



# MARKET REPORT

FOURTH QUARTER 2007

## THE ECONOMY

*While high energy prices slowed overall economic growth, the housing industry remained the dominant story during 2007.*

The economy was faced with conflicting news during the fourth quarter of 2007. While consumer spending started the quarter much more strongly than had been expected, the quarter ended with weaker-than-expected holiday sales. Global competition has kept inflation somewhat tame, but prices for energy and food, which are omitted from the government's official inflation gauge, rose substantially. The dollar continued to decline, which simultaneously increased inflation pressures but also made the products made by U.S. companies more competitive overseas. High energy prices, while good for the profits of many energy-related companies, slowed overall economic growth as both corporations and consumers spent more of their income on energy and less on discretionary items.

The result of all of this conflicting data was an economy that was still growing, but highly vulnerable to any unforeseen shock. Unfortunately, that shock occurred in the form of problems in the subprime mortgage market and the subsequent housing market drop. The developments in the housing industry were by far the dominant story during 2007, casting a dark shadow on an already vulnerable economy. Falling house prices in the United States dampened consumer sentiment, and will continue to weigh on consumer spending. Lending activity has fallen as lenders tightened their standards in response to the subprime mess. As a result, borrowing costs have risen to better reflect the higher perceived risks.

As we move into 2008 the economy remains troubled. GDP growth continues to slow, corporations are spending cautiously, and unemployment claims have risen. The possibility of the economy falling into a recession has increased as GDP slows and inflation rises. We feel that if the economy does fall into a recession it will be very mild and short-lived. The economy will probably remain soft during the first half of 2008, and then improve during the second half as the Federal Reserve's rate cuts take effect. The Fed has already reduced rates by 1% and stands ready for more cuts if necessary. By the end of the first half we feel that robust export growth, lower oil prices, improvement in the housing market, and another rate cut by the Federal Reserve will be enough for gradual improvement throughout the second half of the year.

## THE STOCK MARKET

The effect on the stock market of the uncertainty in the economy was an increase in volatility. As the fourth quarter started, most investors had high hopes that the problems in the subprime mortgage market would remain contained in the banking and financial industries. But as the quarter progressed it was clear that the drop in housing prices and a tightening of lending standards by banks was having a negative effect on most of the economy. The equity markets, which were up for the month of October, quickly turned down during the remainder of the quarter. The most common barometer of the broad stock market, the Standard & Poor's 500 Index, was down 3.8% for the quarter. The Dow Jones Industrial Average was down 4.5% and the small cap Russell 2000 Index was down 4.7%.

*A slow, steady recovery for the market is possible based on low interest rates worldwide, accommodative foreign central banks, strong international GDP growth and reasonable equity valuations.*

For the full year, however, the Standard & Poor's 500 finished 3.5% higher while the Dow Jones Industrial Average was up 6.4%. The Russell 2000 ended the year just slightly below where it started the year. Companies in sectors other than financials and consumer cyclicals performed even better than the market averages. In fact, the 75% of the market not related to these two sectors remain in a bull market. Energy, basic materials, utilities, and technology all returned well over 15% for the year. Overall, stocks did pretty well for the year, considering the events they had to endure. In addition to the drop in the housing market, oil reached \$100 per barrel, causing consumer confidence to drop significantly. The dollar declined and signs of inflation started to emerge. Corporate profitability slowed substantially, mostly in financials and consumer-related companies. The market's ability to shrug off these problems was due to several positive factors: low interest rates worldwide, accommodative foreign central banks, still strong international GDP growth and reasonable equity valuations.

This environment will continue to lend support to stock prices in 2008. Excluding financials, corporate earnings growth is still strong, with some sectors very strong (the technology sector is expected to post approximately 22% earnings growth in the first quarter of 2008). The market may now be fully discounting the financial sector's problems, which could clear the way for a slow, steady recovery for the market. The fact that it is an election year, which typically is a moderately positive year in the stock market, supports this outlook. Given the current and expected growth in foreign economies versus the outlook for U.S. growth combined with the weak U.S. dollar, the fundamentals have been and continue to lead us to increasing exposure to larger cap multi-national companies.

## THE BOND MARKET

*Volatility continued in the bond market as many companies found it difficult to raise the short term debt needed to fund their operations.*

The contagion from the subprime mortgage turmoil also affected the corporate debt market, as corporate and mortgage bond prices headed lower even though corporate defaults remained very low. As financial institutions tightened their credit standards in response to the billions of dollars of write-downs and loan losses, many companies found it difficult to raise the short term debt needed to fund their operations. The result was a lot of volatility in the bond market.

This environment did benefit Treasury securities, which headed higher as a result of the flight to quality by many investors. During a time of great uncertainty, investors rushed to buy the safest assets. This drove the yield on a 10 year Treasury note down to 4.03% by the end of the year. Investors also demanded to be paid more for riskier debt. As a result, the yield differential between corporate bonds and Treasury bonds expanded greatly – to more than 2%. Issuance of the riskiest debt, junk bonds, slowed substantially as very few investors were willing to assume that risk.

In 2008, the bond market is expected to continue to be extremely volatile. While corporate balance sheets are still strong, the slowdown in corporate profits could create a difficult year for debt issuance. Particularly, companies that have heavy debt loads and weak credit ratings could find it difficult to issue debt. However, if the Federal Reserve continues to lower rates as expected, the bond market could rebound. Many investors have begun to feel that prices of many bonds, especially those that are related to mortgages, have stopped falling and are beginning to stabilize.

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