Economic and Social Outlook: *January 2008*

While the Federal Reserve has cut interest rates, many believe the Fed has been too cautious and fallen behind the curve of a slowing economy. We share those concerns and believe the odds of recession have risen to 50/50. Consequently, we're moving from an overweight position in equities to a neutral posture.

Market Overview: Of Haves and Have Nots

In 2006 the S&P 500 benchmark return of 16% overstated by a fair amount the experience of most investors. In 2007 the benchmark's 5% gain will again prove atypical for many investors—only this time in both directions. That's because depending on where you put your money last year you may have done a lot better or a lot worse than "the market."

To note the most extreme divergence, investors in the financial sector lost 21% last year while those who bought energy stocks gained 32%. Almost as dramatically, investors in consumer discretionary stocks like retailers and homebuilders lost 14% while those in materials stocks like chemicals and steel gained 20%. There were even big spreads among the gainers with healthcare stocks rising a mere 5% as technology names surged 16%.

Why such dispersion of returns? Because the S&P 500 has effectively become a global index. While all the companies in the index are based in the US, somewhere around 40% of their revenues now come from abroad. And overseas economies particularly were hot last year while the US was not. So the winners tended to be stocks and sectors with the most foreign exposure while losers were those with the most domestic.

BRICs and Housing in a Tug-of-War Economy

Developing economies around the globe, dominated by the so-called BRICs (Brazil, Russia, India, China), continued to grow at a blistering pace last year. Indeed developing economies now account for a larger share of global GDP than the US. Rapidly building out their infrastructure, these economies had an endless thirst for energy, industrial commodities and technology last year.

Hence the winners listed above. This demand was a huge boon to the export side of the US economy (while raising serious environmental concerns longer term).

On the domestic side, however, things were far less cheery. As home prices continued to fall and the housing sector contracted, the US unemployment rate started moving up. Rising unemployment means slower growth in household income, which in turn means slower growth in consumer spending. Adding insult to injury, lenders grew more cautious and homeowners' equity shrunk (from falling home prices). Both of these further crimp consumers' buying power by making borrowing harder. Since consumer spending accounts for 70% of US GDP, a tighter consumer spells slower growth for the overall economy.

None of this is unexpected to our readers. We've said for some time that the tug-of-war between weak housing and strong exports would cause growth to slow in the overall economy. We said growth would slow to a crawl in the 4th quarter of 2007 and all indications suggest it did. The question we're now revisiting, however, is: Do we slow or do we stall?

Raising the Odds of the "R" Word

Throughout 2007 we were firmly in the "midcycle slowdown" camp that expected the economy to slow but not roll over into recession. Our ace-in-the-hole was a Fed Funds rate that stood last June at 5.25%, affording the Fed plenty of room to cut interest rates if need be. Doing so, we argued, would gun the engines of the economy in the event it started to stall.

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2007 Major Market Performance

	4th Quarter 2007 % chg.	2007 % chg.
DJIA	-3.99	8.81
S&P 500 (large cap)	-3.33	5.49
S&P 1000 (small/mid cap)	-3.94	5.18
S&P 1500 (all cap)	-3.40	5.47
NASDAQ	-1.82	9.81
Lehman State G.O. Municipal Bonds	1.58	4.00
Lehman Gov't/Credit Intermediate-term Bonds	2.90	7.39

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While the Fed has indeed cut interest rates to 4.25%, many believe the Fed has been too cautious and fallen behind the curve, as it were, of a slowing economy. We share those concerns and believe the odds of recession have risen to 50/50.

Yellow Flags

Several developments in the 4th quarter contributed to this shift in our outlook. First and foremost is the rising US unemployment rate. While still at a historically low 5%, this basic measure of economic health will likely continue to rise—and like a fever, that's not good. Another related factor is a softer retail sector. Companies from Target to Tiffany's have reported slowing sales, which means consumers at all income levels are feeling the pinch. This is also reflected in the spread of credit weakness beyond the subprime mortgage sector as American Express, for example, recently reported sharply rising credit card delinquencies. In short, during the 4th quarter we saw a broad-based weakening of consumer behavior as ripples from the housing decline spread across the economy.

While strength in the developing economies (BRICs) offset domestic weakness in 2007, going forward it appears those economies will cool a bit as well. China is raising interest rates in an effort to slow its torrid pace of growth. And as most of the developing economies are export-based, slowing growth in the US means lower demand for what the BRICs are selling. And if the BRICs cool off a bit, that means less demand from them for what *we're* selling. So we can't expect the same relief from the US export sector as we enjoyed last year.

What We're Doing

All of that said, we're not calling for a recession. We simply think the odds of one have risen closer to 50/50. Either way it looks like we're in for six to twelve months of a tougher business environment.

In deciding how to position our portfolios the first thing to note is that stock valuations are low and investor sentiment is wary. Which is to say that much of what we've discussed above is already baked into share prices. This isn't 1999 with euphoria abroad in the land and valuations through the roof. So we don't think there is tremendous downside from current levels (the S&P 500 is already down 12% from its October high).

Secondly, with the Fed already cutting interest rates and suggesting it's about to get more aggressive, the stimulative effects of Fed policy should start registering in the back half of 2008. As the stock market tends to look ahead six to twelve months, investors will soon be pricing shares based on their expectations for 2009. Historically, share prices often rise during a recession as investors anticipate recovery.

For these reasons we're moving portfolios from an overweight position in equities to a neutral posture. As the weather has gotten rougher, we're taking in some sail. Within our equity holdings we're scaling back our exposure to industrials, energy and materials stocks as we see these sectors ceding their leadership regardless of which scenario plays out, recession or just a slowdown. We're positioning neutrally in the remaining sectors.

Our expectation is that as the economy firms sometime in 2008 sector leadership will pass to the classic early-cycle beneficiaries of recovery such as the technology and consumer discretionary sectors. But we're getting ahead of ourselves here. For now, we're taking in some sail and waiting for calmer waters.

Social Advocacy Highlights

In December Trillium filed shareholder resolutions with JP Morgan, Morgan Stanley and Merrill Lynch, asking them to address the **genocide in Sudan**. These banks are among the largest shareholders in the "Big 4" oil companies (Chinese, Malaysian and Indian) doing business in Sudan. The royalties paid by the oil companies to the Sudanese government help finance the massacres in Darfur. We're urging the Wall Street firms to use their influence to press the Sudanese government to accept full deployment of U.N. peacekeeping forces.

Also in December Trillium and Open MIC held our first corporate dialogue on media responsibility (Open MIC, the Open Media and Information Companies Initiative, is a non-profit advocacy group Trillium incubated and spun-off last year.) We spoke to AT&T senior management about their much-publicized **political censorship** of Pearl Jam during a webcast over AT&T's Blue Room site. Trillium is asking AT&T to adopt a policy banning censorship of legal political expression on any of the company's platforms. While we're early in the dialogue, AT&T noted this was the first time investors had raised issues of freedom of expression with the telecom giant.

Trillium recently sent a letter expressing our disappointment in oil giant and former "green" leader BP after it announced its entry into the **Canadian oil sands** business. Oil sands development offers some of the worst life-cycle carbon emissions of all fossil fuels, and has led to the deforestation of 40% of the Canadian boreal forest. We also just filed shareholder proposals on oil sands development in Alberta at ConocoPhillips and Chevron. The upcoming Winter edition of *Investing For a Better World* will cover all of this year's shareholder resolutions and will be posted online at www.trilliuminvest.com.

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