

## Quarterly Market Review

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### Financial Markets and Economic Analysis, Fourth Quarter 2007

#### **Perspective**

When looking back at 2007, the major story of the year was the breakdown in the credit markets during the third quarter, and the subsequent impact to the U.S. financial markets as well as markets around the world. When the year started, many forecasters were calling for a rate cut from the Fed during the first half of the year, as an economic slowdown was becoming more evident. But, the markets posted strong results in the first half of the year, despite a few jitters in China and the first revelations of mis-pricing in the sub-prime mortgage market. The Fed did finally cut rates in September and twice more before the end of the year. But the holders of the sub-prime mortgage debt, and the collateralized CDO's made up of largely sub-prime debt, took huge mark downs over the course of the third and fourth quarters. Leading investment banks have already written off more than \$60 billion in losses on these holdings, and there is every indication that there remains billions more to write down.

Looking forward to 2008, it is likely that this will remain the major story for at least the first half of the year. While Moody's downgraded more than \$50 billion in mortgage related securities in November, there is currently another \$174 billion under review for possible future downgrade. This will also increase the scrutiny on the holders of these notes as they are forced to mark their values down even further. During the fourth quarter, several investment banks, including Citigroup and Morgan Stanley, were forced to seek out capital infusions to strengthen their balance sheets. The infusions came from sovereign funds in the Middle East (notably Abu Dhabi and Saudi Arabia) and the Far East (including China and Singapore). While it is a very positive sign that the major players in the U.S. financial markets are strengthening their weak balance sheets, it could be seen as troubling if the trend of this capital coming from overseas continues. Other major factors for 2008 will include: the ability of the U.S. economy to outperform a currently lackluster forecast in terms of GDP growth and the housing market; the Fed will have to be vigilant of its independence in this election year as they struggle with potential inflation from commodity prices and a generally weak (forecasted) economic picture; and the dollar's continuing slide against the major currencies.

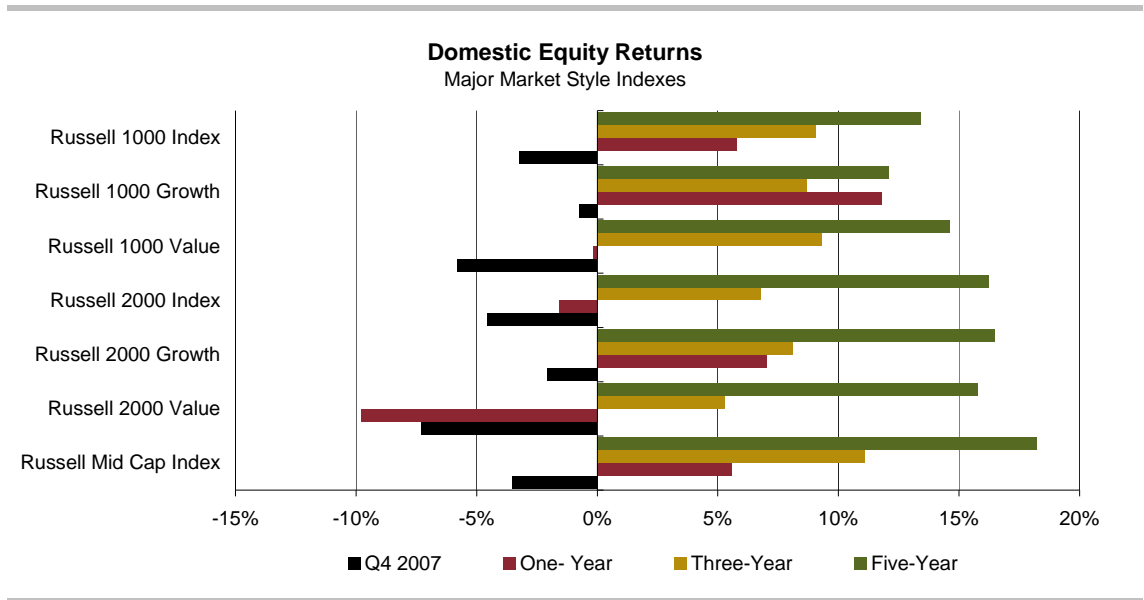
#### **Domestic Equity Markets Overview**

The fourth quarter was negative across the board for the U.S. equity markets, with slightly smaller losses for the growth style indices across all market caps. As was the case for most of the year, the large cap indices outperformed the smaller caps across the board, and the growth style indices outperformed value. This was predominately due to the large weighting to the Financials sector within the value indexes. This sector suffered not only from the bank and brokerage industry markdowns due to sub-prime exposures, but also the exposure to REITs. This marks the first year since 1999 that the Russell 1000 Growth Index (11.81% for 2007) outperformed its value counterpart (-0.17%). The Russell Midcap Growth and 2000 Growth also outperformed their value counterparts for the first time since 2003. As we look forward to 2008, Prima would expect the trend of relative outperformance by larger cap companies and by the growth style indices to continue.

For the fourth quarter, the large cap segment of the market, represented by the Russell 1000 Index, showed mixed results. Energy, Materials and Consumer Staples had slightly positive returns, while the aforementioned Financials sector was down more than 12%. Despite the losses in the final quarter, 2007 was the fifth consecutive year of positive performance for both the Russell 1000 and Russell Midcap Indexes. In the small cap space, represented by the Russell 2000 Index, only the Healthcare and Energy sectors had positive returns in the fourth quarter. Substantial losses in Financials, Consumer

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Discretionary and Technology forced the Index lower by 4.6%. For the year, double digit losses in the Financial and Discretionary sectors, which represent more than 35% of the Index, were too much to overcome, despite significant gains in Materials, Technology and Consumer Staples.



**International Markets Summary**

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The international markets were mixed during the fourth quarter, with a near repeat of results from the third quarter. The Eurozone indexes were slightly lower during the quarter in local terms, but up slightly in dollar terms. The Pacific Rim regional indexes that included Japan were down 6-7% in local terms while those indexes excluding Japan were down 1-2%. The continuing weakness of the dollar added additional return for U.S. investors over the course of the quarter, more than 2.5% for most countries. The major exception was in the U.K, where the dollar strengthened relative to the Pound, lowering returns by more than 2% for U.S investors. Across the EAFE markets, managers had the opportunity to add significant value over the course of 2007 with country selection, as six countries turned in more than 30% returns for the year (in dollar terms) including Finland, Hong Kong and Germany. Avoiding Ireland, Belgium and Japan would have boosted returns relative to the EAFE Index as well, as all three countries turned in negative results for the year.

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The emerging markets closed out the year on a very strong note, with the regional indexes up 7-12% outside of the Pacific Rim. Even the worst performing regional index, the MSCI Eastern Europe Index was up more than 25% for the year in dollar terms. Despite a very volatile year, and a slight drop in the fourth quarter, China was up more than 66% in 2007, but well behind the stunning 80% return in the Brazil Index, in dollar terms. Argentina was the only major emerging market to post a loss in dollar terms for the year. As a whole, the MSCI Latin America Index was up 50% in dollar terms, with 15% of the return coming from a positive currency impact.

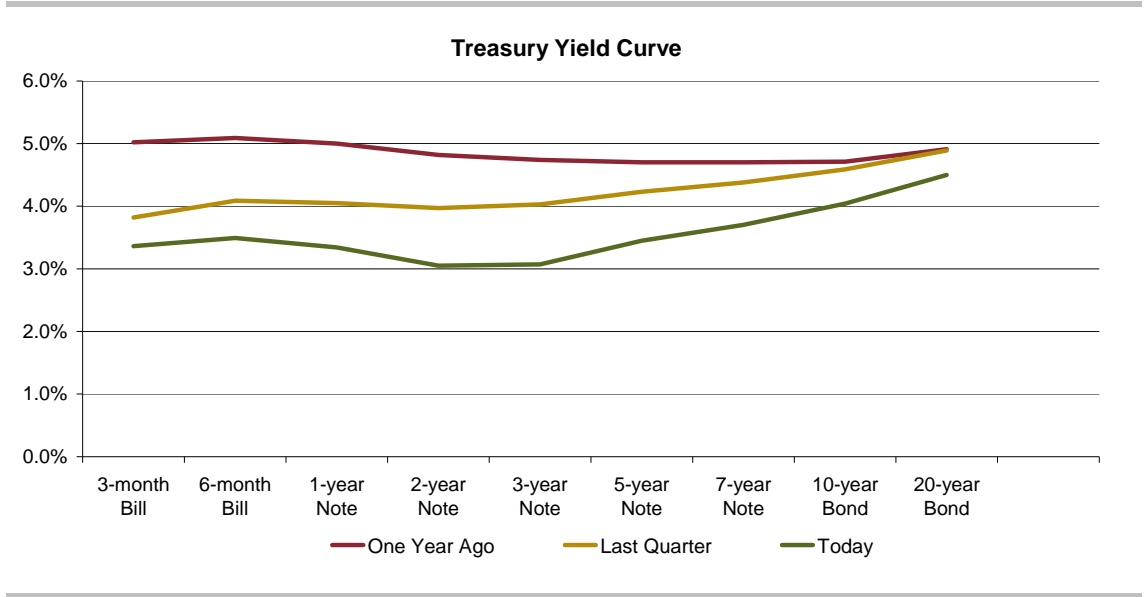
**Fixed Income Summary**

*Long maturity Treasuries had the best return for the quarter and the year, as the 20+ Year Treasury Index returned 6.4% for the quarter and 10.2% for the year.*

With a total of three rate cuts from the Fed between September and year end, it is unsurprising that the taxable fixed income markets had an exceptional fourth quarter. The Treasury yield curve shifted downward by nearly a full percentage point in the 2-3 year range, but less than half of a percent at both the short end (3 month) and long end (20-30 years). This did not keep the long maturity Treasuries from having the best return for the quarter or the year, as the 20+ Year Treasury Index returned 6.4% for the quarter and 10.2% for the year. The Lehman Brothers Aggregate Index was up 3.0% for the quarter and just shy of 7.0% for the year. Although all of the major segments of the market had positive returns for

the quarter, the corporate sector showed some weakness, with the Lehman Corporate Index up less than 2.0%, regardless of maturity. This was even more evident in the high yield sector, as the return for the Lehman High Yield Index was -1.3% for the quarter and just 1.9% for the year.

The municipal market saw similar results, with the broader index up 1.4% for the quarter, with slightly higher returns in the intermediate duration range. Credit quality was an even bigger factor in returns for the quarter as the AAA/AA market doubled the return of the A market (1.6% vs. 0.75%) and the much smaller BBB market lost more than 1.0% for the quarter.



**Outlook**

Despite the sub-prime crisis and its far reaching effects during the second half of 2007, the major U.S. markets turned in broadly positive results and the emerging markets continued to reward investors far beyond historic averages. However, the full effects of the sub-prime crisis have yet to be felt, and it will remain an overhang for the market for at least the first half of the year. With oil prices topping \$100 per barrel in early 2008, broader economic growth could be stunted unless prices fall. Should the dollar’s current weakness continue, investors will be doubly rewarded for looking overseas for diversified growth. Market forecasts for 2008, made by well respected professionals, vary more widely than we have seen in many years. There are almost as many reasons for cautious optimism as there are for blatant pessimism, and everything in between. However the year may turn out, thoughtful asset allocation, clear understanding of risk tolerances and careful monitoring of portfolio exposures will be the best method for creating a positive look back at 2008.

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