



4TH QUARTER 2007 MARKET COMMENTARY AND OUTLOOK

The fourth quarter has always been the “do or die” quarter in the financial industry. Basically, company managements just don’t have another quarter to push off any bad news. This year’s fourth quarter was no exception as banks around the globe were forced to write off many billions of non-performing loans. Below are a few of the stunning headlines released during the quarter:

“Citigroup Chief Quits as Sub-Prime Losses Rocket”

“Merrill Lynch Loses \$8bn and the CEO Has to Go”

“HSBC to Take \$45 Billion of Assets from Two SIVs on to Balance Sheet”

According to Bear Stearns, the third quarter witnessed \$28B in write-downs, much of which centered in the financial services industry. The fourth quarter is projected to see at least \$32B of additional value erased from the books of large financial institutions. In addition, Bear Stearns anticipates at least another \$50 billion will be removed from balance sheets in 2008. As one might imagine, the financial sector, which represents approximately 25% of the S&P 500 index, was the worst performing sector during the quarter, down 15%. For the full year, the sector was down 21%. Obviously, exposure to the financial sector and low quality fixed income instruments were not a good place to be invested in 2007. The good news is the vast majority of Beaumont clients had little to no exposure in either of these spaces.

The Irony of it All

When one takes a step back from these dramatic headlines, I see some amazing irony in the current mortgage/housing debacle. The seeds of this mess were sewn in the early 1990’s during the Japanese real estate bubble. At that time I had the pleasure of visiting Japan and remember a 45 minute stroll around the Imperial Palace in central Tokyo. At the end of the walk, I was politely informed that I had just circled real estate more

valuable than the sum of all the real estate in California. In an attempt to avoid the years of malaise and deflation experienced in the post-“real estate bubble” Japan, the Federal Reserve lowered real interest rates into negative territory after our 2001 technology bubble burst. Similar to Japanese real estate, the so-called “new economy” thesis had inflated technology stock valuations well beyond levels experienced by this sector in the past. Ironically, it was within this attempt to avoid the 15 year post-real estate bubble economic malaise that occurred in Japan, that the ground work was laid for the real estate bubble that the U.S. faces now!

Some Positive News

The Japanese housing bubble burst in the early 1990’s and it was 15 years before the central Ginza district experienced any positive price appreciation. Bubbles can be protracted and our predicament is very troubling due to the nature of the underlying asset (residential real estate which represents approximately 40-50% of individual net worth in the U.S.). The good news is that the temperament of U.S. investors and politicians will not allow for a 15 year extended transition period. Unlike Japan’s culture of “saving face” at all cost, ours is a culture of pointing fingers and replacing those that led us into financial trouble. The current administration will likely aggressively avoid a prolonged recession by continuing to stimulate the financial markets via Federal Reserve interest rate easing. We shall see whether this strategy avoids further market declines. The bottom line is remedies will be pursued.

2008 — Unwinding the Imbalances

Besides an election year and probably an economic transition year, 2008 will see the start of a multi-year unwinding of several imbalances that have developed, intensified, and, hopefully crested over the past few years. The imbalances that we at Beaumont have been talking about include:

- U.S. Trade Deficit

- U.S. Federal Deficit
- U.S. Consumers “Borrow and Spend” Addiction
- U.S. Dependence on Foreign Oil
- U.S. Overextended Military
- U.S. Toxic Political Culture
- U.S. Leadership Vacuum

How is Beaumont Financial Partners Positioned?

At this point many investors might expect that our investment strategy would include primarily cash and fixed income investments! Fortunately, we are not quite there yet but certainly are biased toward caution in light of the current climate. The solution and lubricant for the resolution of many of these imbalances is the slow and steady continued decline in the U.S. dollar.

Asset Classes That We Like Include:

- **Non-Dollar Denominated Assets** — we realize that the “easy money” has been made in equities of the emerging markets, so we’ve begun to trim our exposure to broad based EM investments and have narrowed our focus to country specific opportunities. Some of the countries that excite us are Thailand, Korea and Brazil.
- **Real Assets including: energy, industrial metals, precious metals and soft commodities** — we continue to be believers in peak energy and feel that prices for coal, natural gas and oil will continue to increase due to the combination of global supply/demand imbalances as well as limited production capacity globally. We continue to favor gold and silver as U.S. dollar hegemony fades and inflation begins to pick up in earnest. We are also very intrigued by several agricultural commodities such as sugar and cotton. Sugar prices are at historic lows and demand for sugar ethanol is increasingly becoming an important energy alternative. Cotton prices are cheap relative to historical prices and are a great alternative to synthetic fabrics which are petroleum based. Again, demand from Asia is quite strong and cotton production requires far less use of water and energy than other commodities.
- **Large capitalized, well managed, high quality equities with significant earnings growth from overseas exposure** — we continue to like the

defensive role these names play within our portfolios. The companies we favor have business models that generate significant free cash flow to support dividend payment and growth over many, many years. We also believe the likelihood of continued market volatility will cause investors to rotate to these high quality names.

- **Short Duration Fixed Income Securities** (especially those that are non-dollar denominated) - we are also very enthusiastic about emerging market currencies, in particular those whose currency is pegged to the dollar, in particular Asia, to have sizeable currency revaluations (relative to the U.S. dollar) because of their trade surpluses, above average growth, suppressed currency valuations, and high levels of foreign currency reserves. We have begun establishing positions in client portfolios in this space.

Asset Classes That We Continue to Underweight:

- U.S. financial institutions (especially those with consumer mortgage and lending exposure)
- Consumer discretionary spending
- Small cap U.S. centric companies that will not benefit from continued overseas growth
- Long duration fixed income instruments (especially those not compensating for further credit and inflation risk at current spread and absolute rate levels)

Am I Repeating Myself?

While some of this message may seem repetitive, it is important to communicate with our clients that essentially the long term investment process and themes remain in tact at Beaumont Financial Partners. As we enter 2008, our investment strategy has not significantly changed from our 2007 plan. However, we realize that market volatility has increased substantially and that keeping some cash on the sidelines may allow us to capitalize on market dislocations that often occur in periods of increased volatility.

If you have any questions or comments please contact us at 781-237-7170 or e-mail me at mstack@bfppartners.com.

—Michael P. Stack CFA