



HARBOR VIEWS

MARCH, 2008

THOUGHTS ON THE ECONOMY

We have been incredibly impressed by the resiliency of the U.S. economy for three years but even the most seaworthy of vessels cannot make headway against a perfect storm.

The U.S. economy is pretty clearly performing at a recessionary level of activity. The economy has lost non-farm jobs for four consecutive months, leading indicators have declined for five months and the ISM (formerly the Purchasing Managers Index) has been below 50 (contracting) since January. The question now has turned to will this be a short, shallow recession like the last two or something uglier. We believe the recession will be longer than the last two, perhaps lasting all year. However, the depth will be no worse than recent slowdowns.

The deflation of the credit bubble continues without letup. Financing has all but disappeared for jumbo mortgages, commercial real estate, leveraged buyouts and takeovers. The banking system was rocked in mid March when the Federal Reserve had to step in and broker a bailout of investment bank Bear Stearns. This was done to prevent a domino effect in the banking industry as counterparties lost confidence in one another and withdrew funding. The high level of stress in the credit markets remains but has eased since the dramatic actions of the Fed during March. In addition to the bailout, the Fed has significantly lowered the federal funds rate and the discount rate, the former to a current level of 2.25%. The Fed has also extended credit to investment banks for the first time since the Great Depression in

establishing the PDCF (Primary Dealer Credit Facility). This occurred just weeks after establishing the TAF (Term Auction Facility) and the TSLF (Term Securities Lending Facility). This alphabet soup of credit arrangements was designed to inject liquidity into moribund credit markets. I think we can safely say that the Fed and Mr. Bernanke do finally 'get it'!

It would be nice if the Treasury Department could come up with fiscal and regulatory measures that would also help solve the credit crisis. Their voluntary Hope Now program has lived up to not much more than its name: 'HOPE'! The treasury should be using its balance sheet to buy mortgages and mortgage securities much as was done in the 1930's to support housing. Instead they have empowered the GSE's (Fannie Mae and Freddie Mac) to greatly expand their mortgage activities and portfolios, significantly increasing their risk profiles at precisely the wrong time. Think of a hedge fund levered 30 or 40 to one investing in mortgages in the worst real estate crash in seven decades. If that sounds like a prescription for disaster we are on the same page. It looks like the implicit backing by the treasury the GSE's previously enjoyed, has become explicit without the attendant legislation. The days of GSE's being public entities may be numbered.

We believe the huge increase in commodity prices is reaching bubble proportions and may be the next one to burst. The energy commodities however, because of the very limited supply flexibility, will probably remain high. We expect the secular decline in

the value of the U.S. dollar to continue with its positive impact on exports.

The residential real estate market is now about 12% below its June 2006 peak as measured by the Case/Shiller Index. Further declines of 5-10% are likely this year putting further pressure on the mortgage and banking industries. Commercial real estate is the next area to deflate and cause losses in the banking system that may measure hundreds of billions.

The stress in the residential and commercial real estate markets, which is the root cause of the credit crisis, will probably remain with us throughout 2008, begin to abate in 2009 and return to some level of normalcy in 2010.

We expect economic growth to bounce along at recessionary levels during 2008 and to recover to sub par levels of 1.5% to 2.5% during 2009.

OUR VIEW OF THE FINANCIAL MARKETS

Equity markets around the globe are down significantly this year, China leading the way down almost 40% from its highs of last fall. Interestingly, the U.S. markets are down less than most other developed markets with the S&P 500 down about 7% as I write this letter. Our defensive posture has served our clients well as high cash positions cushion the blow. Our decision last fall to sell the banks, brokers and construction related issues has also helped as they are at the epicenter of the credit crisis. The holdings we now have are ones we are willing to hold through the economic cycle as these blue chip companies are defensive in nature. We expect our energy holdings to perform well as energy prices remain near record levels. Multinational holdings will continue to benefit from strong exports helped along by the continuing secular decline in the value of the U.S. dollar.

The credit crisis and the recession will be with us most of the year which will weigh on equity returns at least until mid year.

Historically, equity markets bottom near the middle of a recession. Even if this recession is a long one as we suspect it may be, the bottom in equity prices will probably occur sometime in the next six months. As we do not expect to be able to pick the exact bottom, we will begin to put cash balances back to work in stocks ratably over the remainder of the year.

The fixed income markets are having one of the worst years on record as many types of credit based products are not able to be traded at all. The aggressive actions of the Federal Reserve are just beginning to thaw things out a bit with some trades taking place in the CDO, levered loan and mortgage markets. We do not believe the credit markets are out of the woods by any means but we may be seeing the beginning of a bottom forming.

In our portfolios, the auto finance sector has been hard hit with prices for Ford Motor Credit and GMAC notes down sharply year over year. Both organizations carry over \$20 billion in cash on their balance sheets and we do not believe either could default under the conditions we envision.

As the credit markets normalize over the next year or so, high yield bonds should perform well as they pay their coupons and the prices increase as the stress diminishes.

We expect to see both the equity and fixed income markets to end the year with low to middle single digit returns.

RAVE

Chairman Bernanke and his Federal Reserve 'GET IT' and are in the traces pulling hard to fix our credit crunch.

RANT

It is disturbing to see the financial rescue package the U.S. Congress has proposed includes major tax benefits for the big residential construction companies that will put millions of dollars back into their coffers. It is this very group that at the root speculated with their shareholders money that the housing boom would continue unabated. They should reap the losses (that risk that attends potential reward) without succor from our national treasury.

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.

HARBOR ADVISORY CORPORATION

500 Market Street, Suite 11, P.O Box 4520
Portsmouth, NH 03802-4520
Tel: 603-431-5740 | Fax: 603-431-2927
www.harboradvisorycorp.com

*Jack De Gan (Editor), Weld Butler
Joan Gordon, Jan Yeaman, Cheryl Crowley*

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.