Rutherford Investment Management, LLC
10300 SW Greenburg Rd. Suite 115
Portland, OR 97223

Phone: (503) 452-1210

www.rutherfordinvestment.com

The Road Ahead—Watch for Bumps

Quarterly Newsletter
Period Ending 12-31-2007

Volatility returned to the markets in 2007. We have seen strong stock market gains between 2003 and 2006, with relatively low market volatility. But 2007 saw wide swings in market averages. The recent bull market has been fueled by an average 17% increase in earnings. However, earnings are now dropping as profit margins come under pressure, and certain sectors, such as financials, are seeing big drops.

For all the uncertainty and volatility, the markets ended in positive territory for the 2007. For the year, the Dow finished the year up 6.4%, the NASDAQ up 18.7% and the S&P up 3.6%. In general large caps fared better than small cap companies. International markets fared better with the Dow Jones World index, (ex U.S.) up 14.4%; emerging markets up 36.4% and Latin America up 46.1%.

In the U.S. market, the best performing sectors in 2007 were Energy, Materials, and Utilities, up 32.4%, 20.0%, and 15.8%, respectively. The worst performing sectors for the year were Financials and Consumer Discretionary, down 20.8% and 14.3%, respectively. The next worst performing U.S. sector was Health Care, up 5.4% on the year.

The outlook for next year is very cloudy as the markets continue to factor in a recession.
In the first three days of 2008 the market gave up half of its gains from 2007. Indeed the start of the year was reminiscent of the year 2000 when the market began the biggest bear market since the Great Depression. The last time the Dow finished the year up after being down in the first three days was 1922.

Recent economic reports give scant comfort. Minutes of the Federal Reserve show they are vigilant, but with no scheduled meeting until January 29, not much is likely to happen to aid the economy unless the Fed makes an inter-meeting rate cut which, while not unknown, is unlikely. Chairman Bernanke and other Fed speakers have made it clear that there will be a 50 bp rate cut at the January 29-30 meeting.

In my view, the odds of a recession have increased to 49% for and 49% against. The tie-breaker is the action of the Fed. The fat lady has to sing.

At the moment the Fed is working hard on the capital markets problems. Libor rates still remain stubbornly high as banks retain reluctant to lend to other banks. However, the money that the

Fed is pouring into the capital markets through their TAF auctions is being “sterilized” by the Fed’s removal of money from the monetary system. This is perhaps the best they can do, given their (real) inflation fears, but the impact on the overall economy is not as great as it might be.

President Bush has also promised a rescue package, but the precise terms are not yet known. Of course any stimulation, from the Executive branch or the Federal Reserve will take months to have an effect. In the meantime, the odds of a recession grow.

The fear of inflation will restrain the Fed from more aggressive action. Commodity prices are soaring across the board. Precious metals such as gold have reached records; industrial metals have soared, and will likely remain high because of demand from growing world economies. Lesser known metals, such as cobalt, used in making batteries have also reached record highs.

On the food side, we have seen record prices in grains, which affect meat and diary prices. The results are being seen at restaurants and the grocery counter.

Even if the U.S. were to plunge into recession, global demand will probably keep pushing up commodity prices. So the Fed has a real dilemma on its hands.

Next year will see continuing inflationary pressure and continuing margin and profit deterioration. This will affect stock prices. We have had a number of years of earnings growth and market returns above historical trend, and now we will probably see growth and stock market gains below historical trends. Look for market gains of about 5% or less next year. Still, over time, equity investments have been rewarding in a diversified portfolio.

Opportunities will still exist in a declining market. Perhaps the best prospect is international markets. Russia, portions of Latin America, Asia, and India are still growing strongly.

We will look for opportunities in sectors which benefit from global growth. We will also look for opportunities in sectors which have the wind at their back, such as commodities, particularly food related stocks. Energy, particularly oil services should be strong. Utilities provide a safer haven and perhaps some gains because of the attractiveness of their yield. In general look for niche companies that are growing in spite of the downturn.

While volatility is likely to continue, long term investors should continue to obtain a better total return in the stock market than in other asset classes.

William D. Rutherford, President
Rutherford Investment Management LLC.

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