



HARBOR VIEWS

DECEMBER, 2007

THOUGHTS ON THE ECONOMY

We remain impressed with the resiliency of the U.S. economy and have made the point many times as the economy has overcome tremendous shocks over the last few years. We have been saying for many months the risks of recession are rising and are higher than any time in recent memory. The economy is very close to recessionary levels of growth and may bump along at this level for the next couple of quarters. Whether this ends up officially being labeled as a recession or whether it just feels like one we don't know.

Housing continues to be a drag on economic growth. Residential real estate sales will contract further this year and prices of existing homes will fall at least another 5%. Nationwide home prices are 7.4% below their June 2006 peak according to the Case/Schiller Index. These lower prices will increase pressure on the mortgage market as well as reduce the 'wealth effect' on consumer spending.

The real problem for the economy and for the financial markets is the credit crisis which originated in the mortgage market. We see the trouble spreading to prime mortgages, credit card receivables, personal loans, auto loans, commercial bank loans and other areas of the credit markets. The response by our thinly capitalized banks will be to tighten credit further. Credit is the lubricant that keeps an economy moving forward especially in a country as leveraged as the United States. This credit contraction will slow economic growth in 2008. Consumers and businesses

respond by spending and investing more conservatively.

The Federal Reserve Chairman Ben Bernanke is speaking on CNBC as I write this letter and he indicated he would stand ready to lower rates to defend economic growth. He also said he does not believe the U.S. will enter into a recession this year. We believe he has been slow to recognize the magnitude of the problem in the risk credit markets and hope his remarks today indicate he now 'gets it'.

The record oil price of \$100 per barrel just set this month may not hold if recession does set in over the next six months. Energy prices will remain elevated and make new highs as we emerge from recession because the supply of oil remains constrained.

Let us lend perspective on a potential recession. In the last 25 years the U.S. economy has spent a total of about four or five quarters in actual recession. Recessions are not only infrequent but are brief. Often by the time economists realize we are actually in one we are nearly out of it. Recessions are a natural and inevitable part of the economic cycle and are necessary to reduce inflationary pressures as well as reduce other stresses in the economy. Unfortunately one of the stresses to be relieved this time is the 'bubble' in residential real estate prices. This should not be of concern unless you are planning to sell your house soon as rising replacement costs put a floor under home prices over a longer time frame.

We expect this slow economic environment to run its course during 2008 and for the economy to be performing close to trend level

growth (3.0% real GDP growth) by late in the year.

OUR VIEW OF THE FINANCIAL MARKETS

The year 2007 ended on a weak note as the credit crisis widened and deepened leading to significant earnings problems among the financial stocks and anything related to the housing markets. The S&P 500 Index provided a total return of just 5.5% for the year which may end up being close to the reduced level of earnings growth for the year.

The equity markets are going to have trouble in the first half of 2008 as the economy bumps along at a new recessionary level of GDP growth. The credit crunch will reduce the earnings of the financial and housing related stocks dramatically as it did in 2007. By year-end the economy will recover to a more normal level of corporate earnings growth. Full year 2008 corporate earnings growth may be in the low to mid single digits. The performance of the stock market will have a tough time significantly exceeding this level of growth. International growth may fare a bit better and we look to our exposure there to provide something of a tailwind in client portfolios.

In anticipation of this weak environment we have raised a fair amount of cash in client portfolios by selling most of our financial holdings during the fall of 2007. We will look to deploy this cash as we feel attractive opportunities arise this year.

The fixed income markets had a volatile and difficult year in 2007 as risk spreads widened in nearly every area outside the Treasury market. Our high yielding auto finance and other corporate bonds saw their prices fall dramatically. We believe all of our current fixed income holdings are secure and will be able to pay their coupons and ultimately mature at par value. Turmoil in mortgage markets will continue in 2008, real estate

prices will fall further and subprime delinquency problems will spread to other segments of the mortgage market. We expect problems in the Alt-A, Option ARM and home equity segments of the mortgage market. If we do enter a recession we can expect delinquencies to rise even in the prime conventional mortgage segment. This will further pressure banks and other financial institutions and ultimately result in attractive buying opportunities in financial stocks and high yield bonds. We hope to recover some of our underperformance in the fixed income markets in the second half of 2008 as the credit markets begin to normalize.

If we do not enter a recession, stock prices are now attractive and may be near a bottom having fallen by 16% from their early October highs. If we enter recession another 5-10% decline in stock prices is likely.

Harbor is positioned defensively for clients with large capitalization blue chip shares of companies that can increase their earnings even in a weak economic environment. Our large cash reserves will allow us to make opportunistic investment selections as they arise early in 2008.

HEAD START

The Alford Foundation which was endowed by Dexter Shoe founder Harold Alford will make a \$500 contribution to a 529 plan on behalf of a child born in the state of Maine. The program starts in 2008 with grants to children born at the Maine General Medical Center in central Maine. The program will expand to other hospitals in 2009.

RANT

The Rant this quarter has to go to the Wall Street Investment Banks that securitized everything but the kitchen sink, paid the ratings agencies their fee to slap a high investment grade rating on the issues, and sold the securities to investors who thought

they were buying a fixed income security they could depend on to provide safe investment returns. Now these bankers are falling over themselves to post the largest multi-billion dollar write-offs in history as they incinerate shareholders capital that took decades to build. The credit crisis stemming from the real estate bubble would have been much easier to contain had not these mortgage pools been securitized and sliced and diced. Add the investment banks to the list of culprits in our credit crisis.

RAVE

Yes! Bernanke finally 'gets it'!

SAFE HARBOR IN SHIFTING WINDS

Most of our clientele come to us from existing clients or professionals who know our work. If you know of a family who is seeking counsel and might appreciate personalized and attentive financial advice from an independent firm we would welcome the inquiry.

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Nod to the ubiquitous disclaimer:

While we are not infrequently, and always quite accurately, accused of being of strong opinion...we want to let the reader know we've been wrong before...will be again and please don't hold it against us. The forward looking parts of the letter are the best educated efforts of fallible humans here at Harbor.