

December 31, 2007 Market Commentary and Outlook

Crisi-tunity Knocks

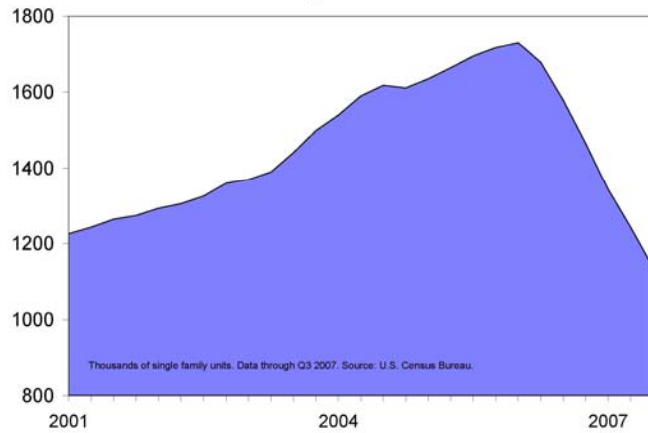
Lisa Simpson: *Do you know that the Japanese use the same word for “crisis” that they do for “opportunity?”*

Homer Simpson: *Yes, CRISI-TUNITY!*

The Simpsons, 12/18/1994

Few will argue that the U.S. economy is in crisis: falling home values, higher unemployment, low consumer confidence, huge losses attributable to sub-prime lending practices, rising oil prices and a falling dollar. During 2007 the stock market had often shrugged off such conditions. But in the 4th Quarter, performance of the stock market began to turn negative reflecting the economy’s woes—a pull-back some thought long overdue.

Housing Starts
Trailing 12 Months



According to a Gallup poll, more than half of Americans expect a recession, while more than two-thirds feel dissatisfied with the way things are going in the United States at this time – a level not seen since 1993.¹ Because so much of the U.S. economy (and that of the world’s) is dependent on consumer spending,

a decline in consumer confidence is not healthy for America’s corporate balance sheets.

But with crisis, comes opportunity. For the U.S. Government, there is now an opportunity to restructure and revitalize the mortgage lending industry. Some of the difficulties facing the U.S. economy are the result of years of low interest rates and loose regulation. In recent years, mortgage lenders extended too much credit to troubled

borrowers on terms that neither the borrowers nor the lenders could afford. The majority of these loans were with adjustable rates and little buyer equity. When interest rates became higher at a mortgage’s reset and the resulting increased loan payments became unaffordable, many borrowers found that the declining value of their homes made refinance or sale impossible. The bursting of the housing bubble will likely force many borrowers into bankruptcy. Worried that defaults will surge in 2008 as monthly payments adjust higher, banks have begun to hoard cash and curtail both institutional and retail lending, causing a dangerous state of credit gridlock. *Can the Federal Reserve and/or Congress effect meaningful reform and offer distressed home owners real assistance?* We will let you answer this question.

No doubt many are feeling significant, economic pain. But the opportunity in such a crisis for others will come with the ability to buy stocks and real estate with cash on hand—but not without a great deal of risk. The trick is knowing when to make those purchases. We think it highly likely the financial markets will remain very volatile for the near term as solutions for housing, credit, and banking problems are worked out.

In the table below, we select two highly divergent investment outlooks from the multitude of possible scenarios that can unfold:

Hypothetical Scenario	Hypothetical Investment Outlook
Sluggish response to crisis; economy stumbles. Public-private attempts to address the sub-prime crisis become mired in legal wrangling. Concerned about inflation, the Federal Reserve hesitates to cut interest rates. As a result credit tightens, consumption declines, and companies struggle. The economy moves towards recession and inflation risk declines.	If credit tightens, cash equivalents and high credit quality bonds are likely to outperform lower-quality alternatives. Short-term prospects for stocks of cash-strapped companies could become particularly dicey as perceived risks of market failure remain elevated. Blue chip companies with strong balance sheets would be poised to perform relatively well.
Early and aggressive bailout; economy revives. The Federal Reserve and regulators quickly flood financial markets with liquidity and push through an effective (but possibly costly) credit rescue package. Confidence is restored, credit conditions ease and consumption increases. However, inflation risks rise sharply.	As liquidity and confidence are quickly restored, the stock market surges. Low credit quality bonds and stocks of weakly capitalized companies could be among the strongest relative performers. However, the outlook for rising inflation may cause high-quality, long duration U.S. dollar-denominated bonds to lag.

¹ Gallup, Inc. November 26-29, 2007, December 6-9, 2007.

During a crisis, even a small change in the timing and nature of government intervention can drastically influence the investment outlook. Given the unpredictability of such intervention (and its effectiveness), we consider focused, event-driven investment strategies to be particularly risky. All too often, the financial markets behave like a manic depressive: What might be thought of as good news on one day can be negatively received on another. Other events might occur to negate or over-shadow what otherwise might be a positive intervention.

We still consider it wise to focus on one's investment objectives, be they short-term or long-term, and to build a broadly diversified portfolio whose holdings are consistent with your investment time lines. We believe different asset classes such as cash, bonds, and stocks each have unique volatility characteristics. And it is the potential for volatility that dictates whether or not a particular asset class should be held in your portfolio and in what percentage. We have said this many times before: *The fact the stock market goes down should never be a surprise to anyone. When it goes down, however, is the surprise.* While a well-diversified portfolio might not take maximum advantage of each and every investment opportunity along the way, it can provide more stability if conditions unexpectedly change for the worse.

Our Take for 2008

As we head into 2008, economic and market conditions will continue to be influenced by the ongoing slump in the housing sector. We're watching for:

Above normal risk of a recession. Whether the odds are 30%, 50%, or 70%, one thing is for certain – the risk of recession is higher than normal. Factors pointing towards recession include rising unemployment claims, falling durable goods orders, weak consumer confidence, high oil prices, lackluster retail sales, falling home sales and prices, declining corporate earnings, credit gridlock, rising personal bankruptcies, and questions regarding the solvency of hedge funds and financial institutions. Should a recession develop, stock prices could head south.

Continued stock market turbulence. Stock prices are likely to remain volatile as repercussions of the credit crisis ripple through the economy. Should credit problems worsen, high-quality companies with strong balance sheets will have a competitive advantage. If, however, credit conditions normalize, weaker companies may outperform on the rebound.

Troublesome consumer price inflation. Barring a moderate-to-deep recession, consumer prices may continue to rise at an undesirable pace as the effects of a weak U.S. dollar and high oil prices propagate throughout the economy. As of November 2007, the trailing one-year inflation rate stood at 4.3%.

Low short-term interest rates. Credit worries and shaky economic growth should keep short-term interest rates in the basement for the next few months. While bonds currently offer little real yield after inflation, they can provide a safe haven in the event that the current credit crisis deteriorates into a full-fledged recession.

Are We There Yet?

The U.S. economy, like a supertanker, is extremely large and difficult to steer. As a result, economic conditions—good or bad—can sometimes persist for longer than one might expect. Based on information from the National Bureau of Economic Research, a recession, should one develop, could last anywhere from six months to five years or more. Since World War II, U.S. recessions have on average lasted 10 months.

Fortunately, economic expansions tend to last much longer. Since World War II, the average economic expansion lasted nearly five years, providing investors with plenty of time to allow their investment capital to grow. For the long-term investor, this can mean more dough, and to quote Homer Simpson again, fewer “d’oh’s”.

Investment Committee
Northwest Capital Management, Inc.
January 3, 2008

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