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## Credit Crisis of 2007 and Economic and Investment Outlook for 2008

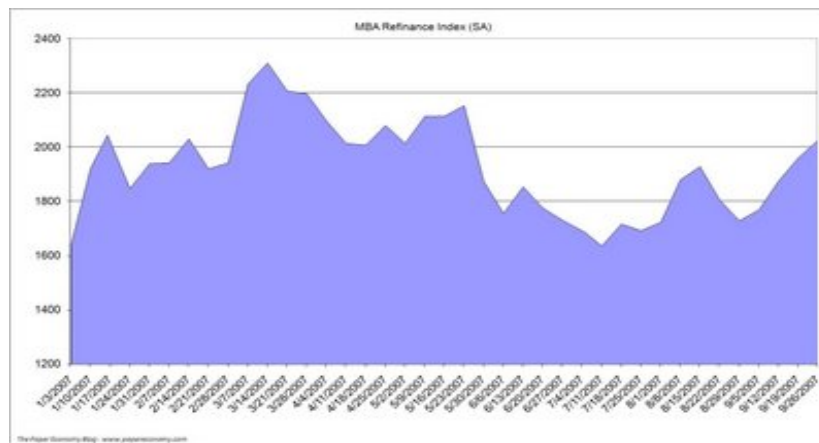
### 2007 Year in Review

One year ago in our annual review of the prospects for the economy and investment, we were very concerned about the housing market and the level of mortgage payment resets. Nevertheless, we felt that strong non-residential construction along with a strong global economy and reasonable growth in consumer and corporate spending would result in 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”. Our outlook was on target. No recession occurred in 2007, and despite the general credit crunch that began in late July, the broad economy and securities markets showed positive results.

Corporate earnings growth beat expectations for most of the year, except for financial companies, which reported large profit write-downs and reduced revenue because of sub-prime and other questionable loans. However, most firms maintained strong profit margins and balance sheets. Thus the “have” and “have-not” companies became obvious. For example, the Russell 2000 Growth index (with few financials) outperformed the Russell 2000 Value index (with many financial and cyclical stocks) by over 16% in 2007.

Employment continued to grow, with payroll employment up 1.3 million for 2007, although the unemployment rate also bumped up from 4.4% to 5% by year-end as new labor entrants exceeded job growth (U.S. Bureau of Labor Statistics). Nevertheless, total personal income (i.e. wages and other income) grew by 4.9% through the first 9 months and another 1% for October plus November. Consumer spending also increased. Personal consumption expenditures showed a 4.4% average increase for the first 3 quarters of 2007 and another 2% for October and November. Even after adjusting for the 12-month increase in inflation (4.3% CPI-U through November) both total and per household income and spending rose in 2007.

The Mortgage Bankers Association Refinance Index (next chart, January-September 2007) shows that while home refinancing dropped off somewhat during the early summer, it largely recovered by the end of summer. Credit is still available for the vast majority of homeowners and they continue to take advantage of it for spending or other purposes.



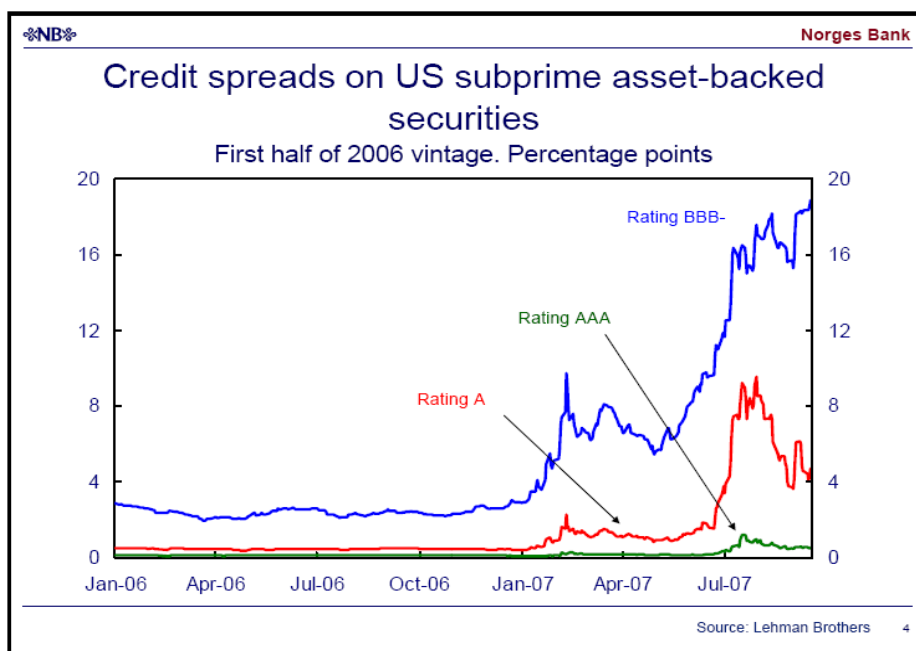
Most foreign countries are expected to have grown faster than the U.S. in 2007. Most of them have underdeveloped mortgage markets and don't offer sub-prime loans. Thus a slowdown in their housing markets did not create the same economic and investment concerns as in the U.S. This stronger economic foundation also resulted in the U.S. dollar declining relative to most other currencies. For example, the Euro appreciated by over 10% relative to the dollar in 2007. Dollar depreciation helped foreign currency denominated stocks and bonds outperform their U.S. counterparts.

High quality U.S. bonds did well in 2007 as a flight to "safe haven" investments occurred. The Federal Reserve also reversed course in 2007 and started lowering short-term interest rates. This combination made many longer term high-quality fixed-income investments more attractive. As a result, yields fell on U.S. long-term government bonds to 4.45% at year-end on the 30-year Treasury bond.

### The 2007 Credit Crisis

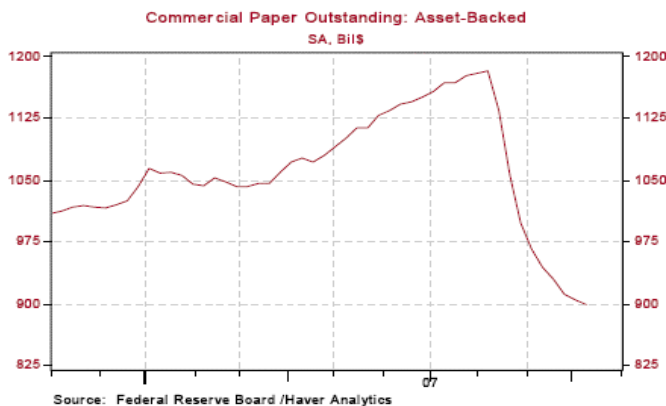
The summer of 2007 saw a short-term liquidity crisis, which morphed into a general credit tightening with economic after-effects expected to last well into 2008.

The triggering event was the subprime mortgage market "melt-down", which in turn was a result of the breaking of the residential housing bubble combined with generally loose credit standards and poor credit decisions across the debt spectrum. The increasing level of default rates in sub-prime mortgages became widely recognized in early 2007, thus increasing the interest rates required by investors. This began in February as can be seen in the next chart. However, risk spreads then improved for several months before the broader and ultimately more damaging general credit crisis began in late July.

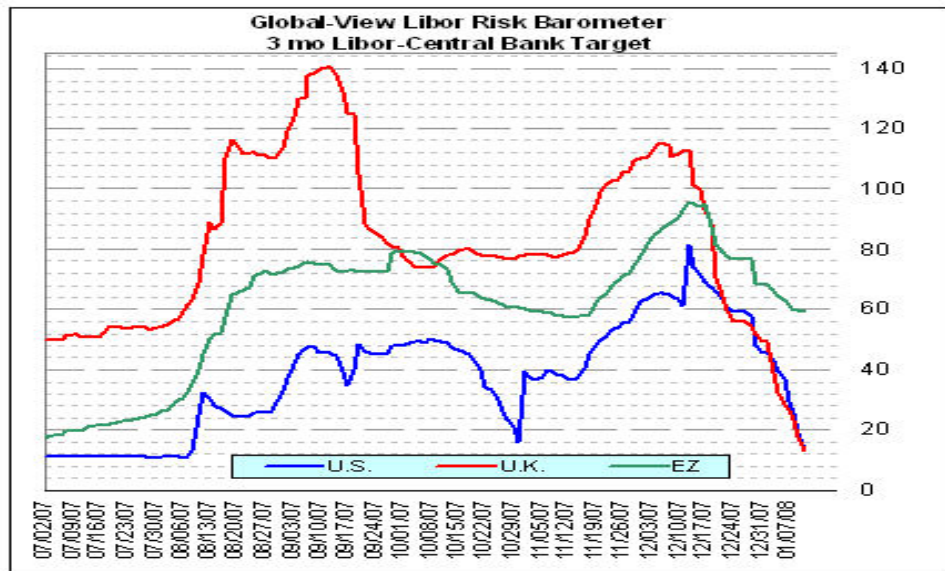


The general credit crisis then began in earnest, as it became clear that the damage was spreading beyond sub-prime. Accumulated losses in sub-prime securities began to impair bank and brokerage firm profits and diminished their ability to fund commitments already made for private equity buy-outs and merger deals. In turn, this sparked concerns about banks and other

financial companies and even the commercial paper that large financial corporations use to finance their activities. This is shown on the following chart, where the large July/August decline can be seen for “asset backed” commercial paper (e.g. corporate debt secured by assets such as mortgages, credit card loans, auto loans and other assets). As auto, finance, and mortgage firms could not roll over their commercial paper at reasonable interest rates, they tapped into stand-by letters of credit that commercial and investment banks had previously agreed to, thus putting an even greater strain on the liquidity of the U.S. financial system.



This financial strain was not limited to just the United States. Concerns about credit quality and liquidity forced interest rates higher in other countries. The increase in credit spreads for money that banks lend to each other increased dramatically in July and August as can be seen in the next chart for LIBOR spreads in the U.S. (lowest line), Euro Zone (middle line) and UK (top line).



Thus a relatively small sub-prime mortgage default issue bloomed into an international liquidity crisis. The immediate response was a lowering of interest rates by the Federal Reserve and subsequent actions to boost liquidity by both the Federal Reserve and European monetary authorities. These worked to some extent as can be seen in the reduction of interest rate spreads after August. However, in November, credit issues once again resurfaced, as shown by the rapid rise in credit spreads. The additional actions taken by monetary authorities appear to have worked, as **credit spreads in the US and UK retreated to pre-crisis levels**. They also improved considerably in the European Union community, but still remain elevated.

The actions taken by international monetary authorities, plus recapitalization of some key banking firms have caused a retreat from credit crisis conditions. The extent and rapidity of additional expected rate cuts plus additional future monetary and financial actions will go a long way towards determining whether the worst is now safely behind us.

## **2008 Economic Outlook**

The consensus estimate for U.S. real (inflation-adjusted) Gross Domestic Product (GDP) growth in 2008 is 2.5% (Philadelphia Federal Reserve—November Survey of Economic Forecasters). This is down 0.5% from the forecast for 2008 made by the same group early in 2007. More recent forecasts by others indicate that growth may be under 2% for 2008. Forecasters continue to reduce growth expectations for 2008.

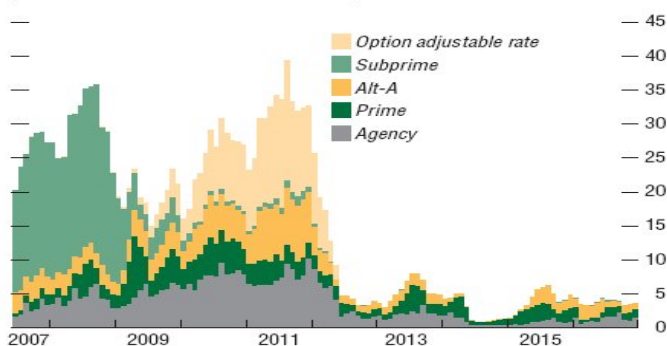
This is also shown in their forecast of an increase in the probability of a recession. This year's forecast survey shows that economists believe that the chance of recession in any quarter in the coming year (2008) has risen to 22.5%. Contrast this to last year's forecast of 18.8% and the prior year's forecast of 14% for probabilities of recession in those years. The current recession probability forecast is now at a level that we must seriously consider the possibility of a recession over the next 12 months. We intend to monitor this throughout 2008, and if the risk of recession continues to rise, this could result in our making significant portfolio shifts beyond changes already made in anticipation of a slowing economy.

The inverted yield curve of 2006 and early 2007 has largely disappeared as the Federal Reserve began a series of interest rate cuts. Inverted yield curves have often preceded recessions, but normal yield curves often presage a recovery from an economic slowdown, as lower rates stimulate the economy. Unlike prior yield curve inversions, the most recent inverted yield curve was partly a creation of Chinese monetary and export policy (more on China later).

The U.S. residential housing market is doing about as poorly as we expected and it may get worse as the year progresses. Delinquency rates for the third quarter 2007 are up almost 1% from a year ago to a record high of 5.59% of loans outstanding (Mortgage Bankers Association). Most defaults are cured, but some moved into foreclosure. In the third quarter, subprime mortgages accounted for 43% of all foreclosures, although they make up only 6.8% of all loans. Adjustable rate subprime loans had the worst foreclosure rate at 4.72% for the third quarter.

However, there is some encouraging news. First is that the dollar amount of subprime adjustable rate loans that face an initial rate reset is about to decline dramatically.

**Figure 1.7. Monthly Mortgage Rate Resets**  
(First reset in billions of U.S. dollars)



Source: Credit Suisse.

As can be seen on the previous chart, early 2008 represents the peak of subprime mortgage resets. By late this year it is expected to have a much smaller impact. Also, as the Federal Reserve orchestrates lower short-term interest rates, the reset burden is expected to drop further. However any noticeable improvement is unlikely until the latter half of 2008 or until 2009. Foreclosures in California equal that of 35 other states combined. Many of the foreclosures are also clustered in Florida due to excess speculation and in Michigan and Ohio with weak local economies. Most states are still doing relatively well. Plus for “prime” higher quality fixed rate loans, new foreclosures in the third quarter 2007 were a still modest 0.22%. Most American homeowners can (and do) make their mortgage payments and lower current short-term and long-term mortgage rates are expected to help some of those otherwise facing foreclosure.

Offsetting much of the housing-related weakness is a strong export market. Exports of U.S. goods and services grew 12.2% for the 10 months ending in October. Exports made up 12.1% of GDP, more than double the nearly 5% share back in 1967. The lower dollar is a big factor in export strength and as we continue to expect a somewhat cheap dollar, we anticipate strong export growth going forward. China recently surpassed Japan as the third largest market for U.S. exports. Continued growth in China (and thus our exports to China) should remain one of the strong underpinnings of the U.S. economy.

The U.S. consumer has continued to spend at a higher rate than many pessimists expected. With continued wage growth and projected lower short-term interest rates, we expect that the U.S. consumer will continue to provide support for the economy. However, employment growth appears to be slowing. If this trend continues, consumer-spending growth could stall. In this case, business capital expenditures and other factors may end up being the key to whether growth is sustained or if recession or near recession becomes reality.

Business capital expenditures are more volatile than consumer spending and often a decline in this spending is the trigger for recession. Chief Financial Officers (CFO's) were surveyed recently about their 2008 outlook (CFO Magazine--Global Business Outlook). The results were not encouraging. Credit conditions negatively impacted 1/3 of the firms surveyed. A reduction in credit availability was noted. Additionally, about one-half of these affected firms stated that borrowing interest costs had increased by about ½% per annum. Own-firm optimism declined, with over 50% being pessimistic about their own firms' prospects in 2008. Capital expenditures are expected to slow as a result, though still expected to grow 4.1% in aggregate. Thus, unless capital expenditure growth is lower than expected and turns negative, a recession should be avoided. Despite some of the pessimism, one-third of the CFOs still expect to acquire one or more companies in 2008, which indicates both attractively priced opportunities and capital availability. They expect to increase prices 2.8% in 2008, which is higher than the 2% rate of increase noted in the prior quarter's survey—so pricing power is expected to improve somewhat.

European CFO's also turned much more pessimistic, but less so than their U.S. counterparts. One-third of them said they also were negatively affected by difficult credit conditions. CFO's in Asia are generally optimistic and expect 2008 capital spending to increase 11% on average.

Much of the pessimism is linked to the higher cost of capital and credit availability. Subsequent to the CFO survey, there has been a marked improvement in the cost of capital (refer back to LIBOR spread chart on page 4). Given the volatility in these credit markets spreads, it makes sense to continue to monitor interest rates and risk spreads for evidence of either continued improvement or deterioration.

Thus, we expect business spending to stay positive for 2008. The same may not be true for government spending. Many states are suffering revenue shortfalls from lower property tax and capital gain tax receipts. California is expected to be among the worst in this regard. Either an increase in tax rates or a reduction in spending are likely to occur, which is expected to further slow down regional economic growth and prolong California's housing woes.

Outside the U.S., Europe's growth rate is expected to slow thanks to both the effects of credit related difficulties and a relative loss of competitiveness to the rest of the world given the appreciation of the Euro currency. Japan remains sluggish despite an otherwise strong Asia. China's growth rate is expected to stay strong for at least several years given their currency controls encouraging strong trade and their infrastructure spending. Even if the U.S. falls into a recession, China's large accumulated trade surpluses and financial reserves should be able to fund their massive infrastructure growth for many years without interruption. China and Asia in general, as well as suppliers of raw materials and industrial goods to the region should continue to do well for some time.

China faces strains from excessive liquidity, including accelerating inflation and growing speculative excesses in real estate and the China-only stock market. These growing strains may require more drastic actions in a few years, but for now maintaining economic growth is China's primary goal and is unlikely to be derailed in the short run. China, and to a lesser extent India and other countries with strong financial reserves and competitive advantages should continue to grow and help the rest of the world in the process.

Given strong global growth, an ongoing reduction of borrowing costs, a resilient consumer and strong exports, we believe the U.S. economy will be able to offset the negative housing, credit crunch and energy cost impacts. Therefore, **we continue to expect no global recession**, though for a stretch of time we probably will have near recession conditions of very slow growth and rising unemployment in the U.S.

While this slow growth scenario appears the most likely, we cannot ignore a growing possibility of a recession in the U.S. We intend to acknowledge this possibility via current and pending portfolio positions and contingent portfolio planning.

### **2008 Investment Outlook**

Estimates for growth of S&P 500 total earnings for 2008 are close to 15% (Zacks 1/7/08), which is quite a contrast to the decline in earnings expected for 2007 (companies are just starting to report for the last quarter of 2007). However, if the embattled financial and consumer discretionary sectors (e.g. autos, appliances,) are excluded, the other S&P 500 firms improved earnings 10.8% on average in 2007. The difference between the "have" and "have not" sectors is expected to continue into 2008.

A slowing economic growth rate is hard to reconcile with a 15% earnings growth rate. This is particularly true if profit margins come under some pressure in 2008 as higher input costs, higher borrowing costs for some firms, and slower revenue growth may not yield the operating leverage we have seen in the past couple of years. Additionally, many firms have curtailed stock buy-backs, which in prior years contributed to positive earnings per share growth and helped most firms beat consensus earnings expectations.

Using current analysts' revisions to earnings estimates as a guide, energy, consumer staples, and to a lesser extent healthcare and technology companies seem most likely to meet or exceed current earnings growth expectations. Nevertheless, our concern is that analysts are bit too optimistic.

Energy, materials, and low-export oriented industrial companies are still at risk if the economy slows further or if the dollar reverses its downward trend.

The dollar could indeed strengthen if some foreign economies also slow. As a result, some safe haven money could flow back into the U.S. Additionally, the dollar now appears somewhat undervalued (on a purchasing power basis) compared to the Euro. The managed currencies in Asia could also continue to appreciate going forward given their strong economies.

The S&P 500 in early January 2008 is currently trading near a 16.5 multiple of 2007 earnings and a 15 multiple of 2008 projected earnings, which are close to the valuations at the end of 2006. **In this case, the stock market is still attractively priced**, particularly in the context of low long-term interest rates and expected inflation rates. Nevertheless, the risk that these earnings expectations will not be met is greater than in recent years.

For the time being, **we are concerned about investing in highly cyclical businesses or financially sensitive firms** within the U.S. stock market. More stable businesses with more predictable growth rates, even if slower, should be overweighted in portfolios, so long as these stocks and their sectors are not overvalued. We expressed the same sentiment last year. It's quite possible that later in 2008, as the Federal Reserve interest rate cuts gain traction, the economy and company earnings will begin to accelerate again. It often takes a year from the start of rate cuts to turn around a slowing economy. The markets have already priced in a high probability of recession, so if a recession is avoided, we could get a fairly large global equities rally. Even if a recession does occur, we expect it to be short and shallow and we would also expect a sharp, but not prolonged drop in equity prices. Either way, **we expect to see some potential buying opportunities in 2008**. Declining markets are not much fun while experiencing them, but they present buying opportunities to make additional profits when recovery is underway. Patience, caution and selectivity during at least the first half of 2008 are likely to be keys to long-term financial success.

Despite higher volatility, the faster growing emerging markets still offer reasonable stock valuations. While some markets like Mexico may suffer from a U.S. slowdown, many more are expected to do well. Thus any sharp short-term declines are expected to be temporary for most emerging markets.

Europe may show more strength than the U.S., but corporate earnings growth may be challenged by some of the same factors affecting the U.S., plus an additional drag from the Euro currency cumulative appreciation, which is reducing export competitiveness. If the effect of currency appreciation were stripped out, then many European stock and bond markets would have had weaker price performance than the U.S. markets. Treating all non-U.S. markets the same would be an error, and selectivity is needed overseas as well. As in the U.S., taking a somewhat more conservative approach is warranted—emphasizing larger, stable earnings growth stocks and paying attention to foreign bonds' credit, interest rate and currency attributes.

Last year we said "Commercial real estate and REIT valuations are questionable" and unfortunately this translated to an asset class that did very poorly in 2007 with the average REIT showing a price decline (excluding dividends) of 19.1% (NAREIT—Equity REIT index). Prices dropped, even though operating fundamentals improved, creating a situation similar to that of

1998. Thus prices and fundamental valuations differences are converging, but unlike 1998, fundamental real estate valuations are not yet cheap by historical standards. **Some additional price declines may be necessary to make REITs attractive** enough to boost our investment allocation.

Due to the credit crunch, high yield bonds barely eked out a profit in 2007. This occurred despite hitting a 27-year low default rate of only 0.9% (according to bond rating firm Moody's). However a transition point may be in the offing. Moody's predicts the default rate to rise to 5% by the end of 2009, as many troubled companies deal with both a slow economy and difficulty in refinancing debt. So despite a rise in high yield bond rates in 2007, it may not be enough of an increase to offset pending defaults later in 2008 and into 2009. Note that defaults do not mean losses, as there are usually corporate assets that can be liquidated to help pay off debt obligations. Nevertheless, to keep loss rates to a low level, we intend to avoid the lowest quality tiers of corporate bonds. Bank loans normally are more senior in the debt structure to most high yield bonds, so the recovery rates tend to be much greater, even in event of default. Their yields are higher now than a year ago, so if higher yield income is desired, senior bank loans appear more attractive than high yield bonds. In a general market or economic downturn, they are likely to decline in value, but much less so than equities.

Many emerging markets bonds also offer high yields along with some credit risk. As trade surpluses have strengthened these economies, we continue to favor these investments, particularly the short duration and non-dollar denominated fixed income securities.

High quality, long-term, U.S. bonds, particularly long-term government bonds, continue to offer more risk than we would prefer given their relatively low current yields. Until yields rise to provide a larger cushion of safety to compensate for potential future inflation and interest rate risks, our exposure to these bonds is expected to remain underweight. However, we recommend holding enough for volatility control and as a hedge against recession, with an emphasis on shorter maturities.

Last year at this time we began increasing our preparations for potential economic and market difficulties. In 2008, we plan to continue and even intensify this approach. This means continuing to own more defensive equities, seeking value in unusual asset classes and specific investments, maintaining our significant foreign exposure and owning more fixed income investments than during the recent past. However, as we expect 2008 to show economic improvement later on, we also do not want to ignore potentially compelling values in beaten down assets. Our diversified portfolios should assist in preserving capital if certain assets decline. This allows us to take advantage of any opportunities in temporarily undervalued assets. Our goal for 2008 remains the same, to be alert to dangers *and* to opportunities.