

2007 Economic and Investment Outlook

Inside this Issue:

We summarize our 10-page report entitled:

“WESCAP’s Investment and Economic Outlook for 2007”.

Please contact us if you would like to receive the full report which contains additional details and discussion regarding inflation, productivity, housing, and various asset classes and markets.

Highlights:

- Growth for the U.S. economy is expected to moderate in 2007 with an increased chance of a recession.
- The housing market is showing signs of weakness and a large number of subprime mortgages are scheduled to reset beginning in late 2007. However, foreclosures currently represent only a small fraction of all mortgages outstanding.
- Our forecast is that the economy will experience a “soft landing”.
- In our opinion, large U.S. stocks, foreign stocks and bonds, and hedged strategies are among the most attractive investments currently.

The U.S. economy is expected to grow more slowly in 2007, but the consensus estimate for U.S. real (inflation-adjusted) GDP growth is still projected to be a robust 2.6% for 2007. However, **we cannot ignore the possibility of a recession over the next 12 months.**

A key worry is the **health of the housing market**. Housing starts are down about 20% from their peak and may decline another 5-10% in 2007. Home prices have also declined in selective markets, though the effect does not appear to have spread nationwide. Nevertheless, because rapid building has occurred along both coasts and other “hot” market regions, inventory levels have risen, thus likely adding to downward price pressures in 2007.

Interestingly, **non-residential construction appears to be strong**—propelled by space needed by industry and government. Furthermore, this growth is expected to more than offset the decline in residential construction.

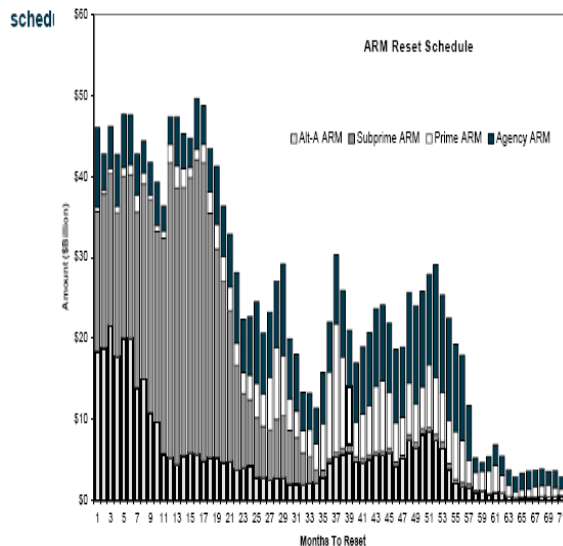
Another key factor in 2007 and beyond is consumer spending. For much of 2006, **consumers were spending close to 1% more than they earned**, with the difference coming from savings,

asset sales or borrowings. This is not sustainable in the long run.

Additionally, there are some cash-strapped homeowners that are close to the limit on being able to make their loan payments.

The following chart shows the number of adjustable rate loans that are expected to reset in the near future (Credit Suisse, 10/06).

Approximately \$1 trillion of adjustable rate mortgages (~9% of total mortgage debt outstanding)



Source: Credit Suisse Fixed Income

Primarily troublesome are the large number of subprime mortgages scheduled to reset in late 2007 and early 2008 (about \$30+ billion/month). These less credit-worthy property owners often have little home equity. What happens with this group of homeowners may determine whether growth merely slows or whether a

303 North Glenoaks Blvd.
Suite 905
Burbank, CA 91502
Phone: 800-820-2453
Fax: 818-563-5174
Email: contact@wescapgroup.com

VISIT US AT OUR WEBSITE:
WWW.WESCAPGROUP.COM

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recession is triggered in 2007 or 2008.

Nevertheless, these concerns may be overblown. The homeowner who can't pay and who can't sell or refinance is still a tiny fraction of all homeowners. This is reflected in the **overall delinquency rate of all mortgages**, which at 4.67% is only up 0.28% from the prior quarter and **0.23% higher than a year earlier**. Note that foreclosures are still at a very low rate, currently standing at 1.05% of all mortgages outstanding.

Given current and expected developments, **we believe that a "soft landing" is in store for the economy**. This entails a slowing, but not declining year of economic and corporate earnings growth, with relatively stable employment, some wage growth, perhaps with a modest bump in the unemployment rate. In this scenario, interest rates also remain stable with the possibility of short-term rates coming down (assuming inflation does not take a jump despite the deterioration in labor productivity).

While a soft landing seems most likely, we cannot conclude

that other outcomes are not possible and in fact are increasingly a concern. **A stagflation and higher interest rate scenario would most likely result in a recession**, as would worse-than-expected developments in housing and consumer spending.

Investment Outlook

With the S&P 500 currently trading at a 16.4 multiple of 2006 earnings and a 15 multiple of 2007 projected earnings, **the U.S. stock market is still attractively priced**, particularly in the context of low long-term interest rates and current inflation rates. Corporate merger and acquisition activity remains high and an estimated \$750 billion available of private-equity firm cash ready to invest should provide strong underpinnings to the U.S. and foreign stock markets.

Energy stocks may be at a crossroads in 2007. Oil and gas prices have taken a big tumble from their 2006 highs. Therefore average earnings growth rates from energy sector companies are expected to be close to nil in 2007 (except for oil service firms).

Foreign stocks and bonds still deserve a large weighting due to more favorable expected growth, or due to currency or fiscal and po-

litical policy considerations.

Commercial real estate and REIT valuations are stretched, but improved business conditions support fundamentals for office space, industrial space and retail space.

Various long-short **hedged strategies continue to be attractive**, particularly merger arbitrage. Mergers and outright global acquisitions by private-equity funds and other investors in 2006 resulted in the greatest corporate transaction level ever, perhaps to be surpassed in 2007.

High quality, long-term, U.S. bonds, particularly government bonds, continue to offer **more risk** than we would prefer, given their relatively low yields.

Should there be any severe market or sector declines, our diversified portfolios should assist in preserving capital. Furthermore, such wide diversification should provide us the financial resources to take advantage of any opportunities in temporarily undervalued assets. Our goal is to be alert to dangers *and* to opportunities.

For more on our investment approach, please visit our website at www.wescapgroup.com.