REVIEW & COMMENTARY
4TH QUARTER 2007

Here a billion, there a billion, everywhere a billion, ole….

A year ago we titled our year end correspondence ***Capital Punishment*** which gave thought to the titling this correspondence ***Capital Punishment; The sequel,*** given recent market activity. However, it is more the investor than the market that gets punished. Seldom has net worth vanished so quickly from corporate balance sheets (thus our title) as the financial engineers who constructed these devastating new hybrid investments- CDO's aka collateralized debt obligations watched helplessly as the liquidity in these markets evaporated. Many of the problems originated with sub prime loans which were packaged, restructured, repackaged, reconstituted then resold to the point where few investors, even the professionals, fully understood the investment. If ever there was a time to give credence to the old adage of 'don't invest in stuff you don't understand' that was it. Financial companies spewed out billions of these debt instruments monthly over several years. Now investors, and the markets, are left dealing with it while many of those who created them live comfortably off their excessive 'retirement packages' (aka severance).

Credit market concerns and the worries that the US economy may have fallen into a recession has left few places to hide in the equity markets. Canadian financial stocks, in the last quarter of 2007, have fallen close to 6 %, some falling further in the first few days of 2008. Material stocks have followed. A few of the bright spots in 2007 were gold and oil. The weakening US currency was of great assistance to these commodities along with some geo-political turmoil providing further upward pressure to oil prices. Frankly, the quicker the economic direction is determined the quicker the Central Banks will act to remedy the situation. Whether they will provide the necessary tonic remains to be seen, however, it would appear that lower interest rates are likely in the first half of 2008.

Prior to proceeding any further with our customary predictions this time of year, it is important to discuss how we did last year in our annual prognostications. They were…

> *Oil prices will stabilize; the first few days of 2007 have been terrifying to those investors who have over-weighted portfolios in oil…Weather aside, we feel that oil will not drop significantly but will exhibit the same volatility as it did in 2006. Look for crude prices to bottom in the first quarter of 2007.*
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> *Income Trusts will do better than the majority of investors predict in 2007….*

> *If the US economy falls into a significant recession, which could be lead by either a significant fall off in real estate values or a downward run on the US dollar, then interest rates will drop. But unfortunately, the US will be in a difficult position- though they have lots of debt, lower rates will lower the value of the dollar….Thus, unless either of the two above scenarios appear, interest rates will remain steady and move up towards the end of next year.*

> *… we feel that equities will outperform mid to long term bonds, especially for taxable investors.*

For the first time in many years we were right about oil. While some of the strength in the last quarter was due to the lower US dollar, the obvious demand issues surrounding China and other emerging economic regions, the stability, or lack thereof, of the Middle East remains a focal point. While the progress of the United States' occupation of Iraq remains questionable, Iran's nuclear ambitions coupled with the political turmoil in Pakistan dampens hopes of near term stability in the region. This is probably the most important variable in predicting 2008 oil prices.

Certainly income trusts generally were pretty decent investments. Several business trusts were taken private, several smaller to mid sized Oil and Gas were taken over or merged and a few others did quite well. Overall, given the pessimism that surrounded the group after the Conservative Government's Halloween trick (rather than treat) they did quite well. In the reflection of year end equity returns, those trusts that maintained their value and paid out healthy distributions were quite good investments.

Our last prediction was correct too, though the last quarter saw many of the portfolios hurt by the drastic sell off in financials and material companies. Canadian banks lost 10% in the quarter and metals & mining lost 3.2%. For the year, the TSX/SP index gained over 9%, mid and long term bonds were able to provide approximately half that gain- and that was before tax.

Now for 2008.

With the exception of last year, we have generally been wrong about oil prices. Fully expecting this trend to resume, we are bound to make that admittance rather than provide any specific target. The Middle East remains a powder keg and will be very influential in the direction of oil prices. Given that we still consider China and other emerging economies to have an ongoing appetite for oil, increasing demand will continue. We believe there is a significant premium to the simple supply/demand equation and thus where Middle Eastern tensions go, so will oil. Given that Energy represents approximately 28% of the TSX/SP index, we would not overweight it but certainly would not take any significant profits either.

The Canadian economy will not fall into a recession, however, it would certainly appear that the US will get quite close, if not lapse into one. The US Federal Reserve will lower interest rates further and continue to inject liquidity (as has the Canadian and many other central banks) which will eventually help resolve the credit concerns surrounding the ABCP's, CDO's and sub prime mess. This will put continued pressure on the US dollar which may in turn keep commodity prices strong. This should bode well for the Canadian currency. The US economy will end up the year (2008) stronger than it started and US interest rates will bottom in the second half of 2008.

Finally, our last prediction, as it is in most years, is that we will be equally as accurate as we have been in past years. During strong markets, a conservative balanced approach is often considered antiquated and too cautious but as we are reminded every time the markets turn quickly you don't always have the time to make the necessary adjustments; it is much better to maintain the appropriate financial posture at all times since it is when the markets take a turn for the worse that the greatest mistakes are made.

Thank you for your confidence and support and best wishes for health and prosperity in 2008.

Stodgell Investment Management Ltd.