BCA Fourth Quarter 2007 Market Review ©

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How a Slowing Economy Impacts Asset Class Performance and Asset Allocation

The fourth quarter of 2007 revealed more evidence of fading economic growth in the U.S. The major cause has been the banks. Lending standards for both commercial and private mortgages have been tightened in the wake of a decline in the quality of existing loans. Banks are inducing an economic slowdown and are further increasing the probability of property foreclosures. Firms will be less inclined to borrow capital to make investments in plant, equipment and technology. The lending industry has stalled and faces further losses in 2008 in the form of loan asset write-downs. The banking environment will not improve until loan asset performance improves in terms of rising collateral values and falling delinquencies.

BCA believes that a mild recession will occur in 2008; as business activity and investment slows and consumers pull back spending. The impact upon asset classes may vary, as follows:

- Domestic stocks – A shift towards high quality and high capitalization companies with multi-national exposure.
- Domestic bonds – Widening yield spreads will favor a tilt towards high quality corporate issues.
- International stocks – High quality companies in developed countries will be less risky than emerging markets.
- Real Estate – REITS experienced re-pricing in 2007 and direct real estate will see falling valuations in 2008.
- Dollar strength – Stabilizes as capital flows into the U.S. rise from improving exports and increased foreign investment.

The slowing economy will reward those areas of the stock market that lagged until recently. The days of cheap money and investors not paying a risk premium are over. Low quality companies with weak balance sheets will be replaced in portfolios with safe high quality names. Falling consumer spending will typically hurt Starbucks, but help McDonalds.

Both fiscal stimulus (tax cuts) and more interest rate cutting by the Federal Reserve will occur in 2008, but such measures will not have traction until 2009. Accordingly, bonds will be an attractive asset class in 2008. The result may be better than coupon bond returns and bonds selling for a significant premium by year end 2008.