



The Ben
834 Chestnut Street, Suite 315
Philadelphia, PA 19107
215.875.8666 • 215.701.8745 FAX

I expect a positive 2008 for both the economy and financial markets. Aside from the hit on home construction, home sales and the subprime mess, the U.S. economy is in pretty good shape. The typical set of problems that precede a recession are not in place. Before most recessions, businesses usually spend too much on inventories, plants and equipment, have too many workers, and pay too-high wages. These expenditures push up costs and force businesses to raise prices (“cost-push inflation”). The Federal Reserve (the Fed) takes notice and starts hiking interest rates. Meanwhile, consumers balk at the price increases and cut spending. The combination of rate hikes, slowing real sales and sharp declines in profit margins throws business decision making into reverse with inventory liquidation and capital spending cuts, leading to falling production and employment. This process snowballs into recession.

However, right now I do not see these factors in operation. Businesses have been generally careful in controlling costs. Investment in inventories has remained low, capital spending has been moderate, employment growth has been slow and labor cost increases have been contained. So I do not see cost-push inflation developing and the Fed has been able to cut interest rates rather than hike them.

However there are risks to this outlook. As I have noted before, in prior years we had a big headwind from the rise in oil and commodity prices and the decline in the dollar. But easy credit market conditions provided a partial offset. Now, tight credit markets provide yet another headwind. Easier monetary policy — Fed rate cuts — helps offset tighter credit markets, but a swing from rising to falling oil prices and from a falling dollar to a rising dollar sure would help. So far, my outlook that these shifts would begin has proved to be wishful thinking. Oil prices briefly touched \$100 a barrel today and the dollar is back down near the record low. If oil continues to rise and the dollar fall, we may be in for a recession this year and global investors may look elsewhere for their financial investments. Not a very cheery possibility...

I will be watching economic and financial market conditions closely to try to see which way we are headed this year. One final thought – there is only one investment where I can guarantee you an after-tax double digit return. Pay off your credit card balances! All the best in 2008 and, as always, please call me with any questions or concerns.

Sincerely,

David Waters

David S. Waters, CFP, CLU, ChFC, RHU
Vice President Professional Planning Associates, Inc.
Phone: 215-875-8666; Fax: 215-875-8745
www.proplanners.org

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