



What really is the Outlook for the Financial Markets in 2007?

If you have read in the last weeks as many opinions as we have about where financial markets may be heading in 2007, then you have encountered the same level of confusion: Will they crash or will they just about continue on the same positive note as in Q4 of 2006? Will the doomsayers be right or will the optimists prevail?

In our opinion of utmost importance is that you as an investor together with your advisor gain an opinion for yourself of what to expect. Only with your own view will you be able to pursue a clear short- or longer-term investment strategy. Without a clear view, you run the danger to not have a strategy but instead react to short-term market movements, and this in general always too late.

Furthermore, economic outlook and the impact of a Special Event on the economy must be analyzed separately. Since the impact on the economy by a Special Event is today by definition negative, whatever assessment of the economic outlook we come up with, it must be then discounted by the impact of the Special Event. Nature of size of the potential impact of a Special Event must be reviewed carefully, which establishes the basis for the choice of the preferred investment risk level. Impacts can be of various geographic or specific market importance, and can last for a shorter or longer duration before a return to conditions before the Special Event occurred.

As we discuss following some aspects from a macro economic perspective, our focus remains largely on the U.S. economy, since unlike other well educated opinions, we continue to believe, that a negative economic development in the U.S. will impact Europe and other economies negatively.

U.S. recession due to U.S. housing crash *versus* slower economic growth due to a soft landing? Some analysts think that the housing market has already bottomed out in terms of price decay. Even if this is true, the impact housing related drivers of the economy, such as the construction industry slowdown, a shrinkage of real estate market turnover and its implications on the finance industry, significant falls in house equity withdrawals (for the 4th month now), the huge amounts of adjustable rate mortgages resetting this year to higher rates, and so on, let us believe that we have to count on a time lag before the negative impact of the housing downturn in the U.S. will be felt fully. This said, with high liquidity levels seems to persist due to money extracted from home equity, very loose lending standards, stock market appreciations, etc., all may continue to support decent economic growth in the U.S. The net net effect of these countervailing movements remains to be determined and requires a cautious investment approach.

USD and U.S. interest rates – down or up? The prevailing view is that the USD will weaken significantly. We do not share this view in the short-term related to the CHF, the EUR and other currencies. Last year, exchange rates by and large were influenced by the short-term interest rate differentials. Since this gap got smaller in the last months, the USD weakened against the CHF, the EUR, etc. For the USD to decline more means a) the interest rate gap widens from today's levels, or / and b) the confidence in the USD sags. The latter reason must be related, however, to a Special Event. We are open to the possibility that the interest rate differential between the USD and e.g. the EUR will not grow but rather shrink. The U.S. experiences a soft landing, while Europe's economy starts to feel the effects of a softer USD (exports) and U.S. economy. As a result, the USD would actually strengthen from today's range of around EUR/USD 1.32 in the next few months.

Stock market indices - up or down? Analysts point to the fact that most stock markets are fairly valued with the S&P 500 for example at a Price / Earnings ratio of 18x. This view is justified as long as the record earnings during the most recent reporting periods can be repeated. What if not? Then today's market valuation may be quickly too high leading to a correction. We think that past earnings may be repeated if: There is no recession in the U.S. and energy and commodity prices remain at today's or lower levels.

Energy prices – up or down? While an economic slow down would reduce energy consumption, it must be borne in mind that overall, energy demand (especially from fossil sources) is increasing while production levels running more or less at maximum. The problem we see today is that the oil and gas prices are heavily influenced by the media focusing on current stock piles in the U.S. and weather predictions. Short-term investors leave the ever growing demand in Asia completely aside. Better than generally expected economic development may also support our view that energy prices will remain range bound or tend higher. To the surprise of some, higher agricultural prices may result in an increasing cost of certain alternative forms of energies.

Special Events – what can they be? They come as a surprise, are of large scale with a rapid impact on the financial markets and possibly a significant detrimental blow to economies. Such Events could entail:

- The unwinding of the huge carry-trade: This possibility depends on significant changes in interest rates differentials in various currencies. We do not see an immediate danger.
- Currency markets: What if the US, possibly combined with the EU, Japan and other countries coordinate a concerted effort to devalue against the Chinese Renminbi, a question the Daily Telegraph asked (November 27, 2006)? What if USD investors lose confidence due to the ever growing levels of indebtedness in the U.S., or because foreign central banks and oil producers move out of the USD in grand style? Voices warn that one should be prepared for the introduction of foreign exchange controls by the U.S. (with EU consent?).
- Derivative markets: What if a recession, or a major credit default, or an unwinding of the carry trade triggers a Special Event? The derivative market has exploded in recent years to now about USD 300 trillion which compares to a paltry USD 12 trillion of the US GDP. The problem with derivatives is that risk is not eliminated but just repackaged and passed on.
- Interruption of oil supply: Middle East, Angola, Venezuela, etc. This risk may materialize.
- Other Special Events that may not lead to explosive impacts but may develop over time include unexpected economic downturn or / and social unrest in China, the proliferation of the expanding religious war(s) (as some name it by now) including rebellion of minorities in Western economies, and more.

Conclusions and Recommendations:

Absent Special Events, economies and financial markets may offer an investor friendly environment in 2007. A slowdown in economic growth in the U.S. and subsequently other economies should be expected. The fundamentals for a weaker USD do not seem to be in place and the currency could strengthen against widespread opinion in the short-term while remaining prone to devaluation as 2007 progresses. Interest rates may not be reduced as much as expected (or not at all) in the U.S., and not increased in the EU nor in Japan.

All in all, the divergence of the various views by professionals on 2007 points to a challenging investment year. "Betting on the right horses" means having to take higher risks ... or luck. After all, investment success depends on appropriate asset allocation and risk levels. We at Cottonfield try to support you in gaining your personal view and then advise you on the selection of actual investment opportunities.

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