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Investment Markets Review

In light of the sharp decline in the stock market in the first weeks of this new year, which comes on the heels of a weak 4th quarter of 2007, I'm dedicating this entire newsletter to sharing with you my thoughts and strategies regarding what 2008 might hold for all investors.

Recap

First, let's establish what has already occurred that has caused the declines we've experienced.

In the second half of 2007, the housing bubble popped. Through the final months of the year, foreclosures and delinquencies skyrocketed, particularly on risky "sub-prime" loans. Home prices declined across the country: in November, the average home was worth 5% less than a year earlier, while some markets saw price declines in excess of 30%. The ramifications of this turmoil were felt in a variety of ways: for investors, primarily through a decline in housing-related stocks and mortgage-related bonds.

As the decline in housing gathered steam, concerns surfaced about the impact on the overall economy, particularly on the consumer (you and me) and their willingness/ability to continue to consume. I shared with you my belief that we would see a widespread slowdown in the US economy, but that view was in the minority for most of 2007.

As we neared the end of the year, signs became clearer that the housing slowdown was in fact impacting consumers, with holiday sales generally weak and credit card default rates rising sharply. Housing continued its downward spiral, with many large financial institutions reporting billions of dollars in losses on souring loans. The possibility of a recession became much greater, and markets began to react to that risk.

The first two weeks of January have seen negative sentiment build, with the consensus expectation now calling for a sharp slowdown at best or a recession at worst. The market has now come to accept the view we've had since September 2007, and stock and bond prices reflect that outlook. From its peak, the Dow is down about 12% from its high reached in October 2007. While not considered a "bear market", we are officially in "correction" territory.

Where do we go from here?

Stocks

The stock market is extremely volatile, as is usually the case in times of uncertainty. To estimate what the future might hold, I look at two factors: fundamental analysis (earnings, valuations, etc) and technical analysis (historical prices, trading volume, etc).

Based on the expectation of a slowdown/mild recession (which we may be in now, and will likely run through the first half of this year in my opinion), my conclusion is that the decline could reach a maximum of 20% in the stock market. This would translate to a Dow at roughly 11,500. At that level, stocks would be valued below historical norms, which hasn't happened in at least a decade. Should the slowdown not be as severe, the decline would likely not reach the 20% level.

Given that estimation, it is likely that we've seen anywhere between 60-100% of the likely decline from this cycle. Thus, while no one can say with certainty that we're at a bottom now, I would venture to say that we've already seen

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the lion's share of the decline. For clients who hold cash, I have begun to recommend investing a portion of that cash in stocks, and I will continue to recommend investing cash as valuations become more compelling or the future of the economy becomes clearer.

Bonds

While interest rates have generally declined over the past six months, I see value in some areas of the bond market. During turbulent times, investors flee to the safest of bonds, namely Treasury bonds, and very little value remains in making new investments there. However, due to the great uncertainty in the economy, many other types of bonds are a better value today than six months ago, particularly tax-free bonds and corporate bonds. For risk-adverse investors seeking income, solid tax-free bonds seem to be an excellent place to make additional investments: in addition to relatively high current yields, the likelihood of tax rates on the state and Federal level increasing in coming years makes tax-free income even more valuable.

Action plan

Declines like the one we're in happen with surprising frequency, and they can be a great opportunity for alert investors. To take advantage of this down cycle, I would recommend "front-loading" your planned 2008 investments: make IRA and ROTH contributions, 401(k) deferrals, and other planned savings early in 2008 rather than waiting for year-end.

It would also potentially benefit you to examine your cash needs and begin to invest any "excess cash" you've been holding.

Finally, if there are any investments you've been looking to sell and reallocate to better investments, by making that swap while the market is down you'll minimize any potential taxable gains on the sale while still enjoying the market recovery in a higher-quality investment.

Resources

For some of you, I've already told you more than you cared to know about the current state of the investment markets, but some of you may desire more detailed information on your current investments or my outlook. Of course you are always welcome to call me and we can talk on the phone or set up a personal meeting. By the end of the month, I will be providing you with a link to a web-based recording of SEI's Year-End Investment Review, where market strategists will give a complete overview of their expectations for 2008, and dissect and discuss the individual investments you hold in your account. Finally, I will continue to post to my website news and research that provides current information about the investment markets.

Conclusion

Understand that we have capable and proven money managers positioning your portfolio on a daily basis based on their expertise in the stocks and bonds they believe will generate the best returns for you going forward. Also, know that in times like these, I invest countless extra hours weighing the information and considering the risks of a changing environment to communicate to you the best strategies to achieve your personal goals. The overall objective of these efforts is to give you the confidence and understanding to make financial decisions that will most benefit you over time.

Quote of the month: "Storms make oaks take deeper root." **George Herbert** *English clergyman (1593 - 1633)*

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