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2007: The Grinch Who Stole Christmas

by Peter Lang

December is so often a positive month for the stock market that December's gains are called the Santa Rally. There was no joy in Whoville in 2007 as the Sub-prime Grinch stole the Rally. The Grinch scared shoppers from spending, evicted homeowners and wreaked havoc on banks and financial stocks. The market, as measured by the S&P 500, finished the year on a down note, giving back more than half of its gains from the October high when it was up 12%.

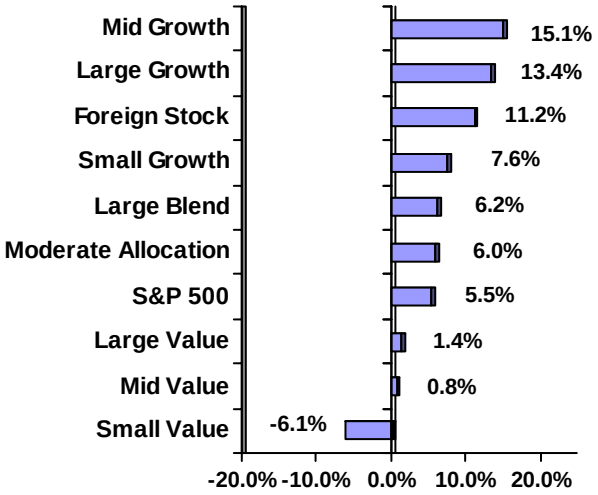
Which stocks performed best?

For 2007, the S&P finished up 5.5%. The chart on the right details how different stock styles performed. The stocks of large companies (businesses worth more than $12 billion) beat the stocks of small companies (businesses worth less than $2.2 billion). Growth stocks beat value stocks after trailing them for the last seven years. Diversifying overseas paid off again in 2007 as foreign stocks rose 11.2%, beating the S&P 500 for the sixth straight year.

Bonds excelled

The financial crisis spurred a bond rally as investors poured money into Treasury bonds. The bond index rose 7% after a 4.3% gain in 2006. Bond returns were above their long term averages.

2007 Total Returns By Style



Above average inflation

Inflation rose 4.1% last year, well above its long term average of 3%. This was due to dramatic increases in food and energy costs. Inflation at 4% wipes out almost half of the returns from the Harbor Bond fund and a large portion of the returns of the American Century GNMA and Federated Prime Cash Obligation funds.

If you diversified your equity holdings with large, mid, small cap and foreign funds, it's likely your portfolio performed fairly well in a below average year.

Outlook and Strategies for 2008

Economic growth is slowing dramatically in America. The recently announced 0.6% growth rate for the fourth quarter of 2007 represented a sharp decline from the previous quarter's 4.9% growth rate. There is a good chance that the economy will slip into a recession this year. A recession is defined as two or more consecutive quarters of declining GDP (gross domestic product).

The Federal Reserve has stepped in to try to prevent a recession by aggressively cutting the Fed Funds Rate. The Fed rate was 5.25% in September. It has been cut five times with the last two cuts coming within eight days of each other, bringing it down to 3%.

What does this mean for me?

Banks use the Fed Funds Rate as a basis for determining how much they charge on credit card debt and on home equity loans. Millions of Americans will see their finance charges reduced next month and they will have extra money in their wallets. This should provide an immediate boost for the economy. A further boost should occur when Congress finalizes the package to stimulate the economy. This will result in most Americans receiving a check to either spend or invest.

Prospects for the market

The stock market always tries to anticipate where the economy is going. At this point, stock prices have already fallen dramatically in anticipation of bad news from the economy. Stocks are cheap now and could be poised for a rebound. A Citigroup Investment Research study has determined that since 1940 the 12-month return for stocks was an average of 17% when they were priced this low.

Asset allocation positioning for 2008

For a long time I have been recommending a balanced portfolio with investments in large, mid and small cap funds, growth and value funds and some fixed income positions for those within ten years of retirement.

For 2008, I believe that large-size companies' stock will continue to outperform the stock of small-size companies. Large-size companies have more of a global presence and they are better able to benefit from the cheap U.S. dollar. I also like the prospects for growth funds in 2008. Technology stocks are suffering in the current bear market. Some say this is simply because investors still have vivid memories of how they fell in the 2000-2002 bear market. However, companies often turn to technology to improve their productivity during an economic downturn.

While you should continue to diversify with foreign funds, don't expect these funds to continually outperform U.S. funds. Foreign stocks have outperformed the S&P 500 for six straight years due to a declining U.S. dollar and the super growth rates of emerging markets like China and India. It may be time for U.S. stocks to outperform foreign stock in 2008.

While there are no guarantees for a market rally in 2008, the keys to success will be to stay diversified, keep investing and increase your savings rate.

How Your Funds Performed versus Their Peers in 2007

Size	Value	Blend (Value & Growth)	Growth
Large	Investment Company of America 5.9% American Beacon Large Cap Value 3.0% *Peers 1.4%*	Fidelity Spartan U. S. Equity Index 5.4% Davis NY Venture 5.0% *Peers 6.2%*	Janus Advisor Forty 35.6% *Peers 13.4%*
Mid	T. Rowe Price Mid Cap Value 0.4% *Peers 0.8%*		Federated Kaufmann 21.4% *Peers 15.1%*
Small	American Century Small Cap Value -2.7% *Peers -6.1%*		Baron Small Cap 11.7% *Peers 7.6%*

Other Funds:

		Category:	***Peers:***
Federated Prime Cash Obligation	5.3%	Money Market	*4.3%*
American Century GNMA	6.4%	Intermediate Government	*6.1%*
Harbor Bond	8.7%	Intermediate Term Bond	*4.7%*
American Balanced	6.6%	Balanced	*6.0%*
American Euro Pacific Growth	19.0%	Foreign Large Blend	*12.7%*

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