Baldwin Investment Management, LLC

PASS THE PEPTO-BISMOL, PLEASE……..

The worry is palpable and the hand wringing is rubbing knuckles raw. One day the stock market indices add a few percentage points – only to lose that gain the very next day. Volatility has reappeared with a capital "V". There seem to be few happy faces (except for Goldman's partners) spread across newspaper front pages or on the evening newscasts. The "black hole" of residential real estate and its derivative financial instruments threaten to swallow the whole U.S. economy, according to some. Adding more misery to the mix is the decline of the once almighty dollar. The American "greenback" in some corners of the world (like Venezuela and with certain rap artists) is no longer held in high regard. There has been "chatter" about currency diversification in certain foreign reserves which unnerves investors fearing a "dumping of the dollar". This is the setting – but what do we think the future holds?

Well, the Federal Reserve has been very clear that it will act to protect the U.S. economy. It will provide liquidity to the American financial system to prevent what has been heretofore a "Wall Street" problem from spreading to Main Street. Already, the Fed funds rate has been cut 1% and the discount rate by 0.75%. Unfortunately, despite Mr. Bernanke's actions, there still are too many on Wall Street who do not believe that the Fed Chairman and his "band of brothers" get it. The Wall Street "suits" think the Fed is "behind the curve" – witness the market's response (i.e. a 300 point drop in the Dow) to the latest interest rate cuts on December 12 – despite the fact that the cuts delivered matched consensus estimates. Skepticism that not enough is being done runs thick. However, the Fed Governors see all the data that Wall Street sees and they see data that Wall Street does not. There is an old saw which admonishes investors never to bet against the Fed. Mr. Bernanke and his colleagues "are on duty". We think that Fed attention to the liquidity problems will be an important support for the stock market in 2008.

People are still getting jobs! No doubt, in a couple of industries (homebuilding and mortgage banking in particular) workers are being laid off. However, in a number of other industries like energy, hospitality, technology, telecommunications, mining, and healthcare, companies are hiring. In fact, there are shortages of skilled personnel in the oil and gas industry. The national unemployment rate is only 4.7% - historically a low number. Additionally, personal incomes have been rising and despite the many times proclaimed "death of the American consumer"; the consumer has continued to spend through all the turmoil according to the most recent statistics as of the middle of December 2007. Sure, some people (perhaps too many people) used their home as a "piggybank" and spent their home equity. But more importantly, we think, people spend money when they are employed. If the unemployment rate were at 6%, then that would be cause for concern. At 4.7%, we believe that employment is another support for the economy and the stock market.

It looks as though the U.S. economy is slowing in Q4 2007 and will be weak to start the New Year. We believe the real estate problems will decrease in significance throughout 2008, economic growth should pick up and 2008 should be a year of moderate GDP growth (+/- 2.7%). Counterbalancing anemic American progress will be much more vibrant international growth, especially throughout Asia (think China, India, Vietnam, Saudi Arabia, etc.) and South America (think Brazil). With these economies expanding, some at double digit rates and with the dollar down, U.S. exports are growing mightily. Emerging markets buy more than half of U.S. exports. In fact, as a percentage of U.S. GDP growth, exports are far more important than residential real estate. So, while the American consumer "may take a breather", consumers abroad (individual, corporate or governmental) should take up the slack.

Next year will be an election year in the United States. This typically means the politicians will be out in force spending money to win votes. Not only will we have spending on national projects (e.g. infrastructure) but also on local ones. Spending by state and local governments is contributing 25% of GDP growth in 2007. So, this "fat wallet" should lend economic support next year.

The real estate implosion probably has more to go on the downside and finding this "bottom" is "the question". But this tumble did not just begin – it has been happening since mid-2006. The point is that housing's contribution to U.S. economic growth has dropped significantly. In fact, the share of economic growth due to residential sector investment is so low now that it has little room to shave the GDP any longer.

Five years ago people were also complaining about the dollar and the ever growing trade deficit which stemmed from an uncompetitive exchange rate. The fear then was that deepening global trade imbalances would "end in tears". But in 2002 the pundits were not worried about a weak dollar. Rather they were fussed up about too strong a dollar. Our currency can not seem to please anyone! Global imbalances do not last forever. Just as some thought it impossible for the dollar to weaken in 2002, some now see no bottom for it. But pendulums swing back and forth. The risk today is that trade pressures in competitive currencies like the Euro damage foreign demand for U.S. exports, not allowing the U.S. to correct in some measure its trade deficit. Another risk is that inflationary pressures build in dollar pegged currencies (i.e. the Chinese Yuan and the Saudi Riyal) which necessitate government action to quell (i.e. raise interest rates) those local pressures. Raising interest rates, if raised too much, could then dampen economic growth. The world has “muddled through” before and will probably do so again. Already, American legislators and Presidential candidates are racing to see who can promise to spend less and at least the Democrats are also talking about raising taxes to cut deficits. In the meantime, a lower dollar is prompting sales of greater exports – a good thing. This should cut the trade deficit and the dollar should appreciate. This is how the system is supposed to work – if given enough time. So, if the dollar begins to “turn the corner” without the Fed having to dramatically raise interest rates solely for the purpose of supporting the dollar, this should be a buttress for the stock market.

Uncertainty, because information is still too incomplete about how serious the residential real estate mess is going to be, is roiling the markets. No question the turbulence is more significant than most had supposed it might be. Nevertheless, there are several strong supports for the U.S. economy and for the world in 2008. These are not merely “straws in the wind” but tangible “towers of strength” about which too many investors in the present emotional chaos have forgotten. The U.S. stock market is not overvalued relative to inflation or interest rates. There will be economic growth in 2008 – though not optimal. Importantly, faster economic growth will be had offshore. So one needs to position a portfolio to benefit from international progress via foreign securities or ownership in U.S. based multinationals. Once the portfolio has been fashioned, take two Pepto-Bismols and call me in the morning!

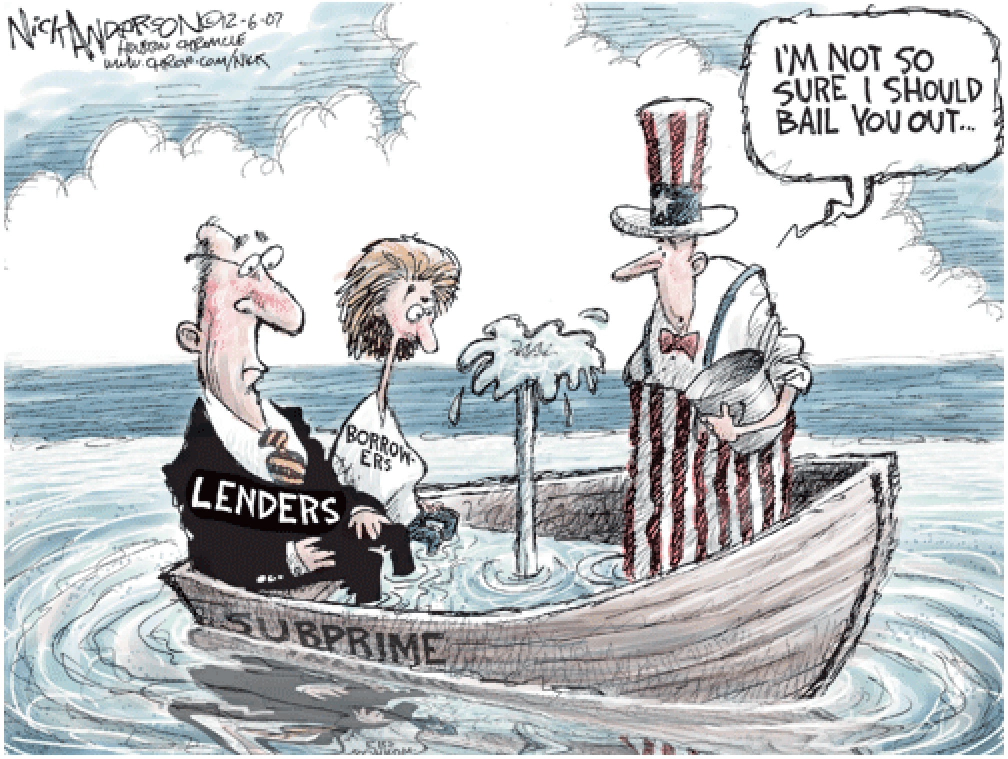
PREDICTIONS FOR 2007	**COMMENTS**
1. The dollar will slowly slide versus the Euro & Yen	Yes
2. The Fed will reduce interest rates in second half of 2007	Yes
3. President Bush will become a dealmaker in working with Congress	No
4. Oil prices will settle at "around" $60/BBL	No
5. Japan's economy will continue to gather steam along with rest of the world	Yes, but slowly
6. Inflation will not be a worry	Yes
7. The U.S. consumer will continue to spend	Yes
8. Corporations will spend more	Yes
9. Housing will stabilize in 1st half of 2007	No
10. The U.S. stock market will go up but not at the 2006 pace	Yes

The big miss this year was the housing call (#9). The world focused on the "disaster du jour" announced by a variety of financial firms caught up in the mortgage maelstrom. This single topic seemed to control investor sentiment for most of 2007 as people worried increasingly about counterparty risk and which institution might go bankrupt. Stock and bond market volatility increased dramatically as a result. Oil prices approaching $100/barrel were worrisome on and off. But inflation remained well behaved for most of the year – so not much negative market effect from the oil arena. President Bush, even though his popularity plumbed new depths amongst voters, stayed intransigent on many policy issues and refused to "deal" with the new Democratic controlled Congress. Lucky for George W. only Congress' unpopularity surpassed his own, so he had some room to successfully fight legislation he did not like. In the end, "legislative lockjaw" had no material negative influence on the stock and bond markets in 2007. It looks like we got 7 out of 10 predictions right for the year - not bad. We only wish that the expected 2007 stock market underperformance (see #10) was not so glaring! So what about next year?

PREDICTIONS FOR 2008

1. Late in 2008, the Fed will begin to raise interest rates
2. The dollar will appreciate in value vs. the Euro and Yen
3. Housing will stabilize in the second half of 2008
4. Financial stocks will outperform in 2008
5. There will be Middle East progress in Palestine and in Iraq
6. Oil prices will come down
7. Inflation will be a little worrisome in the first half of 2008 - but not in the second
8. Hillary Clinton will not be elected President; and Michael Bloomberg will run if the Republican field is "muddled" coming out of South Carolina
9. International equity markets will continue to distance themselves from U.S. markets
10. The U.S. stock market will do better in 2008 than it did in 2007

A FINAL THOUGHT



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