Year End 2007

As the calendar rolls to 2008, I am increasingly confident in the portfolio strategy that we have been focusing on throughout the past few years. Namely, our concentration in precious metals, energy, and foreign currencies are all acting to provide solid and stable returns. This combination of assets proved to be more rewarding and far less volatile than stocks in general in 2007, but then again, the S&P 500 closed the year with gains of just 3.5%.

Two of the three primary asset classes we focused on in your portfolio performed exceptionally well. The precious metals had a breakout year with gold and silver returning 30.5% and 14.2%, respectively, and closed at levels not seen in nearly three decades. Furthermore, as oil continues to make new all-time highs of nearly $100 per barrel, energy investments also did extremely well. The energy component of the S&P 500, gained 36.7% in 2007.

Somewhat disappointing, however, were the investments in foreign bonds and foreign currencies. Despite the dollar weakening in 2007 as I predicted (down roughly 8% on a trade-weighted basis), investments in foreign bonds and currencies had slightly negative returns.

But 2007 market performance was dominated once again by the declining dollar. I have stated many times in the past that I believe we are in an environment whereby equities in general can only show gains if the unit of value (dollars) from which they are priced declines. It has now been more than eight years since both the stock market and the U.S. dollar both showed gains. And I expect this trend to continue.

The big story of 2007, however, was the decline in the housing market. On a national basis, we have now seen home values show an annual decline for the first time since the Depression, and the mortgage market has suffered significantly. This concept is nothing new to long time clients, as I have been expecting a weak housing market for a few years now, but this reality seemed to finally sink in to the markets this year, despite the peak occurring in the summer of 2005.

This housing story, in my opinion, has only begun to play out, despite many market pundits continuing to call a bottom with every piece of negative data. Hundreds of mortgage lenders have now gone bankrupt or no longer exist in their previous form, and major financial institutions have already written down nearly $100 billion of mortgage related debt. Current estimates put the total figure at present around $400 billion, so we may still have quite a ways to go.

The reason that this is so important is that the U.S. economy has been largely dependent on mortgage equity withdrawal to fund consumer spending. When the “average Joe” is no longer able to utilize debt-induced consumption, the economy slows down, which it looks to be doing presently. This should be either negative for equities in general, or negative for the dollar as the Fed may try to continue to weaken the dollar and increase the money

supply to negate these effects. It is entirely possible, and likely probable in my opinion, that should the credit expansion reach a point of saturation, we could see *both* the dollar decline and the equity markets decline simultaneously. This is also not a new concept to long-time clients, but from an economic standpoint, the dangers continue to increase.

I have discussed this scenario for the last several years, and it has been the primary rationale for my focus on commodities and foreign currencies as the core of investment portfolios. 2007 seems to be the year that the financial markets have also recognized this fact, as this quarter, the dollar decisively broke to an all-time low while gold, silver, oil, and many other “hard” commodities are simultaneously at or very close to all-time highs. (This technical set-up was discussed in detail in last quarter’s report.)

The simultaneous action of all these forces acting in tandem is extremely bullish for our portfolio positioning at present. The equity markets have become extremely volatile of late and continues to look very precarious. However, “hard” assets have remained remarkably stable in the face of the recent volatility as they are beginning to see heavy inflows of capital, and yet they remain under-owned as investments by most market participants.

I am quite excited about the prospects for 2008. About seven years ago, I anticipated a major secular shift from the investment community whereby U.S. stocks (and by extension the dollar) would begin to be replaced with foreign and “hard” assets (foreign currencies and commodities). When these major secular shifts occur, usually lasting 15 to 25 years, they are extremely slow in market recognition initially, until such a time when the trend becomes so obvious that the additional flow of funds begins to become self-fulfilling (which may be happening now). In finance, this is referred to in three distinct phases: denial, migration, and panic.

If I am correct on this secular shift, we may be only about a third of the way through the process (as the financial community moves from the denial stage to migration). Seven years of “denial” may seem like an exceptionally long time, but consider that stocks have performed well over the last five years. However, relative to the dollar’s decline or the performance of the energy and precious metals, it has been quite lackluster. The decisive breakdown in the dollar to new lows and simultaneous breakout in most commodities in the 4th quarter of 2007 looks to me to have solidified this recognition shift in the financial community. If this continues to be the case, the prospects of these assets relative to the broad equity markets should begin to perform exceptionally well as the migration and panic stages develop (a process which may still have a decade or more in outperformance).

Financial markets are dynamic, and trends in asset prices have many varying degrees within many varying time frames. But the longest trends are secular in nature. 2007’s price action, particularly that in the 4th quarter, seems to have gone a long ways towards bringing the financial markets closer to the recognition of a broader investment shift, one we have been discussing for years. Should we be entering the migration phase of a multi-decade secular trend, we may begin to see a dramatic outperformance from portfolios in

both absolute and relative terms. This action looks to be very bullish for our investments and portfolios going forward, and I anticipate a very solid year in 2008 as the technical price action in 2007 has set up these asset classes very nicely for continued bullish action.

As always, please let me know if you wish to discuss these or any other topics in more detail.

Wishing you all the best throughout 2008!

Sincerely,

Shane Hoover
Hoover Capital, L.L.C.
shanehoover@hoovercapital.net