



The Centurion Counselor

Fourth Quarter 2007

UNDERVALUED SECTORS (CONSIDER!)

- MEDIA
- CONSUMER DEFENSIVE
- MEDICAL DEVICES
- MEDICAL DIAGNOSTICS

OVERVALUED SECTORS (AVOID!)

- JUNK BONDS
- EMERGING MARKETS
- MONEY CENTER BANKS
- REITS

Annual Crystal Ball Issue

I have never been one to take advice! As an example, Casey Stengel once said: “Never make predictions, especially about the future.” However, for those of you who know me, throwing caution to the wind is an annual event when we publish our “Annual Crystal Ball Issue.”

But, before we undrape our crystal ball from its velvet silk-stringed cocoon, we must first reconsider the events of 2007 to see just how accurate our predictions were.

We will divide **Our 2007 Predictions** into three categories: (1) Those “dead on,” (2) those partially correct, and (3) those that frankly just missed the mark.

(1) “Dead on:”

- “We would have an environment of increasing inflation coupled with low or flat growth . . . inflation will increase to the low 3% range . . . growth will slow to the high 1% range.” Although the final numbers for 2007 are not in, the rate of inflation is currently near 4%; and, it appears, growth in the fourth quarter will be near 1%.
- “ . . . put pressure on real estate prices. This will lead to an increase in foreclosures and heartburn for some lenders.” As of this writing, 213 major mortgage brokers have gone out of business since the start of 2007. Wall Street and most major banks have announced billions of dollars in losses due to bad home loans. Home prices dropped nationwide this year for the first time since the 1930s.
- We stated that investors should avoid the following sectors: junk bonds, money center banks, and publicly traded REITS. The public REIT sector and money center banks were the worst performing sectors.

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Annual Crystal Ball Issue (continued)

- We believed that consumer defensive and medical device companies would out perform the market and they easily beat the market averages.

(2) **“Partially correct:”**

- Oil would go to “\$40 and, at least, a hundred in the future.” Oil dropped to the low \$50s early in 2007 before hitting \$100 on the first trading day of 2008. What a difference a day makes.

(3) **“Missed the mark:”**

- “We do not see the Fed easing this year.” The Fed did ease several times in the second half of 2007 in response to the sub-prime crisis.
- “We look for a down or flat first half of 2007 with a rally in the fourth quarter.” Once again, the sub-prime crisis foiled us. The Dow reached new highs near mid-year but sold off in the fourth quarter.
- We predicted that emerging markets would under perform, but they didn’t get the message. They were one of the strongest sectors led by China.

Also, noteworthy is the fact that although the economy continued to expand at what appeared to be a fairly solid pace in November (according to measures of consumer spending), the economic data in December had something of a stag-flationary feel. Manufacturing activity appeared to have turned downward according to the ISM report, and the unemployment rate in December rose sharply to 5.0%.

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Although this indicator is volatile from month-to-month, it increased by 0.6% points over the last 12 months—an increase that in the post-war period has reliably signaled the onset of recession with a batting average of 10 for 10. While we do not think that the economy has slipped into recession, it is a significant warning sign and makes the January economic data cycle very important. Meanwhile, on the inflation front, the early January numbers showed inflation has moved up to an uncomfortable 17-year high.

What does all of this mean for 2008? We have listed what we believe to be some of the significant headlines. It is also important to keep in mind that from an investment perspective the old adage remains even more important: “Never put all of your eggs in one basket,” and maintain a well disciplined and highly diversified investment approach.

- Fed will cut rates to 2 ¾% (currently 4 ¼%).
- The United States will have a mild recession.
- When the United States catches cold, China will get pneumonia.
- Several municipal bond insurers will file for bankruptcy. (This may happen before you receive this newsletter.)
- Credit Default Swaps (CDS) will become a household word. CDS is the next big bank problem. In essence, they involve selling real risk to an imaginary insurer; but, just like my old imaginary friend when I was a child, there is no substance.
- Credit cards, auto loans, and commercial mortgages will also become Wall Street headaches.

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Annual Crystal Ball Issue (continued)

- After a weak first six months, equity markets will pick up--mostly to end unchanged for the year.
- Housing will remain weak all year.
- The Dollar will rebound this year.

The above may seem all “doom and gloom,” but *down* years are important factors in a healthy economy. We have had successive bubbles--such as the internet and real estate--just to name two. Now the economy needs to purge itself. If the politicians allow this to happen naturally, the eventual result will be another 10-plus years of a healthy and growing economy. The major fear we have is that with 2008 being an election year, Washington will try to help us. This may very well put off a recession, but it will not purge the system of its excess.

Some of our investors’ will notice that we ended the fourth quarter of 2007 with a higher than normal cash balance. We did this because of market conditions at year-end. This does not mean that we have abandoned strategic asset allocation it means that in some cases we believed that the risk reward based on the particular clients time horizon and risk tolerance could be better suited by allowing cash to build in the portfolio.

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