Strategic Times
Timely Economic Insight for Income Investing

Volume 20 December 2007

The Fate and Weight of 2008

2007 saw some very revealing comments from former Fed Chairman Alan Greenspan. It got us thinking about some of his more memorable comments.

- *"History has not dealt kindly with the aftermath of protracted periods of low risk premiums."*
- *"An informed borrower is simply less vulnerable to fraud and abuse."*
- *"Anything we can do to raise personal savings is very much in the interest of this country."*
- "*I guess I should warn you, if I turn out to be particularly clear, you've probably misunderstood what I've said."*

The last being one of our favorites. It seems that even though these were stated prior to current economic events, Mr. Greenspan may prove a wise soothsayer.

Much has changed over the last 12 months. At the beginning of the year Fed Funds stood at 5.25% where it had rested since the last rate hike in June of 2006. Housing had peaked and inflation was running at an annualized rate of 2.50%; much lower than the print in November that stood at 4.30%.

The S&P 500 started at 1418 and would rise to over 1550 within 6 months. From there the ride got a bit bumpy as the sub prime and credit challenges came to light. The S&P 500 then dropped to 1407 within the next 6 weeks only to rise to a high of 1565 and back down to the 1407 area. Sounds a lot like a double bottom for you technicians out there.

Not to be outdone, the yield curve did its best to show its multiple personalities as well. The Yield Curve has shifted dramatically on the short end. Many may recall that this move is similar to 2000/2001. In the 13 months in which the Fed first cut rates we saw the 3 month TBill drop from over 6.00% to 1.71%. Then, as is now, the long end of the curve remained anchored.

Additionally, the economy and its various aspects went through a tremendous amount of volatility. We will first provide our thoughts on the economy and then we will look at multiple asset classes to uncover where we see value and where there may be more risk.

The Consumer's Economy

The economy's headlines were dominated by housing, sub prime, Collateralized Debt Obligations (CDOs), inflation and an ever-growing spending strain of the US consumer. As the uncertainty rose, the headlines got correspondingly worse. As we have stated before, where there is a heightened state of uncertainty, the market and the media usually will price in "Armageddon-esque" scenarios; however, these premonitions rarely come to fruition.

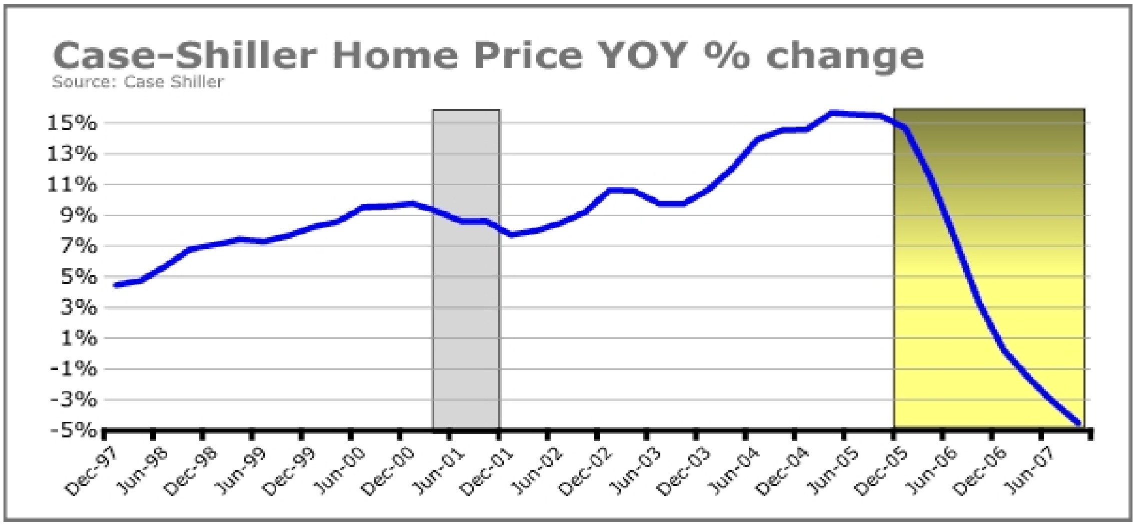
Matthew Lloyd
Chief Investment Strategist

In This Issue

Markets Snapshot

	01/03/07	12/21/07
3 Mos Tbill:	5.04%	2.98%
2 Year:	4.77%	3.17%
10 Year:	4.66%	4.17%
30 Year:	4.77%	4.58%
S&P 500:	1,416	1,484
DJIA:	12,474	13,450
NASDAQ:	2,423	2,691
Gold:	$627 oz	$811 oz
Crude:	$58.32	$93.31

The housing market gave back the accelerated returns from the last decade as it cooled down and the credit contraction impacted the global economy.



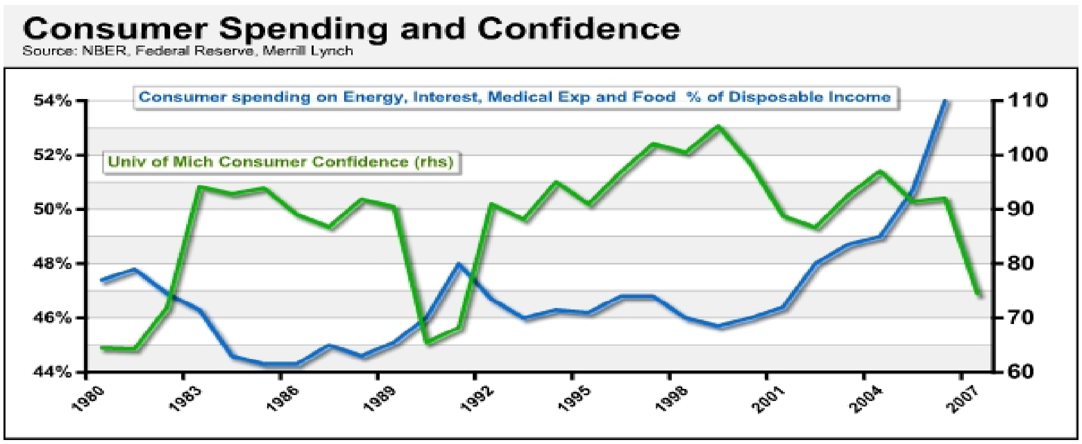
Now, consider that the number one area to monitor in the economy is the consumer. Currently, the consumer has had 63 straight quarters of increased spending; a record for sure. As access to easy credit and the "liquefying" of assets made it easier to buy today, the consumer set forth on a spending binge, unmatched in recent history. We think we are in the beginning stages of a slowdown in the spending of the US consumer for a number of reasons.

1) Access to credit is more difficult and more expensive to come by. The use of credit cards is rising and so too has the delinquency rate, albeit from historic lows.
2) The consumer is coming off of two asset-based expansions versus economic. As Merrill Lynch pointed out, asset-based expansions take nearly 3 times as long to recover versus those of economic. The Fed lowering rates to an anemic 1% during the last credit cut cycle fed an already liquid market with more fuel in which to seek out higher yielding assets as well as correspondingly reducing the inherent risk perceived in the instruments.
3) When we consider that this expansion has created only 60% of the jobs that are normally created, the labor market may be a bit vulnerable. This could add to the strained confidence the consumer has in the future of the economy.
4) The political and tax environment may cause increased anxiety. With the AMT patch still not passed and the possibility of 20 million tax payers caught in the AMT net, the consumer cannot bank on a more accommodating policy and or taxation system.

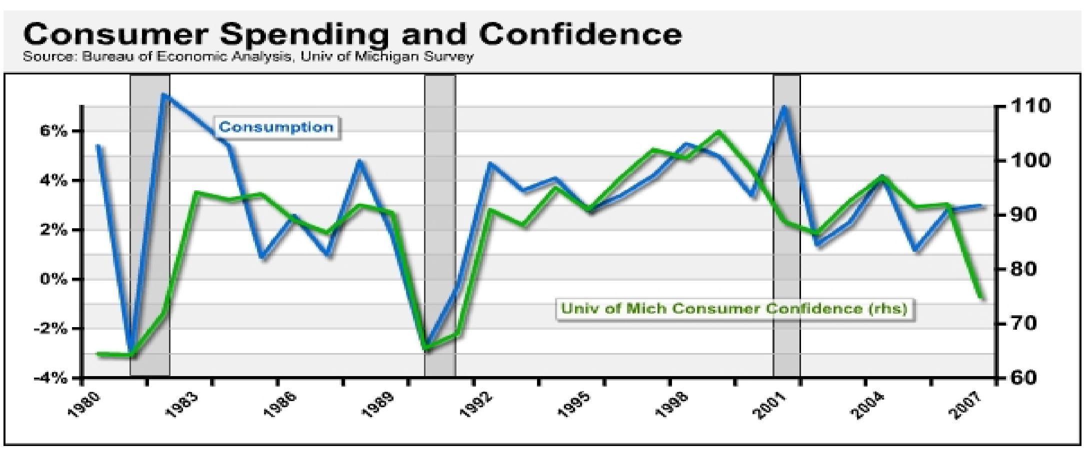
To graphically represent some of the pressure the consumer is feeling, consider the chart on the next page. The amount of disposable income spent on energy, interest, medical and food has risen steadily since 2000. Clearly it would be easy to state that the costs of these four components have risen steadily, however, one more conclusion can be drawn. If disposable income had grown in coordination with these expenses, the blue lines may have been far more muted. This is further verification that wages have not grown in coordination with the overall market.

"They are the men and women who have the courage to strive for the happiness which comes only with labor and effort and self-sacrifice, and those whose joy in life springs in part from power of work and sense of duty."

Theodore Roosevelt



The other point to take from the chart is that as the disposable income became increasingly scrunched, the confidence dropped dramatically. The University of Michigan's consumer confidence number hit a high of 112 in 2000 and hit a recent low of 74.5 for December's reading. We've seen similar large drops in the confidence number in two other periods: 1990 and 2001. Both points preceded our two most recent recessions.

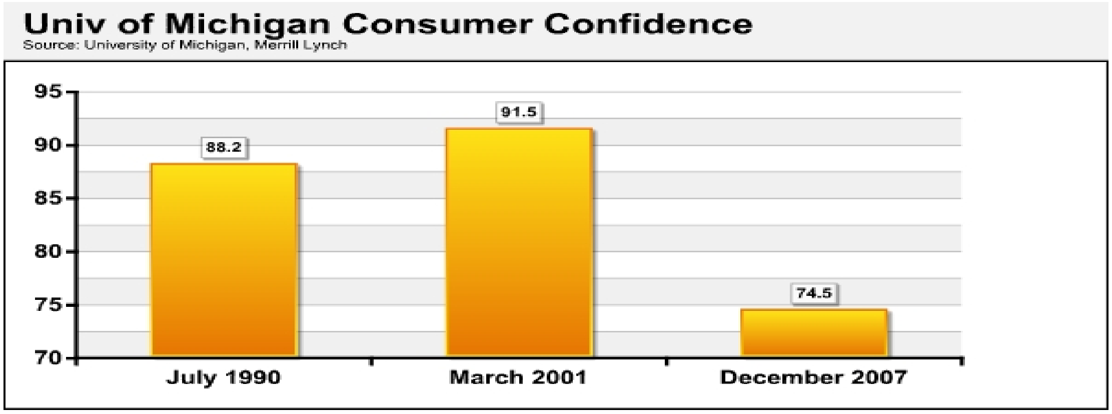


The above chart may be the most obvious of all charts, but it visibly shows that how the consumer feels is how the consumer spends. Please note the recent divergence in consumers confidence versus the steadiness of consumption. Look for consumption to follow the confidence number. It is said that if you want to hide something valuable, lay it in plain sight. Such is the value of this chart and its parochial but effective argument.

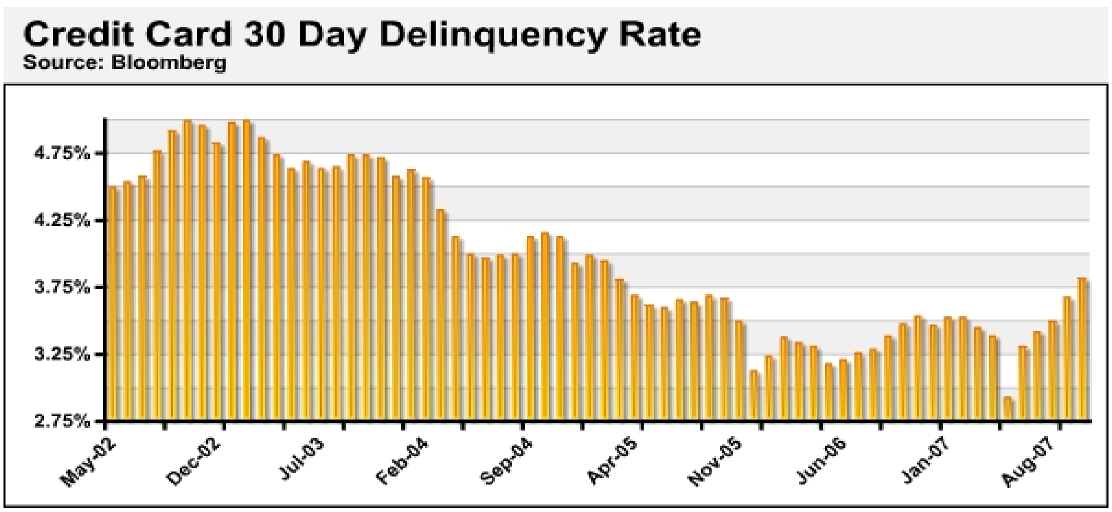
"The degree of one's emotion varies inversely with one's knowledge of the facts—the less you know the hotter you get."

Bertrand Russell

Perhaps the most disconcerting of the confidence number is the relative decline versus other recessionary points as evidenced below.



One area that is also concerning is the rising delinquency on credit cards. Consider



The consumer is feeling strains as we have not seen credit card delinquencies at this level since early 2005.

When measuring the economy, one must clearly look at the US consumer who is not only 70% of the domestic economy, but 20% of the global economy. We believe the consumer will reign in spending and increase savings as concern for the future of the economy begins to stabilize. This will result from not only the consumers sentiments, but also from the credit crunch. Credit will be available, but at a higher cost and much higher scrutiny than in recent history.

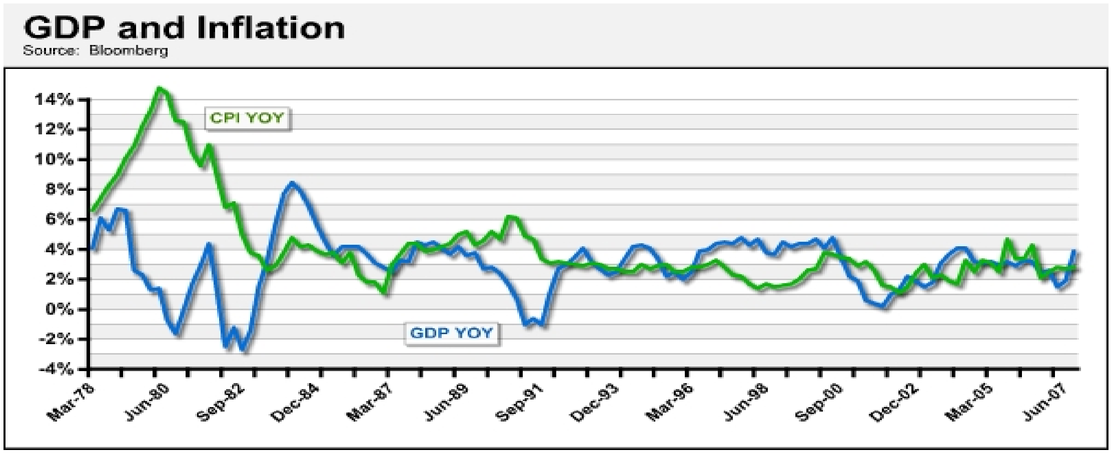
We believe the biggest risk to the economy is not stagflation, hyper inflation or recession, but rather deflation. We are already seeing deflation in the housing market and must act quickly to quell any spillover to the demand for various goods. An increase in savings, though positive from our anemic levels, could add fuel to the deflationary environment. Though a deflationary environment appears remote, it is an area where we dare not tread as it could take an intense amount of stimulus and time to work through.

"Over the past five months, this confidence index has literally collapsed by 16 points and in the 30 -year history of the data series, we've only seen two other times, outside of Katrina, when consumer confidence has fallen so far so fast at this crucial time of the year: 1990 and 2001 –and both times the economy had slipped into an official recession"

David Rosenberg
Merrill Lynch
"The four horsemen and the silver lining"
12/10/2007

The Fed's Fight

The Fed has done an admirable job, on a long-term scale, in balancing growth and inflation. Notice the chart below and how the volatility of inflation and growth have been minimized since the extreme environment of the late 1970s and early 1980's.



The Fed has had its hands full over the last 5 months. The Fed lowered rates from 5.25% to 4.25% over the last 3 meetings. During this time we have seen the following economic releases:

- November Producer Price Index (PPI) came in at 3.2% making the year-over-year change in PPI a whopping 7.2%.
- November Consumer Price Index (CPI) came in at 0.8% making the year-over-year change in CPI 4.3%.
- The Import Price Index is running at 11.4% annually.

For the Fed who has the mandate to control inflation and maintain steady growth, easing of the Fed funds rate with this inflationary environment seems criminal. However, it is abundantly clear the there is a larger challenge to the Fed.

The stability of the banking and credit system is on very shaky ground. For years, Wall Street has increasingly bought more esoteric investments and packaged them into a nice box called a Collateralized Debt Obligation ("CDO"). Since there was always another buyer of the instruments, primarily due to liquidity and cheap credit, the perception of the risk of these instruments was hardly recognized. Many of these CDOs carried sub prime pooled mortgages as well as various other debt instruments that were meant for only the most informed and risk attracted investor.

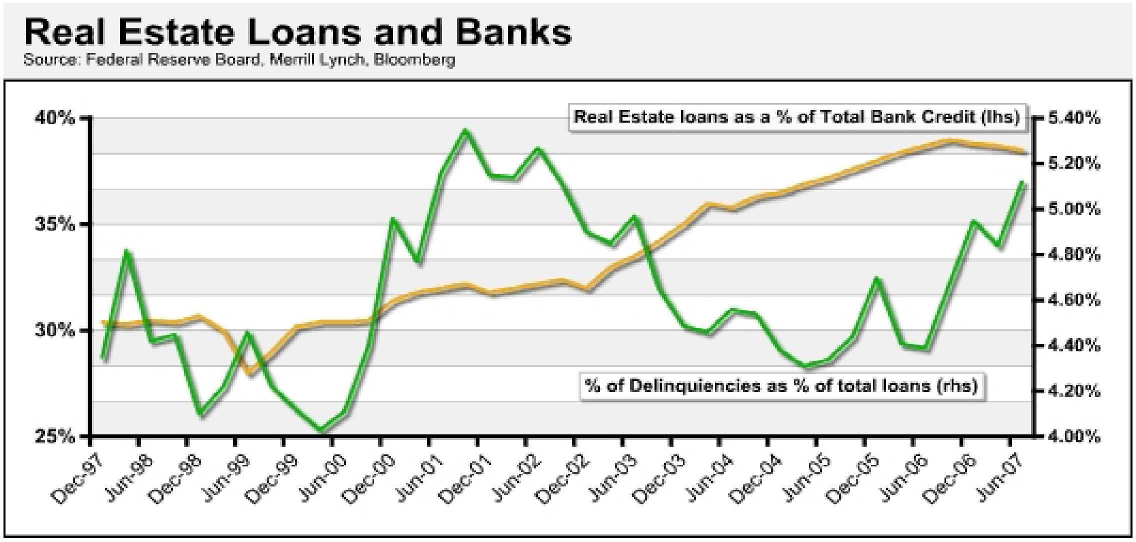
As the pricing of these became suspect and thusly marked to a better estimated market, many of the vehicles that invested in them began to feel the strain. Overnight, the asset backed commercial paper market that served as a rolling liquidity system for many of these instruments froze. The Fed attempted to ease this pain by lowering the discount window rate, injecting money into the system and reducing the standards for collateral when getting these loans. All in an effort to better estimate to what degree the financial system is vulnerable to this credit crunch.

Many may see the resemblances to the Long-Term Capital Management issue from 1998. There are some similarities, however we believe there is one large difference. In 1998, the Fed could get the parties together in a small room to hack out a solution

"Emperors and armies come and go...but unless they leave new ideas in their wake, they are passing historic consequence."

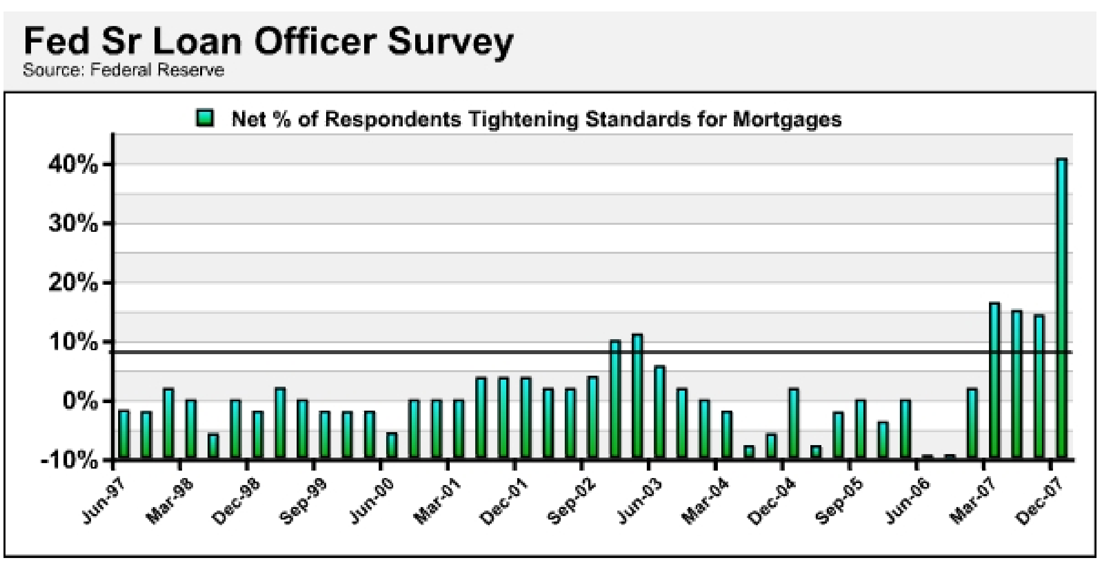
Alan Greenspan

would disrupt the markets as little as possible. With the current situation, the Fed would have to rent out an arena and multiple interpreters at their call as this has infected the entire global financial system.



One of the Fed's concerns is the vulnerability of the financial system. With the amount of real estate loans as a percentage of total bank credit only recently coming off of its highs, there is reason to be concerned. At the same time, delinquencies are rising on total loans.

The typical reaction is to reign in lending and tighten lending standards. According to the Fed Survey of Senior Loan Officers, we are currently at the most restrictive of lending standards since measuring began.



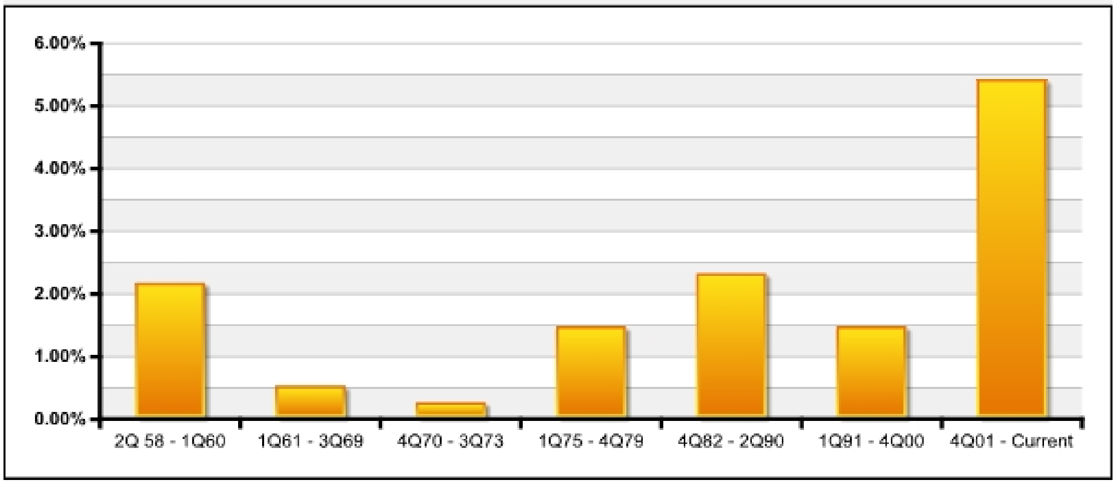
The consumer will have a more difficult time of getting credit in the near future. This is an important development as we will see on the next page. The consumer has been reliant on multiple sources of credit over the last 63 quarters. However, the degree to which debt has been added versus disposable income in this last cycle is significant.

"The net fraction of domestic banks that reported having tightened their lending standards for commercial real estate loans over the past three months increased notably, to 50 percent relative to the July survey."

The October 2007 Senior Loan Officer Opinion Survey on Bank Lending Practices

Consider the chart below with estimates from David Rosenberg of Merrill Lynch.

Household Debt as % of Disposable Income Annual Increase by Cycle
Source: Merrill Lynch, Federal Reserve Board, Bureau of Economic Analysis, National Bureau of Economic Research



"There's always somebody who is paid too much and taxed too little—and its always somebody else."

Cullen Hightower

With the banks beginning to restrict lending, the Fed will increasingly be looked upon to assist them with continued easing and less restrictive policy in general.

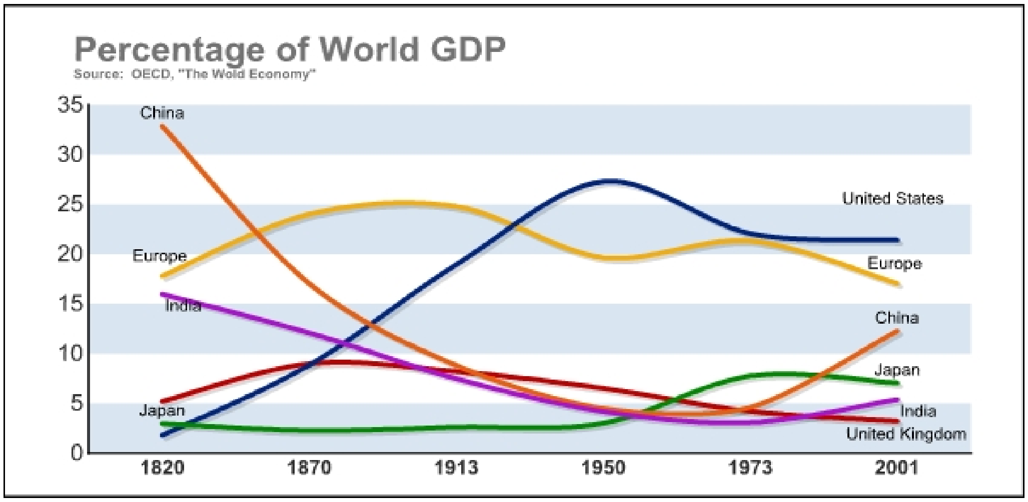
We expect the Fed to continue its easing policy throughout 2008. We ultimately see the Fed Funds rate at a 2 handle based on what we currently see on the horizon. The recovery of housing should begin at some point in late 2008 or early 2009. Unlike what happened with the equities in 2000, it will not be a V-shaped recovery. Look for this to bottom out for a while before it begins it's ascension back to their old highs. Equities took 4 1/2 years before they recovered back to their old highs and housing may be in the same range.

We would expect GDP to retract from the current estimate of 2.3% for 2007. The earlier part of 2008 may be most vulnerable, however look for a bounce back in the second half of 2008. By the second half, some of the Fed's easing will have worked itself throughout the economy and the financial system will have had the balance sheet pendulum swing harshly back towards the conservative side.

The Global Arena

The last year has brought about a rebalancing of risk on the global side. The globalization process is one that will continue to play out for decades.

There are some dynamic long-term forces at work which will ultimately cause more rebalancing of global dominance. Over the next century, we believe the role of the United States as patriarch of the global economy will shift to more of a "big brother" role. We would expect to see a continued rise of China, India and Japan as a percentage of worlds output.



"Globalization presumes sustained economic growth. Otherwise, the process loses its economic benefits and political support."

Paul A. Samuelson

Recently the European Central Bank (ECB) left rates unchanged. However, we believe that if you consider the contagion of the tightening credit crunch, they are closer to easing than raising rates. Assuming the ECB embarks on rate cuts at some point in 2008, that would place 65% of the worlds GDP in easing mode. Quite a beneficial backdrop for a myriad of global assets.

According to Bloomberg, who surveyed several economists, the expectations for GDP growth for various countries are listed below. 2007 and 2008 are estimates while 2005 and 2006 are actual.

Country	2005	2006	2007E	2008E
United States	3.2%	3.3%	2.3%	2.2%
Japan	1.9%	2.2%	1.1%	2.2%
EU	1.6%	2.9%	2.2%	2.0%
United Kingdom	1.8%	2.8%	3.1%	2.2%
China	10.9%	10.2%	11.2%	10.6%
India	9.0%	9.2%	8.8%	8.6%
Brazil	2.9%	3.7%	4.8%	4.4%
Russia	6.4%	7.0%	7.4%	7.1%

As we can see, the greatest growth is coming outside of the United States. This will continue for some time, though not on a linear plane. We point to the following table from earlier in the year to show where UBS' estimates show the most significant growth.

	2005	2006	2007E	2008E
Advanced Economies	2.5%	3.1%	2.4%	2.6%
Developing Economies	7.7%	7.8%	7.0%	6.8%
World GDP Growth	4.8%	5.1%	4.4%	4.4%

We believe the developing economies will be the dominant leader going forward. The US consumer slowdown will have an impact on global growth, however it will be more mitigated in today's more diverse economy.

The dollar may still be a bit vulnerable, however it looks to have gotten ahead of itself versus a few of the major currencies. The Euro, pound and yen all look to have made the bulk of the move that we expected. The dollar may continue to weaken versus the developing markets, however it will not be a straight shot. It will take time to find an equilibrium in those markets.

The one aspect that could cause a profound disruption is if the pricing of commodities were to move towards a basket of currencies. It could also be impacted if there were to be a dumping of dollar-denominated securities on the open market by some Foreign Central Banks. We are already witnessing a diversification into other currencies from recent purchases by these foreign Central Banks.

Global investing will continue to be essential to successful portfolios for both return and risk management. Consider the following correlation table of various exchanges from around the globe as we continue to believe the dollar is the most overweighed asset for domestic investors.

Various Global Equity Index Correlations, 01/03/03—12/14/2007 Source: Bloomberg

	Dow Indu dollar	S&P 500 dollar	DJ Stoxx euro	FTSE 100 pound	Nikkei 225 yen	Hang Seng hk dollar	Brazil Bovespa real
Dow Indu dollar	1.00	0.97	0.78	0.78	0.46	0.44	0.63
S&P 500 dollar	0.97	1.00	0.78	0.77	0.47	0.45	0.67
DJ Stoxx euro	0.78	0.78	1.00	0.91	0.47	0.44	0.48
FTSE 100 pound	0.78	0.77	0.91	1.00	0.45	0.43	0.52
Nikkei 225 yen	0.46	0.47	0.47	0.45	1.00	0.52	0.46
Hang Seng hk dollar	0.44	0.45	0.43	0.43	0.52	1.00	0.46
Brazil Bovespa real	0.63	0.67	0.48	0.52	0.46	0.46	1.00

Opportunities

When inflection points occur in the markets, there is an enormous amount of uncertainties that arise. In these uncertainties, however, opportunities arise.

Clearly the perception of risk has worked its way back into nearly every facet of every asset class. Until recently, the market had not priced risk into the equation.

Over the next section we will summarize some of the areas where we see value.

"We must ensure that the global market is embedded with broadly shared values and practices that reflect global social needs, and that all the world's people share the benefits of globalization"

Kofi Annan

Equities

Gene Peroni, Senior Vice President of AAM (A Division of FIS), summed up the market conditions in his December 10th commentary:

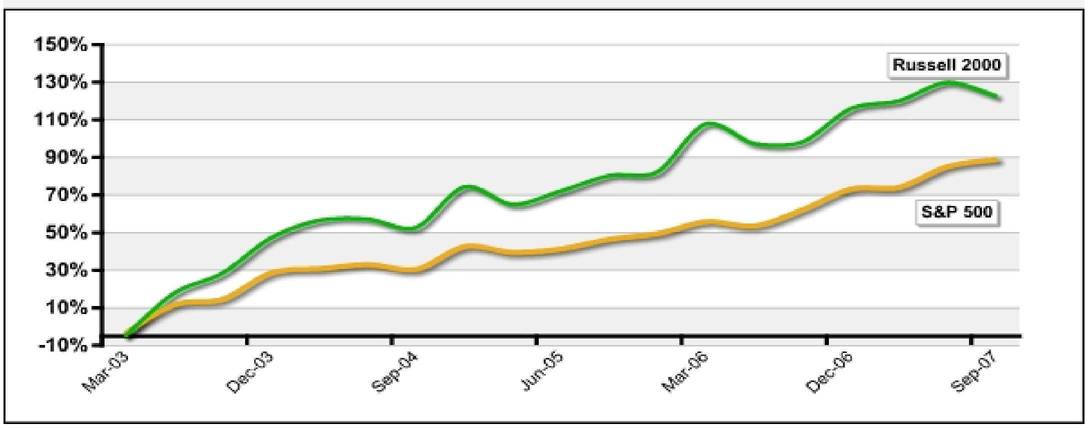
> *"The strong could get stronger, but they may also be subject to more expansive trading swings that reflect transient changes in traders' attitudes or temporary reactions to headline news items. I believe the risk-reward ratios for leading stocks and industry groups is at least as attractive today as it was a year ago."*

A slow down in the US economy combined with the substantive write downs effect on balance sheets of the financials clearly makes it a challenging time for corporate profits. Due to this, earning expectations have declined dramatically.

According to their respective firms' 2008 outlooks, Citigroup expects 2008 S&P 500 earnings to grow at 5.2% while Goldman Sachs expects a growth of 5.8%. Merrill Lynch is expecting operating earnings to drop by 7.3%.

With this backdrop, large-cap companies should be able to offer more stability with earnings and typically offer more international exposure. Relative performance of large-cap versus small-cap also points to a potential shift back to over performance for the larger companies.

S&P 500 and Russell 2000 Return
Source: Bloomberg



The growth will be driven by global exports from a weaker dollar as well as growing foreign domestic demand. Globalization will not be a smooth process; however, especially in the next year as elections raise the protectionist rhetoric.

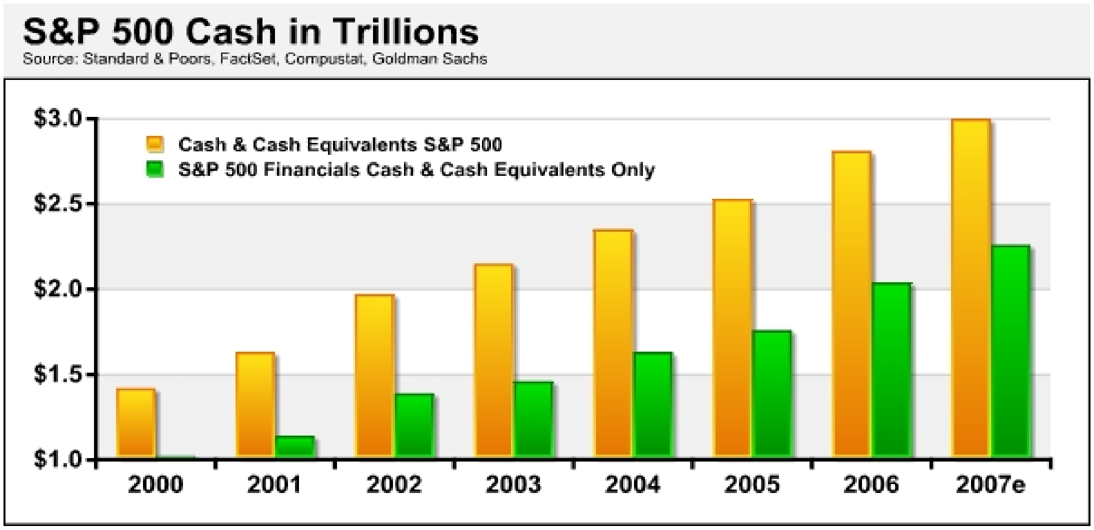
We will expect to see many who seek election using increasingly harsher language, especially towards China. With the lack of a free floating exchange, restrictive market entry, lack of patent infringement and alarmingly high amount of product recalls, it is easy to conclude that a traffic jam lay ahead. Many of the protectionist chants at one time or another quote the trade imbalance as the leading reason why the state of affairs is out of balance. However, remember that 30% of our imports from China come from US owned companies.

The US has fallen from 32% of the world's GDP to 27% over the last 5 years requiring investors and companies to seek returns and new products outside our border.

"We project a year-end 2008 S&P 500 fair value of 1675, compared to the current 1480. This conclusion assumes that: (1) nominal profit growth stays below the historical trend, (2) the required equity risk premium remains elevated, and (3) real interest rates return to normal levels, leading to higher bond yields. Equities appear to offer excellent value relative to bonds assuming, as we do, that there is no recession."

Abby Joseph Cohen
Goldman Sachs
Issues and Outlook 2008: Back to Equilibrium
12/04/2007

One other area that offers an argument for larger capitalized companies is the balance sheet. Since 2000, in which the auditors and accountants were under much more scrutiny, balance sheets have improved dramatically.



S&P 500 cash per share has doubled from $1.4 trillion in 2000 to a current level of almost $3 trillion. Financials, who will require this extra buffer during the beginning of the credit crunch have the lions share at nearly $2.2 trillion. This is important in that we are big believers in dividends and this should allow for dividends, for the most part, to continue albeit with a few exceptions. S&P 500 dividends per share stood at $24.88 at the end of 2006. Goldman Sachs expects 2008 dividends per share to rise by 7% annually over 2007/2008 to $28.50.

We would continue to invest in large-cap strategies that emphasize dividends. We would also stress global equities and those domestically that have a substantial exposure to foreign markets. Domestically, we like technology, utilities, health care, consumer staples to name a few industries. The financial sector's challenges have yet to fully play out, but there will be an immense amount of value in this sector in short order as the interest rate environment softens some of the sub prime and CDO blows.

Fixed Income

Clearly the current interest rate environment will bode well for the majority of fixed income portfolios. Those areas where high credit quality was emphasized will see the benefits in the short run while the lesser credit grade will take a bit more time to realize the lower interest rate environment. This is typical because as spreads widen on the lower grade credits, they may offset lower treasury yields.

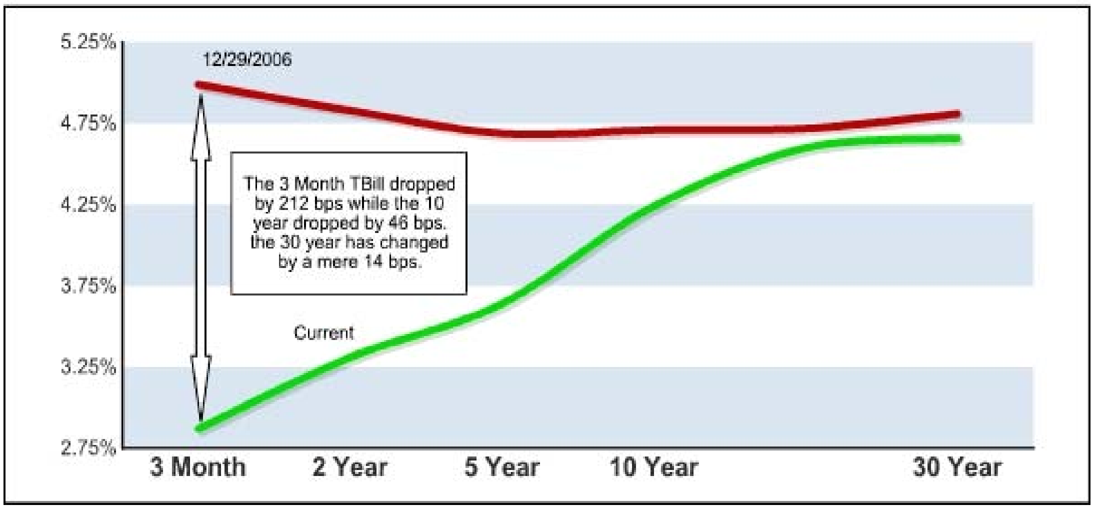
Treasuries

The flight to quality did not disappoint during the last few months. The interesting component was the whipsawing of the short end that saw the 3 month Tbill drop from 4.90% to 3.10% in 8 trading days. It then sold off back to 4.50% over the next 6 days.

"Having been bullish for the past six years, with the supports coming from low valuations, favorable fund flow and an upswing in the profit cycle, we think a different approach is warranted in 2008. Rather than simply emphasizing the strength of the best case - although it is still our favored outcome - we think the outlook has become a lot more binary."

Ian Scott
Lehman Brothers
Equity Market: Outlook 2008
12/11/2007

Yield Curve Change
Source: Bloomberg



The shape of the curve is back to normal after spending the bulk of the last two years in a flat to inverted state. Since measurement on the 1 month Tbill began in August of 2001, the steepness of the curve has averaged 232 basis points. We currently see a spread between the 30 year and 1 month Tbill of 207 basis points. The spread at the beginning of the year stood at 9 basis points.

For those who want a bit more history, the steepness, defined as the spread between the 30 year and 3 month Tbill, has stood at 190 basis points since 1987. The spread at the beginning of the year stood at a 19 bps inversion. We currently are at 179 basis points.

We bring this up because the curve has some moving to do, even with the significant change that has come about. The short end of the curve is still 100 bps lower than Fed Funds and we would expect it to continue to drop as rates continue to drop and more write-offs spook the markets. One event that could cause the long end to spike would be the dumping of Treasuries from foreign central banks. We consider that a remote possibility, with the more likely scenario being a methodical diversification into other foreign currency-denominated securities.

Agency and Corporates

Spreads have widened on both Agency and Corporate Bonds as the market tries to determine how much risk is on the balance sheets of these two areas.

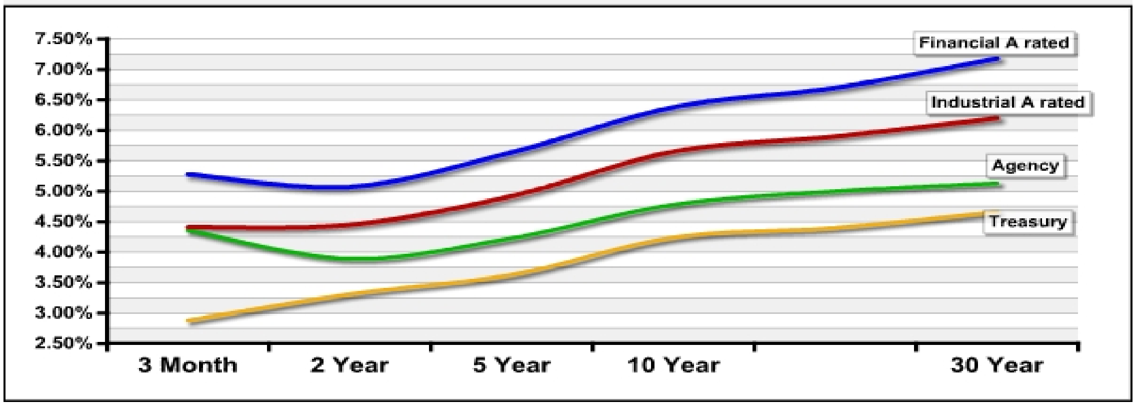
Both areas currently offer value, however the window to pick up these attractive spreads will close quickly if history is any indication. With regard to the Corporate area, prudent portfolio management, credit scrutiny and selective entry points should be paramount for those who enter into this asset class. We believe a methodical approach is best

"The historian must not try to know what is truth, if he values his honesty; for if he cares for his truths, he is certain to falsify his facts."

Henry Adams

Fixed Income Yield Curves

Source: Bloomberg



Spreads on the 10 year started the year very tight. Agency debt stood at 36 bps, A-rated industrials stood at 77 bps, and A-rated financials were at 83 bps. Currently, agency debts is at 53 bps, A-rated industrials 140 bps, and A-rated financials are at 213 bps. There is a tremendous amount of Armageddon priced into the financial area.

What this is telling us is that it is time to start expanding into lower -rated issues methodically and in a selective manner. It clearly depends upon the risk-tolerance of the investor as to how much if any should be allocated to corporates. We believe that it is an opportune time to methodically enter corporates while spreads are wider than their historic average. Our previous and current allocation for general fixed income portfolios are below:

	Previous	Current
Treasury	10%	**5%**
Agency	15%	**10%**
Corporates	25%	**35%**
CMO/ABS	25%	**25%**
Other	25%	**25%**

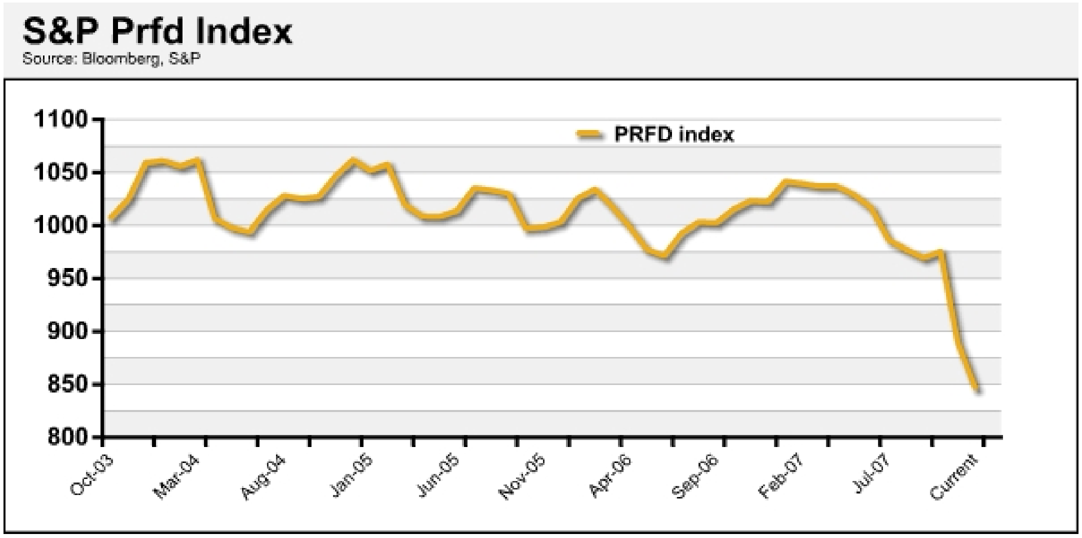
One more note for those who are concerned about money fund yields and net asset values. In our opinion, yields will erode more quickly than in previous periods because of the pricing of many of the underlying issues held. Year-end pricing should bring about the first of many of the disclosures to both traditional money market funds and the more vulnerable enhanced money market funds. One thing to remember, enhanced money market funds are not required to maintain a $1 NAV, though this may get lost in the reports from the media.

The above shows a potential opportunity for those concerned as agency paper on the short end has an attractive spread versus treasuries. Investors might consider taking a ladder approach in these type of securities on the short end to potentially mitigate some of these risks.

As with other financial dominated issuance debt, the performance has been very lack luster recently.

"I guess I'd better talk about bonds in hushed or, better yet, hurried tones - making my point and then heading for the exit before you lose whatever interest you thought you had. It doesn't bother me anymore, though, this second-class citizenship. Actually it was the first thing I realized when I signed on to the bond market in 1971, and something you should be made aware of before you read any further: Bonds don't make as much money as stocks do, so they are the wallflowers at the debutante ball - being asked to dance only out of pity, inebriation or ties to a wealthy father."

Bill Gross, Fortune "Sleep well at night: Buy bonds" 05/17/2007



For the longer-term yield seeker, preferred securities should be considered. Preferred securities have historically performed well in an easing rate environment. We would expect some volatility in pricing in the near-term, however traditional spreads should come back as the credit crunch is played out. With the nature of the liquidity and small denominations inherent with preferreds, it would be prudent to diversify into multiple names. We would also look for Qualified Dividend Income (QDI) where we could potentially take advantage of the preferential tax treatment...if for only a little while.

"Our houses are such unwieldy property that we are often imprisoned rather than housed by them."

Henry David Thoreau

Mortgage Backs

If there is an area where the baby has been thrown out with the bath water, mortgage-backed securities fit the bill. There are many opportunities for the conservative investor as well as the high-yield seeker willing to risk principal.

Fannie Mae and Freddie Mac, the work horses of the mortgage industry, have seen substantial headline risks over the last few months. Many may recall that both agencies have been under scrutiny by Congress over the last several years for "lax reporting" and portfolios management risk. As we stated last year, all changes to their accounting and processes will only benefit the bond holder; however, it made equities less appealing in our opinion.

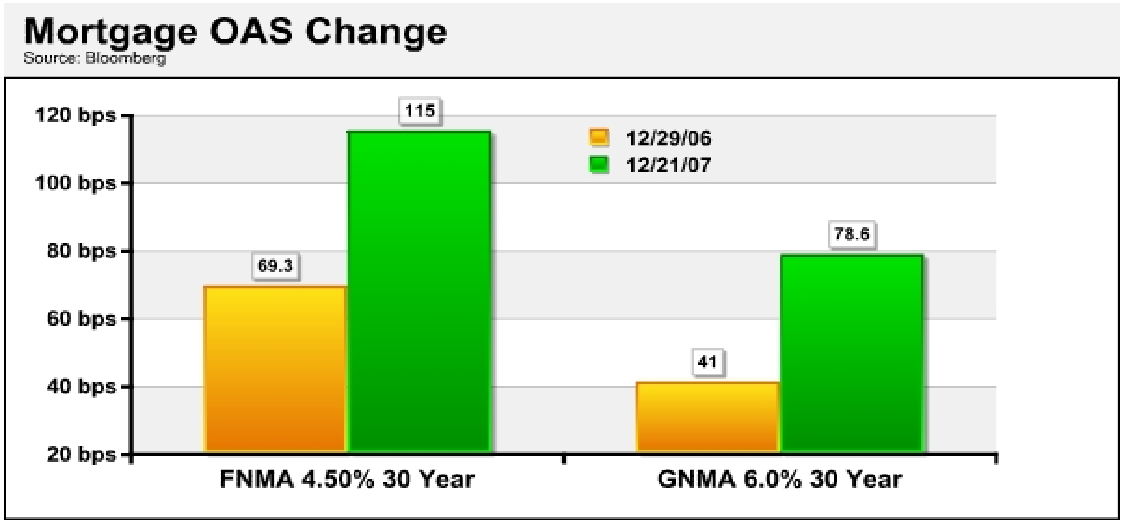
For those who are seeking a more conservative investment, consider GNMA pass throughs where the yield pick up is hovering around 120—130 basis points. There should be less vulnerability in GNMAs as they are explicitly backed by the federal government.

Fannie and Freddie, who originated mortgage-back securities, will continue to trade wider as the housing and economic slow down takes hold through 2008. For those looking into this area, greater scrutiny may occur including, but not limited to:

- Avg FICO score
- When originated
- Loan to equity value of home
- Seasoning
- Speed factor assumptions

For the more adventurous and risk seekers, look at some of the whole loans with the same scrutiny as above.

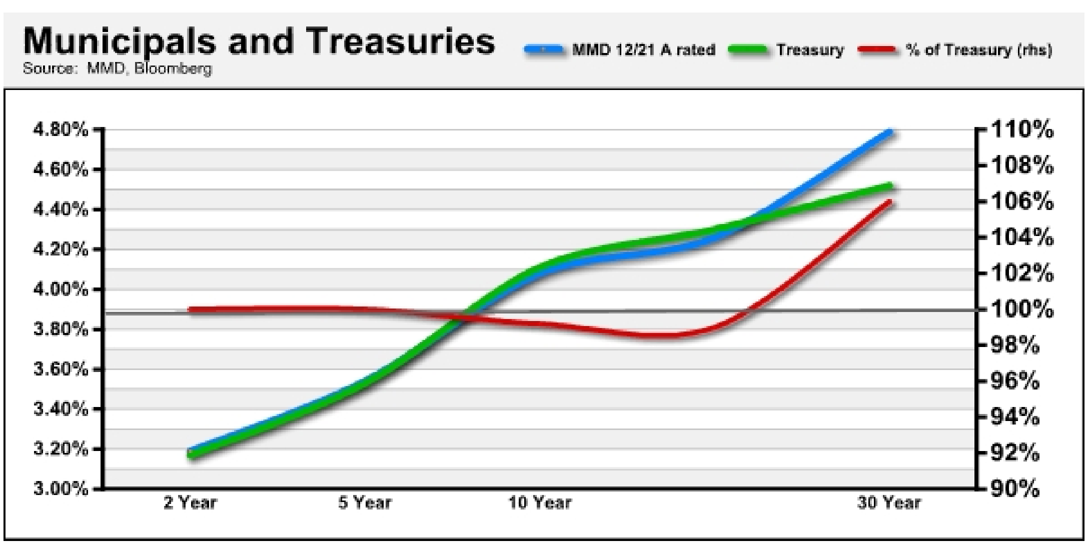
We believe mortgage-backed securities offer a good yield for the risk taken. Speed assumptions may be off of what has historically been seen because of substantive changes to the perception of the underlying instruments.



Municipals

Municipal bonds had a more rigorous year in 2007 compared to recent years. The contagion of the sub prime market directly tied to the insurers who had exposure to the municipal market caused a widening yield dichotomy between the cleaner and higher-rated issues versus the more complex and lower-rated issues. The flight to quality did not just occur in the Treasury arena.

Consider the following chart which graphically shows the flight to treasuries and the steepening of the municipal curve.



"In an ordinary period we would have to say that the year ahead was unambiguously bond friendly. And, yes, over-all investors should view the market positively."

Merrill Lynch
"Looking at a murky 2008"
12/17/2007

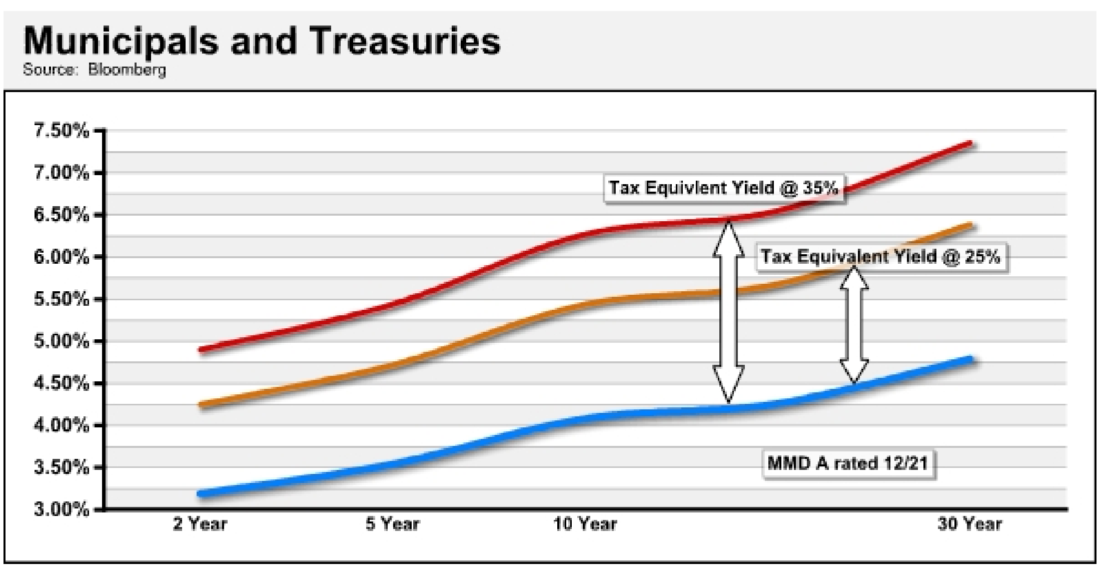
Nearly every maturity of the A-rated MMD (Municipal Market Dealer) index is at 100% of Treasuries and nothing less than 98%. This is a rare occurrence. Consider that the average spread between Bloomberg's A to AAA rated municipal index has averaged 105 basis points since 1991. The blended index is currently 45 basis points which has happened only 11% of the time.

To further illustrate the attractiveness of municipals, consider the high-grade municipal yields as a percentage of Treasuries based upon various levels of the Treasury curve from Lehman Brothers using MMD for current percentage. *(Blue box denotes current level range.)*

Treasury Curve Ranges

2 Year Treasury Range	2.5% - 3.0%	3.0% - 3.5%	3.5% - 4.0%	4.0%+	Current % A rated MMD
2 Year Muni % of Treasury	74.23 %	76.03%	73.34%	71.62%	100.6%
10 Year Treasury Range	3.75%-4.25%	4.25%-4.75%	4.75%-5.0%	5.25% +	
10 Year Muni % of Treasury	84.54%	81.97 %	82.09 %	81.08 %	98.1%
30 Year Treasury Range	4%-4.5%	4.5%-5.0%	5.0%-5.5%	5.5%+	
30 Year Muni % of Treasury	91.99 %	94.64 %	91.53 %	94.16 %	104.5%

The appeal of municipals will also vary. Historically, it has been assumed only the highest earners benefit from municipals tax-free yield. Due to the compression of overall yields and lower base rates, the appeal has widened to more of the moderate to high income earners.



"If I owe you a pound, I have a problem; but if I owe you a million, the problem is yours."

John Maynard Keynes

Entering 2008, municipal securities are one of our favorite areas for multiple reasons:

- Attractive after tax yield compared to other taxable fixed income assets.
- Historically low default ratio and inherent strong credit quality.
- Secondary market may benefit in 2008 due to tighter funding from wider spreads/steepening curve.
- Potential for higher tax rates may make after tax yield higher in the future.

There are also some inherent risks that don't make a necessary lay up of investing in the class. There should be analysis of the underlying quality of the bond and the diversification of various maturities, types, coupon and call schedules therein.

Some of the risks that investors should be aware of:

- Further secondary selling of those securities that have ties to insurers that have sub prime and CDO ties.
- Higher issuance of municipals due to potentially less tax revenue derived from general slowing business conditions and housing hangover.
- Look for potential headline risks from under funded pensions confronting various municipalities.

We believe the recent injection of capital to MBIA from Warburg Pincus tentatively places a floor on needed capital for the majority of the insurers. Though we believe the insurers (FSA, XLCA, Ambac, FGIC and MBIA) will maintain their AAA status and appear attractive, the turbulence is not over yet. A high level of scrutiny should be placed with diversification among the insurers, underlying credit fundamentals as well as durations of municipal portfolios.

"Local governments are becoming more dependent on sales taxes and other revenues that are sensitive to the economy. Local governments are also facing increasing fiscal stress from rising costs and an aging public sector workforce."

Thomas Dinapoli
Comptroller State of New York
"Slowdown raises risk for New York localities, Dinapoli says"
Henry Goldman
Bloomberg
12/21/2007

Commodities

Commodities enjoyed a prosperous 2007 as a whole, though not all performed well. We have been bullish on the commodity sector for the last few years and our long term bullish perspective remains intact. However, we believe 2008 may see some minor corrections in those areas that may contain the most speculative of hard assets.

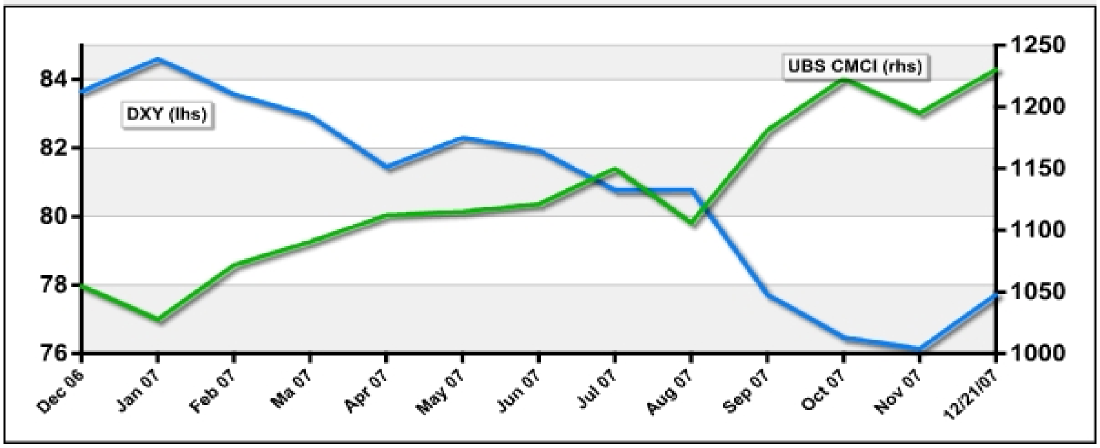
Our long term bullish view is based on four criteria.

Demand. The long cycles of the past have started with a rise in demand. We believe the industrialization process of China and India in particular is well in place. Never in our history have we seen so much demanded of our natural resources from a population and timeframe standpoint. With 1 in 3 of the people in the world living in China and India, we expect the demand component to only rise over the long run. We may see flat growth in the demand component of our bullish view as the US and other areas of the globe slow down. The argument that global growth is immune to a slow down in the US does not resonate as much when we consider the US consumer is nearly 20% of the global GDP which is up from 14.9% in 1980 according to Merrill Lynch, IMF and Bureau of Economic Analysis.

Supply. The supply component is what we believe determines the duration of the cycle. After years of under investment in the discovery of new fields, new refineries, new mines and new technologies, the demand catches up with the over supply condition from the 1990s. The problem is that a switch cannot be flipped to instantly add on supply of xyz commodity. With the awareness of the world increasing as to our ecological impact of mining, drilling and use of natural resources, the lag time for new facilities becomes an even larger challenge.

Dollar. With the weaker dollar, an influx of investment money came into the markets. As the dollar weakened and correspondingly other currencies appreciated, it made commodities relatively cheaper then before.

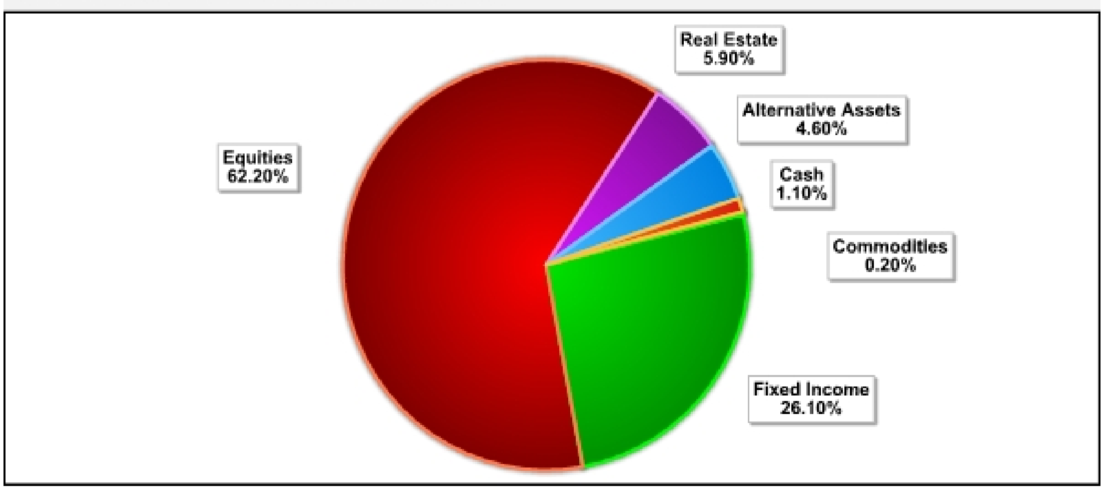
Trade Weighted Dollar and Commodity Index
Source: Bloomberg, UBS



With our belief that the relative nature of the dollar and contagion of the credit crunch on global growth, the dollars weakness may take a rest and will have a more minimal impact on commodity prices in the next year.

Investment. One area that doesn't get too much publicity is the under allocation of commodities into pensions and endowments which total nearly $7 trillion combined.

Pension Allocaiton
Source: Deutsche Bank, Pensions & Investments, Goldman Sachs



"Since oil prices started rising in 2002, US consumers have underpinned the global economy with annual spending growth of over 3%, cumulatively the size of the UK's GDP."

Lehman Brothers
Energy : Outlook 2008
12/11/2007

To quantify what a shift in investment strategy among pensions into more commodities, consider the following. A shift to a 3.0% from a 0.2% allocation would bring in $185 billion more into commodities. A radical shift mirroring more of the Harvard and Yale endowments of 10% would bring in a net $640 billion into this asset class. As liquid as commodities are, these type of dollar movements would have an impact on the returns of the asset class.

Of the four components of our bullish argument, supply and investment continue to reinforce our sentiments. The demand side, though in a significant upward trend for the long term, may be slightly neutralized due the global slow down we are predicting. The dollar component may pull out some of the speculative money in the short run.

For 2008 we particularly like agricultural and a few select base metal components. We would expect energy in general to be in a trading range with natural gas potentially having a better performing year than oil.

In the long run, commodities should have some form of allocation appropriate to the client needs and risk tolerance.

Conclusion

We see a continuing of the market conditions that impacted the markets in the latter part of 2007. The full impact resulting from the CDO / sub-prime induced credit crunch has not yet been fully divulged….or understood. We would expect with year-end reporting and more scrutiny from regulators, rating agencies, and the media, there will be an acceleration of write downs and financial resolutions.

We see a global slowdown resulting from the credit crunch. It is important to remember that ultimately we may see $300 billion+ (potentially more) being written down from CDOs and the sub-prime mortgages which will not only erode earnings but balance sheets as well. This is a sizeable amount; however, the market size for all mortgage debt outstanding ending Q2 2007 is $13 trillion according to the Federal Reserve Board which would equate to a 2.3% write down. Though not a minimal amount, due to the traditional reactionary approach by lending institutions, according to several sources there may be over $2 trillion of credit pulled from the markets. This over-reaction results in a sense of paranoia that creates opportunities for the investor willing to take more risk.

We believe the markets are ripe with opportunities across a myriad of asset classes. It is mandatory to know that these opportunities have arisen because of the re-pricing of risk into the markets. Risk had been absent for some time, and as such there is quite a bit of "catching up" to do.

We have made some shifts in our allocations for 2008, though they must correspond with the needs of risk tolerances of the investors. In our opinion, the markets and corresponding returns therein will be awarded to the nimble, the experienced, the risk takers and investors with a systematic and methodical approach.

As we stated on the Slippery Slope edition, "in our view and with a bit of Yogi Berra wit intertwined, 'history continues to repeat itself, only a bit differently every time.' And those slight changes make all the difference."

"It's like the '70s. We're in a period of a commodity bull market and inflation. I would not buy government long-term bonds. We'll be going down for years to come. Commodities are telling you to sell Treasuries. Inflation is everywhere."

Jim Rogers
"Analysts see new risks on inflation front"
Daniel Kruger and Wes Goodman
Bloomberg News
12/04/2007

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