



EARL M. FOSTER ASSOCIATES

I N V E S T M E N T M A N A G E M E N T

NEWSLETTER

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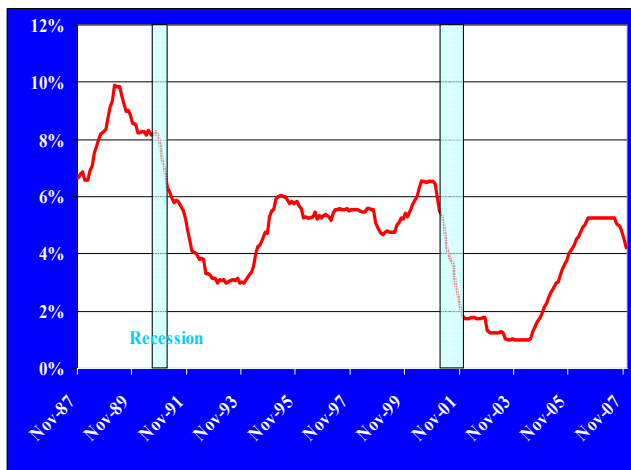
OUTLOOK FOR 2008

Can Stocks Overcome Recession Fears?

The risk of recession continues to increase as a result of the sub-prime lending crisis, multi-billion dollar write-offs by the nation's leading financial institutions, falling residential real estate values, a lackluster Christmas shopping season, and crude oil at record levels. The Federal Reserve is trying to avert a downturn in the economy by lowering interest rates and making credit available to the banking system.

Chart I

The Federal Funds Rate



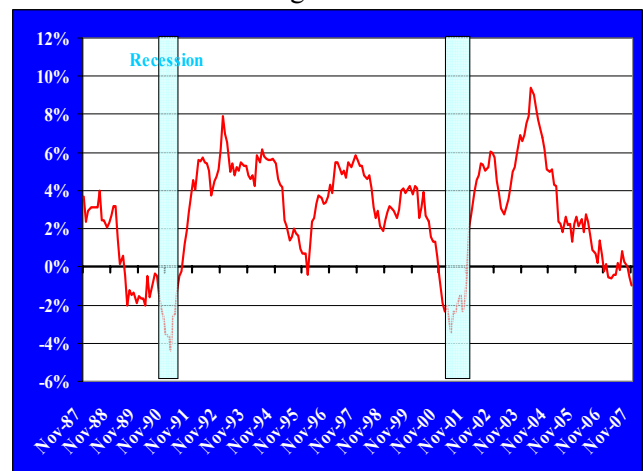
Has the Federal Reserve acted soon enough and with strong enough measures to sustain the economic expansion? It is questionable. Monetary stimulus normally requires 12 – 18 months before its impact on the economy is realized. The Federal Reserve began to lower interest rates last August, and the effects may not be realized in time to forestall a recession. Moreover, the four reductions in the targeted Federal Funds rate since last summer (from 6.25% to 4.75% at year-end) only reverses a minor portion of the prior 17 increases.

From another dimension, the Index of Leading Economic Indicators is giving an ambiguous message at this time. Its percent change versus a year ago is in negative territory, but not at the depths realized during

the last two recessions. The economy is receiving support from export growth, assisted by a weak dollar that has offset extraordinarily weak conditions in the residential housing sector. In addition, retail sales continue to grow supported by a modest increase in employment and wage gains in excess of 3.5%.

Chart II

Index of Leading Economic Indicators

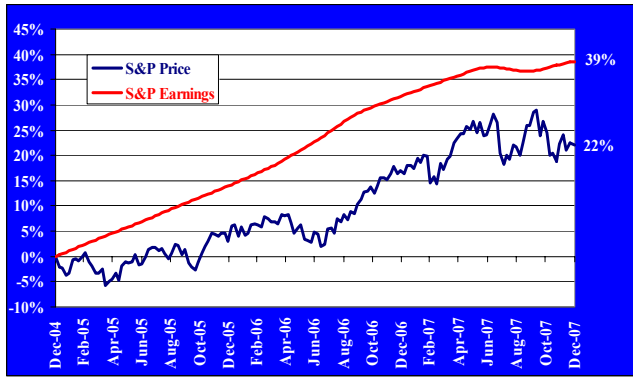


Nevertheless, further deceleration in the economy is likely as the resilience in retail sales will be challenged over the winter months as millions of home owners face escalating mortgage payments and sharply higher home heating costs. Economic growth, therefore, is expected to slow to a marginal pace that could “flirt” with negative numbers for a quarter or two.

The Standard & Poor's Index seems to be discounting an economic slowdown just as it has a number of times in the past several years: beginning with a 6.5% decline in the spring of 2005, a 5.8% drop during the summer of 2006, and the more recent decline of 7.7% last summer. Since 2004, the rise in the Standard & Poor's Index was substantially less than its 39% growth in earnings (See Chart III). This caused the trailing price-earnings ratio to decline from 18.1 to the current 15.9.

Chart III

S&P 500 Index Growth in Stock Prices and Earnings
12/31/04 – 12/31/07



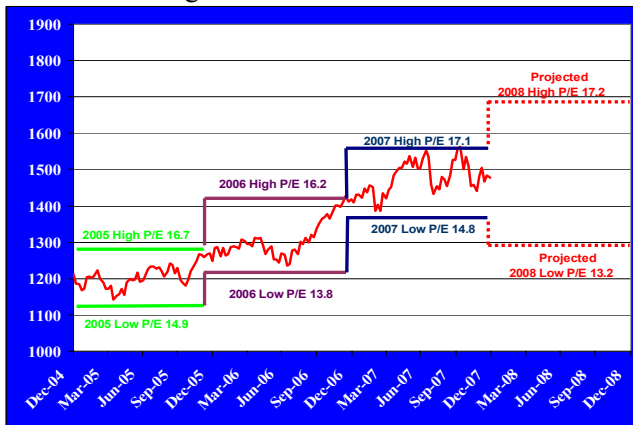
INVESTMENT STRATEGY

Investors enter 2008 challenged by a wide range of expectations regarding corporate earnings; projections range from a decline from last year’s level to gains in excess of 10%. While profit performance in the healthcare and technology sectors remains strong, the earnings for the balance of the economy are less certain, especially for the financial sector, which comprises nearly 20% of the Standard & Poor’s Index. As a result, our projected 2008 trading range for the Standard & Poor’s Index is 1300-1700, considerably wider than last year’s actual range of 1364-1576.

The lower end accommodates a 5% - 10% decline in earnings. This negative possibility, should it occur, would imply a decline of as much as 10% from 2007 year-end levels. However, such a decline may be temporary and could be shallow compared to most “bear” markets, which were preceded by higher price-earnings ratios and broader economic weakness than currently experienced.

CHART IV

Value Range for the Standard & Poor’s Index



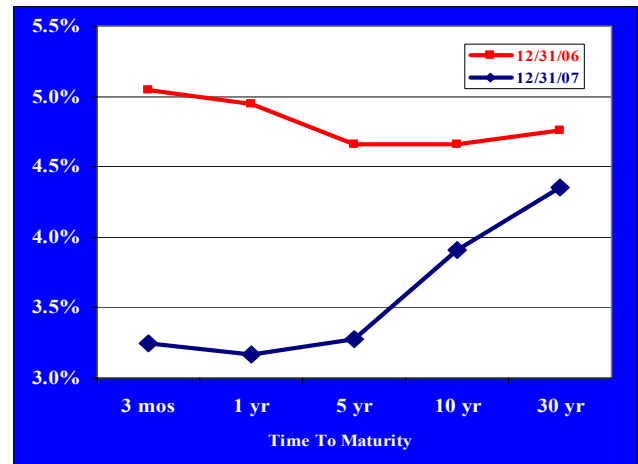
If an economic decline is averted, however, stocks could

generate double-digit percent returns, perhaps performing better during the second half of the year when conditions in the real estate and credit markets are more stabilized and the lagged benefit from last year’s monetary stimulus has more of an impact.

On balance, it is believed that portfolios should enter 2008 with some cash reserves to insulate against near-term volatility, which could be similar to that experienced during the last half of 2007. While the domestic economy may exert downward pressure on profits in 2008, it will be mitigated by the profit growth generated from operations overseas and a recovery in earnings in the financial sector from the aggressive write-offs taken in 2007. Those factors, in combination with additional monetary stimulus and modest price-earnings ratios, make it possible for the Standard & Poor’s Index to re-visit last year’s high of 1554. If so, upper single-digit percent returns could be achieved.

CHART V

The U.S. Treasury Yield Curve



The fixed income strategy remains cautious. At the beginning of last year, the 3-month Treasury bill was yielding more than the much longer-term U.S. Treasury securities (see red line in Chart V). As the year progressed, this relationship reversed and short-term yields declined in response to the easing in monetary policy, while longer-term Treasury yields declined only slightly as elevated crude oil prices increased the risk of inflation.

Therefore, fixed-income purchases should be limited to occasional “nibbling” to those that may be temporarily under-valued during the current financial crisis. Otherwise, more aggressive acquisitions should wait for later in the year to better evaluate the inflation risk.