

WEEKLY MARKET MONITOR DECEMBER 17, 2007

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DRIVERS OF RECENT MARKET MOVES

In the last few days and weeks, security market gyrations continued in force. Investors seemed to respond quickly to each bit of economic and financial news, including reports on rising inflation, subprime mortgage fallout, slowing GDP growth, and Fed actions to lower short-term bank lending rates and increase liquidity.

- How are investors reacting to recent economic and financial market news?
- Which markets have outperformed and which have trailed?

Despite continued financial market gyrations, the economy looked a bit better through the end of November. Retail sales came in better-than-expected, payrolls continued to increase, industrial production rose after declining in October, and both the manufacturing and nonmanufacturing purchasing managers' indices indicated that the economy was still expanding. Meanwhile, as has been the case since late 2005, housing continued to exert a considerable drag on growth. Counterbalancing that drag, the foreign trade balance has been slowly improving, helping to sustain economic expansion. So, all in all, the fourth quarter shaped up through November as another quarter of expansion, albeit at a very slow pace: an anemic but positive 1% annualized real GDP growth rate, compared to the 4.9% growth rate registered in Q3.



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Meanwhile, inflation picked up in November. Overall (or headline) Consumer Price Index (CPI) inflation rose a hefty 0.8% during November (9.6% on an annualized basis) due to soaring energy prices. And, “core” (excluding food and energy) CPI inflation came in higher-than-expected at 0.3% (3.6% on an annualized basis), up from a string of lower readings in prior months.

Not surprisingly, despite sending signals at the end of October indicating reluctance to cut interest rates further, various Fed members made it crystal clear that they were increasingly worried about the economy succumbing to the recent volatility in the financial markets and the attendant rise in the cost of credit. Markets began to anticipate that the Fed was poised to cut interest rates again at their December 11th meeting, despite the better tone on the real side of the economy in November and the risk rising energy prices posed to continued price stability.

In sum, the U.S. economy appeared a bit better in November, but these still-sluggish conditions plus continued financial market volatility set the stage for the Fed in December to lower the Fed Funds rate by 0.25% to 4.25%, despite some

risk of inflation moving higher with soaring energy prices. This constellation of soft economic growth, investors’ appetites for risk diminishing, and the prospects of further Fed ease helped push the average yield on 10-year Treasury notes down to a very low 4.15% in November versus the 4.53% reading we saw for October.

The accompanying table shows returns for a variety of equity and fixed-income indexes for the last month, three months, and year-to-date. Not unexpectedly, stock markets continued to be all over the place in November, and down significantly on average compared to October, as investors shed riskier assets in favor of the safety afforded by U.S. Treasuries. In particular, the broad S&P 500 and Russell 3000 domestic indexes fell over 4% during the month of November, but were still up about 6% for the year.

This year the value-growth cycle turned and, after six years of underperforming value stocks, large-cap growth equities (Russell 1000 Growth) were down during November, but had returned over 12% year-to-date. In contrast, large-cap value equities (Russell 1000 Value), were down nearly 5% for the month and up less than 1% for the year through the end of November. Similarly, small-cap stocks (Russell

SELECTED MARKET INDEX RETURNS (% THROUGH 11/30/2007)

INDEX	1 MONTH	3 MONTHS	YTD
S&P 500	-4.18	0.98	6.23
Russell 3000	-4.50	0.80	5.78
Russell 1000 Growth	-3.68	3.77	12.22
Russell 1000 Value	-4.89	-1.61	0.80
Russell Mid-Cap	-4.78	-0.06	5.93
Russell 2000	-7.18	-2.88	-1.50
DJ Wilshire RESI (REIT)	-9.78	-5.14	-12.97
MSCI World	-4.09	3.56	10.46
MSCI EAFE	-3.29	5.89	13.73
Merrill Lynch BB-B Cash Pay (High-Yield)	-1.57	1.37	2.69
Lehman Bros. Aggregate Bond	1.80	3.49	6.67
Lehman Bros. TIPS	3.97	6.54	11.81
Lehman Bros. Short Govt/Credit Index	1.70	3.01	6.97
iMoneyNet Taxable All Average (Money Market)	0.35	1.11	4.33

2000), which had beat large-cap stocks for several years, were down over 7% for the month and by 1.5% for the year. Reflecting the market's turn away from value and smaller-cap stocks, the worst performing index in the table was REITS (DJ Wilshire RESI), which seemed to react to continued revelations about residential mortgages securities by falling nearly 10% during the month of November.

During November: equity investors were now focusing much more on company fundamentals (such as earnings growth) than earlier in the year. After all of the recent volatility in equity markets, investors now seem to place increasing emphasis on the fundamental earning power of a company in valuing its stock.

On the international side, the broadest global and foreign stock indexes — MSCI World and MSCI EAFE — were also down for the month. Nevertheless, year-to-date, the foreign MSCI EAFE index handily beat all other equity indexes. The falling dollar, continued corporate restructuring, and commodity extraction activities in other countries have helped foreign equities strongly outperform U.S. equities for the last couple of years.

In fixed income, the growing attraction of Treasuries and some other fixed-income securities was evident. The only fixed-income index in the accompanying table with a negative November return was high-yield bonds

(Merrill Lynch BB-B Cash Pay), which are corporate bonds that are often positively correlated with equities. Other fixed-income indexes were positive for the month and for the year through November. In particular, year-to-date the broad Lehman Aggregate Bond, Treasury Inflation-Protected Securities (TIPS), and short-term bond indexes exceeded the returns of all equity indexes, again with the exception of the large-cap growth index. Investors often treat all Treasuries as a safe haven in volatile times and the last few months has been no exception. With strong one- and three-month performance, TIPS (or inflation-linked bonds) year-to-date return came within 50 basis points of matching large-cap growth stocks.

In sum, recent market volatility is sharply evident in monthly equity returns, even though most equity indexes remain positive for 2007 through November, with foreign and large-cap growth stocks leading the pack. And the growing attraction of bonds is evident in monthly and three-month fixed-income returns, with TIPS in the lead. If current trends continue for the near future, investors have grown increasingly discriminating as they look for good prospective company earnings or the safety of government bonds.

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