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Gloomy Focus on Financials will Eventually Fade to Opportunity

It is hard to argue with the claim that the economy is experiencing a serious slowdown. Last Friday's employment numbers were horrible and confirm the economy is slipping into a recession if it isn't already there. Banks and the rest of the financial community are in a deep recession as they pay for the sins of the recent past. Some analysts estimate that bank balance sheets will see write-downs as high as $1 trillion. The U.S. consumer is not in a good spot right now – too much debt and declining wealth. The Fed recently released data showing total household wealth fell by $533 billion as lower stock prices added to the damage from falling house prices.

Unfortunately there is probably more bad news ahead as the consequences from the housing bust are not over. The Fed reported that the aggregate percentage of home equity fell sharply during the quarter to 47.9%. Since this is an average number and many homeowners have no mortgage debt, the proportion of homeowners with negative equity likely increased significantly. We have consistently warned that the fall-out from the housing and debt bubbles will take years, not months to work through and this data adds to our conviction.

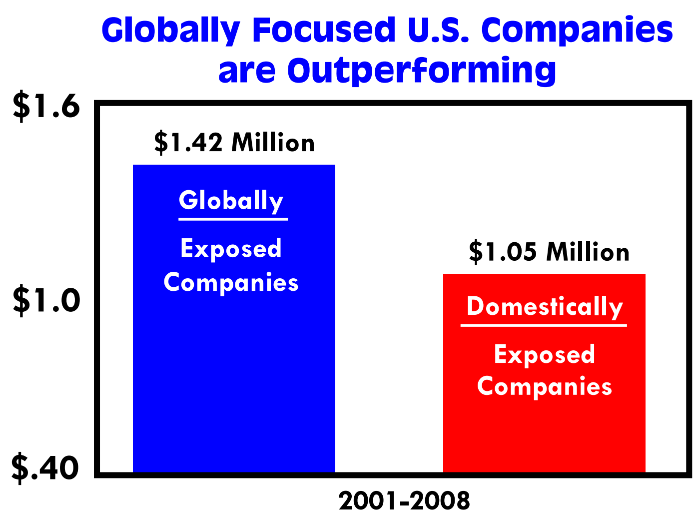
However, despite these issues and the sloppy stock market so far in 2008 there are **signs of strength.** The commodity and agricultural markets are near all-time highs. Despite our problems the emerging economies remain very strong. While the U.S. is still a major influence on the world economic scene, our importance has declined. According to the IMF, the U.S. share of world imports fell to 14% last year from over 20% in 2000, while the import share of the developing countries grew to 40.6% from 33%. During 2007, the developing countries produced over 52% of global growth. Last year consumer spending of the world's 17 largest emerging-market countries was equal to 65% of U.S. consumer spending. Clearly our problems will not be the death knell to the emerging markets that some commentators claim it will be.

In contrast to the U.S. consumer, Corporate America's balance sheets (with the exception of the financials) are as good as they have ever been. According to Standard & Poor's, the total cash held by companies in its industrial index exceeded $600 billion, up from $203 billion in 1998. Moreover, U.S. companies used only 11.7% of their cash flow to service debt in the third quarter, according to Economy.com. Better still these companies remained relatively lean during the good times decreasing the need for drastic layoffs like we experienced earlier this decade. Plus despite all the angst shown by the stock market the leaders of America's largest corporations are upbeat. General Electric's Jeffrey Immelt expects earnings to grow 10% in 2008. Industrial equipment giant, Emerson, predicts earnings will grow in the range of 11% to 15% this year, while PepsiCo sees strong growth overseas leading to earnings growth of at least 10%.

Not surprisingly, high-quality stocks with a global focus have significantly outperformed those stocks with a domestic focus since the credit crisis started in earnest last summer (see chart).

This is a trend that is likely to continue. In his recent letter to shareholders Warren Buffett made a strong argument for the continued decline in the dollar which would bolster the business prospects for America's leading export companies. A falling dollar brings with it the potential for higher inflation. However, although inflation has perked up a bit, it doesn't appear to be a lasting threat or long term interest rates would be well above the current level of around 3.5%. Mr. Buffett also stated that he plans to further increase his exposure to foreign earnings. An easy way for the U.S. investor to accomplish the same goal is to buy stocks of U.S. multinational companies.

The silver lining to downturns is that they create a lot of value. We know from experience that the best buying opportunities occur during periods of stress like today. Warren Buffet has said that it pays to be greedy when others are fearful, and clearly the markets are fearful right now. All stocks get punished in corrections including those companies that continue to grow in value. Investors would be wise to underweight investments tied too heavily to the U.S. consumer while emphasizing ownership of companies with significant foreign business exposure, attractive valuations and strong balance sheets. We are pretty confident that volatility in 2008 will not all be to the downside. **At some point much of the current gloom will dissipate, the outlook will brighten, and stocks will likely move higher.**



Information is based upon analysis of 32 Globally exposed industry groups verses the S&P500 Index and 28 Domestically exposed industry groups versus the S&P500 Index. Data is derived and estimated from information by the Bank Credit Analyst March 2008 Publication. Research Inception from study was 1998. Information used for the study above is from 2001 through February of 2008. Based upon growth rates in the period applied to beginning investment values of $1,000,000. No guaranteed is made or implied. Investments in the stock market may lose value.

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