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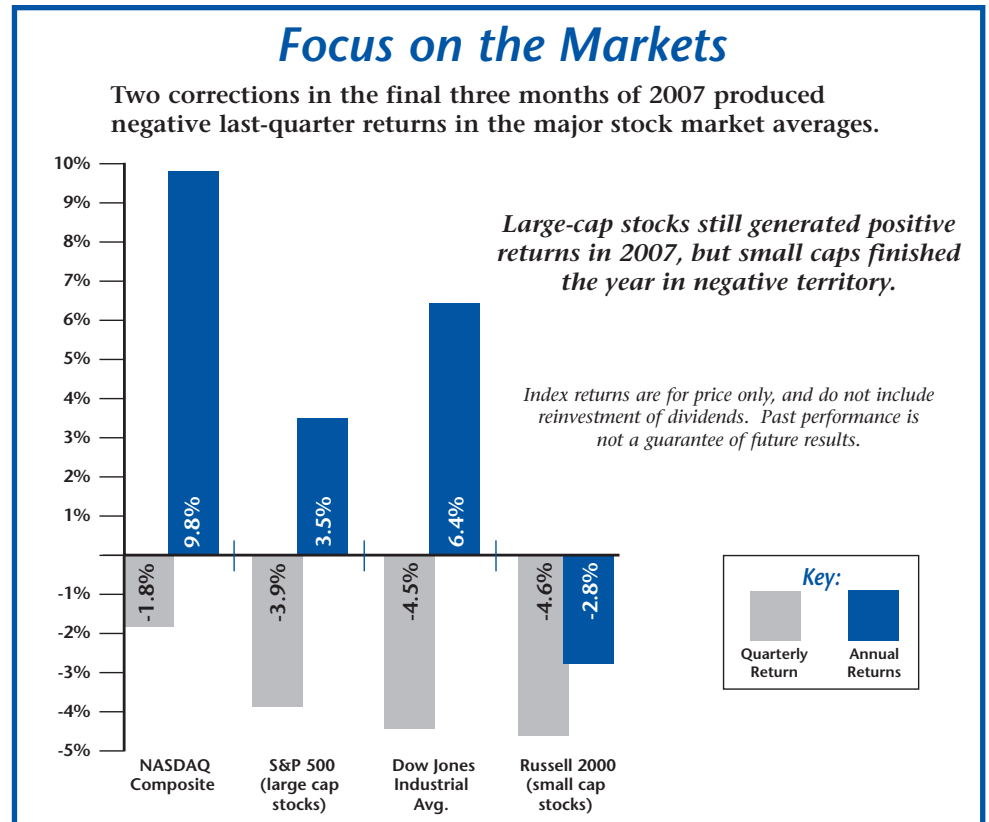
Investor Fears Dominate Final Quarter

The Federal Reserve Board could not save the day in the final quarter of 2007, as it had in the previous quarter.

Instead, stock prices declined in a highly volatile market over the closing weeks of the year. Investors seemed to ignore strong economic fundamentals as they focused instead on every potential negative factor that conceivably could emanate from the housing and subprime mortgage fiascos.

In the third quarter of the year, the Fed was able to allay fears and facilitate a market comeback by reducing the fed funds rate by one-half a percentage point and injecting additional liquidity into the markets. However, in the fourth quarter, the market clearly was disappointed that the fed cut interest rates by only one-quarter of one percentage point and failed to hint at further rate cuts. Investors took little encouragement even after the Fed and several other major central banks injected hundreds of billions of additional dollars into the global financial system to loosen credit and stabilize markets. The stock market remained unimpressed. Investors seem to be saying: "We want it fixed, and we want it now."

We do not want to downplay the damage the housing slump and the subprime mortgage debacle are having on some homeowners and on those financial institutions that either made bad loans or that invested in risky mortgages. Nevertheless, we believe that we have been witnessing more of a crisis in confidence than a dramatic deterioration in economic fundamentals. Investors and lenders have become fearful and credit markets have come close



to seizing up, despite the truckloads of money made available by the Fed, other central banks and several Wall Street institutions. Fears have been exacerbated by worries about high energy prices and potentially rising inflationary pressures.

The crisis in confidence in credit markets along with anxieties about all-time highs in oil prices, which have been subject to fears of supply disruptions rather than an actual supply problem, have combined to provide the latest building blocks in a wall of worry that has overwhelmed capital markets. The war in Iraq, in contrast, almost has

receded to become a secondary issue.

As we know, all investors hate uncertainty. With each new announcement of write-downs of bad loans or foreclosures of mortgages, investors become less confident anticipating when the worst will be over. As market volatility persists, investors' emotions are in turmoil. We even are hearing talk about a possible recession.

Now is a good time to use historical perspectives to help sort out the risks. Here are some key considerations that we should ponder:

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- Recessions rarely have occurred when interest rates are this low and heading lower and when the Federal Reserve is adding liquidity to the financial system;
- Stock market valuations are very reasonable, with price/earnings ratios, based on current operating earnings, below long-term averages;
- Accelerating global growth is increasing demand for U.S. products and offsetting the effects of decelerating domestic growth;
- Governments at home and abroad are moving vigorously to contain the adverse effects of the credit crunch;
- Inflation is well contained;
- Productivity growth is solid;
- Employment is strong.

It is becoming apparent that sentiment is dominating the investment environment, with the market reacting dramatically to each new announcement or event, without attempting to put it in the context of the overall picture. Consider, for example, that the U.S. dollar has been steadily weakening for much of the past years. Suddenly now, alongside talk of a possible recession, we are also hearing about the possibility of importing inflation because of high-priced foreign goods. That possibility, however, must also be weighed against the fact that a weak dollar makes U.S.-made products more attractive on world markets. In fact, recent reports have shown that the U.S. trade deficit has narrowed as we export more goods and services to foreign markets. In addition, inflationary pressures are held in check by the continuing effects of productivity gains deriving from technological advances. These gains help constrain overall labor costs and dampen inflationary pressures.

Where does all this lead us to as we enter 2008?

At Lighthouse Asset Management, we remain firmly in the non-recession

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Q: Some market analysts say that stock market prices are attractive, while others say they are too high? Who is right?

A: Both are correct. It depends on whether you consider prices in relation to the most recently reported earnings, which may reflect extraordinary charges and write-downs, or in relation to current operating profits.

At the close of 2007, for example, the overall price of S&P 500 stocks, based on anticipated 2008 operating earnings, was a little more 16 times earnings –reasonable by long-term standards.

However the price of the same stocks, based on most recently reported earnings, was notably higher. In these cases, the most recently reported earnings often include one-time write-downs on company balance sheets, which become charges against earnings reported during the period when the write-down occurred. This is consistent with revised accounting standards. In the past, such

write-downs were considered extraordinary events.

Let's look at an example. If a financial institution wrote down the estimated value of mortgage-backed securities among the assets on its balance sheet, the amount of the write-down would be deducted from the next reported earnings. This event does not affect the profitability of the institution's current operations, nor does it affect its cash flow. Nevertheless, it is a charge against earnings. This is precisely what happened for many major banks and financial institutions in the fourth quarter of 2007. Because the financial sector accounts for approximately 20% of the capitalization of the S&P 500, this had a noticeable impact on the P/E of the overall market.

It should be worth noting that many of these financial institutions are receiving significant new capital infusions from investors who saw a buying opportunity because they believed in the long-term value of the companies' franchises. Over the long-term, operating results add value to an investment.

camp, although we do anticipate a slowing economy and continuing market volatility. The factors that appear to be slowing the economy stem from problems in the housing industry and among financial institution. The issues in the housing and subprime mortgage industries are being addressed, and the major central banks have poured new liquidity into the financial system to stabilize the capital markets and rebuild investor confidence. Other parts of the economy, notably the export-producing sectors, are strong.

It appears that fear, rather than reason, was the guiding sentiment in the market in the closing weeks of 2007.

Entering 2008, let's keep three important concepts in focus:

1. Concentrate on long-term investment goals, not short-term market disruptions;
2. Changes in market sentiment and trends often begin during times of anxiety;
3. Attempting to time the market just doesn't work.

We should be mindful of the advice of legendary investor Warren Buffett: "Be fearful when others are greedy; be greedy when others are fearful."

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