in price. What would happen if; the world economies slow and overall oil demand declines slightly...and the Iraq War rapidly stabilizes allowing the US to accelerate it's withdraw...and the US dollar saw even a modest 10-15% positive gain? We are not certain, however we do know very few people seem to believe this is possible in 2008. Our goal is to continue to design portfolios that try to manage risk through reasonable asset allocation and proven asset managers who place risk management as a top priority. Overall we believe growth prospects could accelerate in the 2nd half of 2008 spurred by current monetary policy.

“In the end, how your investments behave is much less important than how you behave.”

**Benjamin Graham
The Intelligent Investor**

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