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LINNARD FINANCIAL MANAGEMENT & PLANNING, INC.

Registered Investment Advisor, Wealth Management & Financial Planning

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Outlook & Trends

There are a number of conflicting factors driving the economy today that will impact your financial results. This issue of *Outlook & Trends* discusses several that are important for you to consider. To stay on the course to your financial goals, it is helpful to maintain an accurate perspective of where we are in the continuous flow of economic events, as well as having a sound investment strategy and a financial plan as a guide. Hopefully this letter will help you with the perspective. Hopefully you have an advisor helping you with your strategy and financial plan.

Economy

The economy is like an engine that requires a tune-up. While most of the engine is in good repair, the spark plugs in several cylinders are gummed up, causing the entire engine to run roughly and decelerate. The US economic engine hit its maximum RPM in 2004. The Federal Reserve began raising interest rates at that point, and economic growth has been decelerating since. The Fed policy primarily affected economic sectors like housing and mortgages, where excess growth depended on low interest rates. These sectors are still working off their problems and many homeowners continue to see the values of their house fall, particularly in the south and the west.

In addition, the value of the dollar has been dropping since 2002. This makes US assets less expensive in the eyes of the rest of the world and has made foreign goods 45% more expensive to us. The cheaper dollar supports the larger US companies that sell products internationally, protects domestic jobs and helps our tourist industry. The dollar's fall has also had the effect of increasing our cost for commodities, like oil, that are used worldwide. If the dollar's value had been constant since 2002, the price of oil would be more like $60, rather than the $90 we have today.

These forces leave us with an economy that has been growing more slowly than before. Annual corporate profit growth, a primary driver of stock prices, has slowed to about 2%. The last six times that the profit growth rate dropped to this level, after reaching a high of over 20%, profits dropped by more than 10%. Leading economic indicators, which include the stock market, suggest continued slower activity. Investors have been fretting about the credit market problems infecting the remainder of the economy. But the market can overreact. Economist Paul Samuelson once said, only partly in jest, that the stock market has "predicted nine out of the last five recessions". Securities analysts are more optimistic about the future than the present. Although their profit growth estimates have been cut back to almost zero for 2007, they expect next year's results to be 15% higher. Since the stock market values expectations rather than reality, the analysts' forecasts may matter more to market values than current data.

Financial Markets

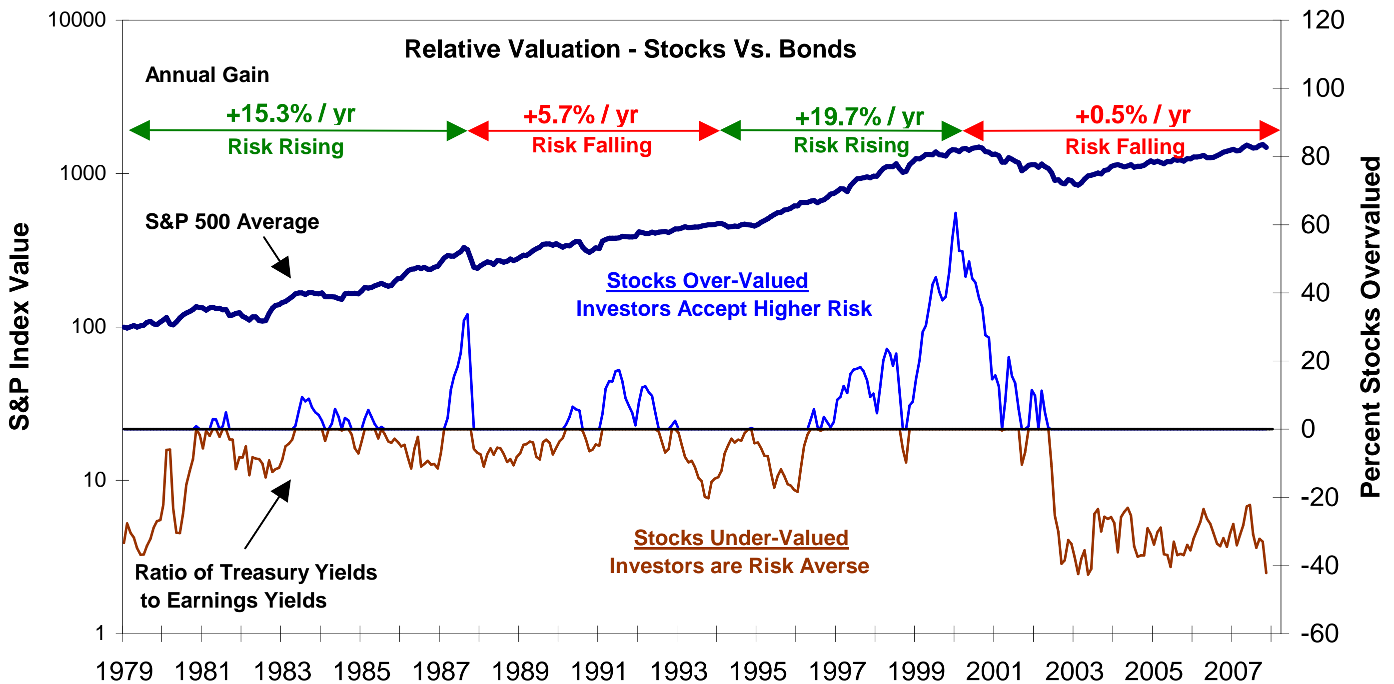
In the last issue, we spoke of a stock market correction that appeared to be ending. End it did, but then prices promptly fell back off again, creating a "consolidation" in a wide trading range as investors and analysts pared back their near-term profit forecasts. Prices bounced around, dropping over 12% in the process. The S&P 500 eventually finished 3.5% lower than it began. It is not unusual to see this type of volatility when the overall trend flattens out.

Financial theory says that stock prices are based on three factors: earnings estimates, interest rates and investors' willingness to take risk. Higher earnings estimates and lower interest rates produce higher stock prices. Greater risk aversion causes investors to demand a greater return and therefore reduces the amount investors are willing to pay, which reduces stock values. The current flat market trend is caused by the combination of near-term earnings

estimates weakening, and interest rates falling. Investors' appetite for risk has not changed much. There is also often a noticeable seasonality effect. The last two months of the year tend to be the strongest for stocks, because analysts often revise their earning estimates upward as they look ahead to the next year. At mid-year, overly optimistic early forecasts collide with reality and projections are reduced, producing weaker prices during the third quarter. This year, instead of being strong, November and December produced a 5% loss. The last time we had a net loss during these two months was at the end of 2000, just before the last major bear market. This is a potential warning.

Market Valuation

There is a big difference between now and 2000, however. In 2000, investors welcomed risk, thinking only of the great gains to be had. Today risk is shunned. The "Fed Model" shown below compares earnings expectations to the yield on Treasury notes. The graph shows that stocks were 60% overvalued relative to Treasuries in 2000, but are 40% undervalued today. The graph also clearly illustrates how shifting investor attitudes impact returns. While investors change from low risk tolerance and low stock valuations, to high-risk acceptance, stock returns average 17.5% per year. During the periods when risk aversion rises and valuations fall, average returns are only 3.1%.



Right now we find ourselves at one of the lowest valuation levels in almost 30 years, at a point similar to the market bottom of 2003. There is nothing here to say that stock prices cannot go lower, particularly if earnings estimates continue to fall, or the intermediate trend continues to be weak. However, it is reasonable to observe that current valuations are appealing from a long-term perspective, and may tend to limit a further decline. The graph also suggests that, if the economy continues to grow over the long-term, there can be significant stock price appreciation going forward over a multi-year period as investors' attitudes change once again to become more tolerant of risk.

To learn more about *LFM&P* investment management and financial planning services, our client goal-centered and risk-managed financial philosophy, and to better understand the value we can bring to your financial life, we encourage you to contact us or look at our website, www.linnardfinancial.com.

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