



CAPITAL MANAGEMENT, LLC

www.smscap.com

Phoenix Tower • 3200 Southwest Freeway, Suite 3300 • Houston, Texas 77027-7526
Phone 713-623-1534 • Fax 713-589-9496 • Email info@smscap.com

January 2008

By Steven M. Sheldon, CFA

About SMS Capital Management

SMS provides investment management services to individual investors desiring to preserve and build long-term wealth. As a fee-based firm, SMS has an independent, objective and sound approach to portfolio management. The firm is a Registered Investment Adviser.



About the Author

Steven Sheldon has more than thirteen years of professional experience analyzing and managing investments. Prior to founding SMS, Mr. Sheldon worked as a senior member of a corporate principal investments group. Mr. Sheldon has an MBA from Tulane University and a BBA from The University of Texas. In addition, he is a CFA charterholder and a member of both the CFA Institute and the Houston Society of Financial Analysts (HSFA).

2008 Market Forecast

As 2007 comes to a close, perhaps it will be best remembered as a year that kept investors reaching for the Dramamine bottle. Yes, it was a year of lots of ups and downs and twists and turns. Stock market volatility, which had been noticeably absent the last several years, made its unwelcome return in 2007, and in a big way. Unfortunately, I do not see the volatility letting up much in 2008 with the economy transitioning into a lower gear. No doubt, there will be enough drama to rival a Britney Spears family reunion.

As we enter the New Year, there is no shortage of investor concerns. The U.S. economy is teetering on the verge of a recession, our military is still bogged down in Iraq and Afghanistan, there is no clear frontrunner to be our next President, corporate earnings are slipping, oil and gold are chasing all time record highs, and there is even talk of stagflation in the air. And that is just the short list.

Of course, there will always be challenges facing the market - the proverbial "wall of worry" that the market seems to climb. To put it all in perspective, Rosanna, Rosanna Danna would have said in her famous Saturday Night Live bit, "It's always something...if it's not one thing, it's another...if it's not sub-prime mortgages, it's inflation, and if it's not Michael Vick with his dogs, it's Roger Clemens and his steroids."

Right now, a big dark cloud is hovering over the financial sector and may be spreading to other areas of the market. Financial services and some other economically sensitive sectors of the economy seem to be factoring in a full blown recession next year. A slowing economy is likely in the cards; however, there is a decent chance the economy makes it through this period intact.

Perhaps all the worry is just that and there might be some positive surprises next year that will offer the market some relief. Lower oil prices, improvement in the Iraq situation, a significant government-sponsored bailout for the sub-prime market, more foreign investment in battered U.S. stocks, and a sooner than later bottoming of the housing downturn are all possibilities.

Eventually the market mood will swing to the bright side and take the market higher. At this point, I will go with my cautiously optimistic view for 2008. Next year, I see decent earnings growth in large/mega cap stocks taking the overall market up 5%-7% (representing a high single digit return including dividends).



CAPITAL MANAGEMENT, LLC

www.smscap.com

Phoenix Tower • 3200 Southwest Freeway, Suite 3300 • Houston, Texas 77027-7526
Phone 713-623-1534 • Fax 713-589-9496 • Email info@smscap.com

2007 Review – A Sub-prime Time

After setting all time highs during the year, the major U.S. indexes kept tumbling back down and even logged the first official 10% correction in almost half a decade. After all the turbulence, the major indexes are poised to still finish on the positive side with a 4.7% return for the S&P 500 or 6.7% if you include dividends (as of December 21st). Not too bad considering the decimation of the sub-prime lending market that enveloped the entire financial sector, the largest sector of the market as measured by market capitalization.

Other than heightened volatility, big themes in 2007 included the end of small caps seven year leadership streak (large caps finally took over), continued weakening of the U.S. dollar (leading to stronger international performance), and higher returns for “growth” stocks returns over “value”.

On the fixed income front, a flight to quality drove up the prices (and the yields down) of U.S. government bonds. High yield bonds, REITs, and other corporate bonds all lagged as investors preferred safety over higher yields in these shaky credit times.

2007 Total Returns (Including Dividends)

Index	2007 Total Return (%)*
S&P 500	6.78%
Russell 2000 (Small Cap)	0.95%
MSCI EAFE (International)	8.84%
Emerging Markets	29.92%
U.S. Bond Aggregate	5.76%

It’s Not All Bad

There are clear signs that the U.S. economy is slowing amidst the severe housing downturn and credit crisis. Unemployment, which has held up well over the last several quarters, will start to rise in the next few months as financial services, construction, and retail firms seek to reduce costs by slashing payrolls. This is a necessary part of a recovery.

The Federal Reserve has lowered rates and will likely lower rates again in the not too distant future in response to further data supporting the view that the



CAPITAL MANAGEMENT, LLC

www.smscap.com

Phoenix Tower • 3200 Southwest Freeway, Suite 3300 • Houston, Texas 77027-7526
Phone 713-623-1534 • Fax 713-589-9496 • Email info@smscap.com

economy is slowing. This should help alleviate the strain on the consumer who is being pinched by rising bills. However, heightened inflation brought on by higher commodity costs will limit how far the Fed can cut rates without running the risk of further stoking inflationary pressures.

One bright spot for the economy has been the strength of U.S. exports. A weak dollar, a strong global economy, and a slower pace of imports have worked to reduce the amount of our trade deficit. Over time, this should help halt the dollar's slide and reduce inflation as the stronger dollar will make imports more affordable. Strong exports are also cushioning the economy from bearing the full brunt of the housing downturn. If the U.S. economy is to avoid a recession, continued strength in exports will be crucial. Fortunately, a reasonably healthy global economy supports the notion that U.S. exports will remain healthy for the next several quarters.

Portfolio Positioning

We do not know when this bull market in stocks will finally come to end, but we do know that we are not at the beginning (that was back in October of 2002). At this point in the cycle, investors should make sure they are comfortable with their portfolio allocations. If a portfolio is heavier in equities than desired as defined by your overall investment objectives (including risk tolerances), use any strength in the market to take some profits made over the last several years. This year has proved that timing the market can be a difficult if not impossible task. However, making gradual shifts in asset classes by taking profits from outperforming areas and reinvesting in underperforming asset classes should keep your portfolio risk down while delivering solid returns over time.

Next year the market will likely continue to reward companies that can deliver consistent earnings growth during the economic slowdown. That would suggest growth will again outperform value. While my forecast is for the overall market to advance mid single digits, I think that the large cap segment (consisting of heavier weighting of global technology and healthcare and companies) might do better than the overall market and deserves to be overweighted in portfolios. Financial stocks are a big component of the "large cap value" category and will be a wild card next year. While they may rebound from oversold conditions, I don't see the fundamentals supporting the earnings growth necessary to get a sustainable recovering until late next year at the earliest. As part of a diversified portfolio, investors should maintain some exposure to that area but would not overweight that area just yet.



CAPITAL MANAGEMENT, LLC

www.smscap.com

Phoenix Tower • 3200 Southwest Freeway, Suite 3300 • Houston, Texas 77027-7526
Phone 713-623-1534 • Fax 713-589-9496 • Email info@smscap.com

On the fixed income front, interest rates would have to fall substantially further to get another strong year in U.S. Treasury funds. I do not see that happening. Therefore, taking some profits from those funds and holding some cash makes sense given the current level of yields. If yields spike up during the year, use that as an opportunity to move back into U.S. Treasuries or start nibbling at some corporate bond funds.

*None of the information or data presented herein constitutes a recommendation by SMS Capital Management, LLC or a solicitation of any offer to buy or sell any securities. Information presented is general information that does not take into account your individual circumstances, financial situation or needs, nor does it present a personalized recommendation to you.

Although information has been obtained from and is based upon sources SMS Capital believes to be reliable, we do not guarantee its accuracy and the information may be incomplete or condensed. This report is for informational purposes only and is not intended as an offer or solicitation for the purchase or sale of a security. Past performance is no indication of future results.