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Watch for bumps on the economic road ahead

2007 saw up-and-down markets, and 2008 could bring more of the same

SUMMING IT UP

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Volatility returned to the markets in 2007. We saw strong stock market gains from 2003 to 2007, with relatively low market volatility. But 2007 saw wide swings in market averages.

The recent bull market has been fueled by an average 17 percent increase in earnings. However, earnings are now dropping as profit margins come under pressure, and certain sectors, such as financials, are seeing big drops.

For all the uncertainty and volatility, the markets ended in positive territory for 2007. The Dow finished the year up 6.4 percent, the Nasdaq was up 18.7 percent, and the S&P ended up 3.6 percent. In general, large caps fared better than small cap companies. International markets fared better, with the Dow Jones World Developed-Ex U.S. Index up 14.4 percent, emerging markets up 36.4 percent, and Latin America up 46.1 percent. In the United States, resource stocks led the way with a 40.4 percent increase, and utilities were up 19.8 percent.

The outlook for next year is cloudy, as the markets continue to factor in a recession.

In the first three days of 2008, the market gave up half of its gains from 2007. Indeed, the start of the year was reminiscent of 2000, when the market began the biggest bear market since the Great Depression. The last time the Dow finished the year up after being down in the first three days was 1922.

Recent economic reports give scant comfort. Minutes of the Federal Reserve show it is vigilant. But with no scheduled meeting until Jan. 29, not much is likely to happen to aid the economy unless the Fed makes an inter-meeting rate cut, which is unlikely although not unheard of). In my view, the odds of a recession have increased to 49 percent for and 49 percent against. The tie-breaker is the action of the Fed; the fat lady has to sing.

At the moment, the Fed is working hard on the capital markets problems. Libor rates still remain stubbornly high as banks retain reluctance to lend to other banks. However, the money the Fed is pouring into the capital markets through its TAF auctions is being "sterilized" by the Fed's removal of money from the monetary system. This is perhaps the best it can do, given its (real) inflation fears, but the effect on the overall economy is not as great as it might be.

Another tool of the Fed is the federal funds rate. After the recent jobs report, the likelihood of a 50 basis-point cut was priced at 93 percent in the futures market. While a 50 basis-point cut is needed, whether it will be delivered is yet to be seen.

President Bush has also promised a rescue package, but the precise terms are not yet known. Of course, any stimulation from

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the executive branch or the Federal Reserve will take months to have an effect. In the meantime, the odds of a recession grow.

The fear of inflation will restrain the Fed from more aggressive action. Commodity prices are soaring across the board. Precious metals such as gold have reached records. Industrial metals have soared – and will likely remain high because of demand from growing world economies. Lesser known metals, such as the cobalt used in making batteries, have also reached record highs.

On the food side, we have seen record prices in grains, which affect meat and diary prices. The results are being seen at restaurants and the grocery counter.

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Next year will see continuing inflationary pressure and continuing margin and profit deterioration. This will affect stock prices. We have had a number of years of earnings and market growth above historical trend, and now we will probably see growth and stock market gains below historical trends. Look for market gains of about 5 percent or less next year. Still, equity investments have been rewarding in a diversified portfolio over time.

Opportunities will still exist in a declining market. Perhaps the best prospect is international markets. Russia, portions of Latin America, Asia and India are still growing strongly.

Look for opportunities in sectors that benefit from global growth. Look also for opportunities in sectors that have the wind at their back, such as commodities – particularly food-related stocks. Energy, particularly energy services, should be strong. Utilities provide a safer haven, and perhaps some gains, because of the attractiveness of their yield. Health care stocks can provide gains. Health care real estate investment trusts offer good yields. In general, look for niche companies that are growing in spite of the downturn.

Although volatility is likely to continue, long-term investors should continue to obtain a better total return in the stock market than in other asset classes.

William Rutherford is the founder and president of the Portland company Rutherford Investment Management, listed in Barron's as one of the leading separate account managers in the country and recipient of a four-star rating from Morningstar. He is also the author of a critical appraisal of Alan Greenspan's term as Fed chief, "Who Shot Goldilocks?" Contact him at 888-755-6546 or wrutherford@rutherfordinvestment.com.