

**AND THAT’S THE “YEAR” THAT WAS...
For the Year Ended December 31, 2007***Market Matters...*

Market/Index	2006 Close	2007 Close	1 st Qtr Return	2 nd Qtr Return	3 rd Qtr Return	4 th Qtr Return	2007 Return
Dow Jones Industrial	12,463.15	13,264.82	-0.87%	8.53%	3.63%	-4.54%	6.43%
NASDAQ	2,415.29	2,652.28	0.26%	7.50%	3.77%	-1.82%	9.81%
S&P 500	1,418.30	1,468.36	0.18%	5.81%	1.56%	-3.82%	3.53%
Russell 2000	787.66	766.03	1.66%	4.12%	-3.39%	-4.89%	-2.75%
Fed Funds	5.25%	4.25%	0 bps	0 bps	-0.50%	-50 bps	-100 bps
10 yr Treasury (Yield)	4.71%	4.04%	-6 bps	38 bps	-45 bps	-54 bps	-67 bps

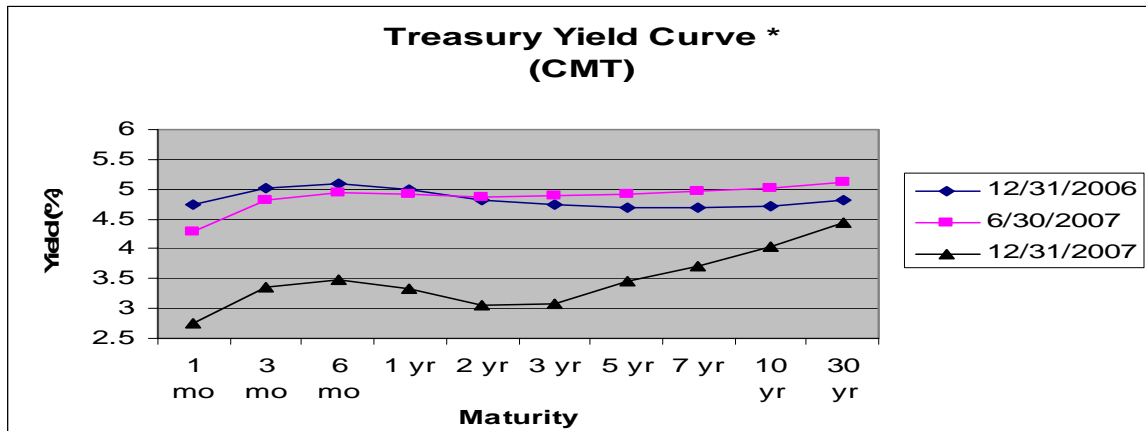
When 2007 began, few people outside of some (unsophisticated) mortgage borrowers and a handful of (unscrupulous) mortgage lenders knew about subprime loans. As the year progressed, however, they served as daily news headlines, the justification behind some significant “executive suite” dismissals (rather, early retirements), the culprit for sizable losses at the largest financial institutions, the reason many investors incurred adverse performances in their equity portfolios, a main driver behind the economic slowdown and the continued sluggishness in housing, the hot topic at Fed policy meetings that led to 100 bps cuts in interest rates, and the occasional “humorous” punch line on the nightly talk show circuit (at least, before the writers’ strike).

While few people noticed when the headlines were dominated early in the year by lesser known lenders, the financial world turned upside down once the big boys entered the fray. By June, **Bear Stearns** was forced to bail out two hedge funds that incurred huge mortgage-related losses and the race was on to see which institution could top them with similar writedowns. A “who’s who” of global players lost a staggering combined \$100 billion plus over the past six months: **Countrywide, Citigroup, Merrill Lynch, Morgan Stanley, Bank of America, Wachovia, Barclays PLC, HSBC, Freddie Mac** and too many others to name. Along the way, Warren Spector (Bear), Stan O’Neal (Merrill), Charles Prince (Citi) among others lost their jobs (but retained those cush severance packages). **Abu Dhabi Investment Authority, Singapore Investment Corp, China Investment Corp, and Temasek Holdings** all made capital infusions to aid in the liquidity needs of the nation’s largest financial firms (and inject a global footprint).

In January, crude briefly traded below \$50/barrel. Suddenly, geopolitical turmoil in Nigeria and Iran (and elsewhere), a free-falling dollar, and hedge fund speculation prompted supply concerns, and OPEC made no real effort to ease the situation (thanks Hugo). The tragic assassination of Pakistan’s leader Bhutto pushed oil prices close to \$100/barrel by the end of the year.

During the first quarter, China’s Shanghai Composite plunged nine percent in one day and the world indexes followed suit. The scare proved a non-event and many markets seemed headed for double-digit gains at the year’s halfway point. The Dow surged past 13,000 (and then 14,000), while the S&P 500 also hit record territory. Enter the subprime fiasco and weak third quarter earnings. With daily reports of mortgage writedowns, the Dow suffered its first fourth quarter loss in 10 years and ended 2007 with a 6.4% gain, almost 10% below its 2006 return. Financials dragged down the markets as the sector lost about 20% for the year. Techs served as one savings grace and the Nasdaq outperformed many other domestic indexes. The energy sector also benefited from rising prices. Small-caps struggled as investors turned to more stable industry leaders. Emerging markets impressed (again) as Brazil and Indonesia jumped over 40% and Shanghai soared almost 100% (despite the February scare). Treasuries benefited from a flight-to-quality and three rate cuts, though lower-rated corporate and mortgage-related issues suffered through the credit crisis. As 2007 ended, most folks wished they had never heard of subprime.

Economically Speaking...



* Reflects changes in interest rates over various time frames.

The year 2007 was a *tale of two crises*... Recession or inflation (or both)? Over the past year, the subprime fiasco and rising oil prices highlighted the business news de jour and created contrasting negativity for the economy. The subprime lending mess served to stall any projected housing rebound and created a full-fledge credit crisis as the nation's (rather, the world's) largest financial institutions suffered ill-effects. While housing initially felt the brunt of the ever-growing challenges, other sectors of the economy began to slow as well. (Thus, recessionary fears emerged and even such noted "naysayers" as Alan Greenspan began assigning percentages to its likelihood.) By contrast, oil prices soared throughout the year and \$100/barrel could not be overlooked from an inflationary perspective. With average Joes (and even rich Joes) facing higher gas prices, the newfound energy crisis took its toll on their pocketbooks and retailers began crying gloom and doom heading into the holiday shopping season (so what else is news?).

The dueling crises created some dilemmas for Chairman Bernanke and his cohorts at the Federal Reserve. On one hand, the credit concerns suggested that rate cuts were in order to inject liquidity into the system and improve the borrowing abilities of businesses and consumers alike. On the other hand, such an accommodating monetary policy could prove disastrous if inflationary pressures were truly heating up. When all was said and done, the credit issues won out and the Fed lowered interest rates by 50 bps in September and followed up with two additional 25 bps cuts in October and December. The policymakers also moved to inject additional liquidity into the economy by adding new auctions late in the year. (WWGD...What would Greenspan do?)

Inflation: In November, wholesale inflation rose by its largest amount in over three decades as rising gas prices moved through the system. Likewise, consumers began to feel retail pressures as everything from clothing costs to airline tickets to prescription drugs jumped late in the year.

Housing: Residential construction and new home sales plunged to their lowest levels in 16 and 12 years respectively as the housing slump continued throughout the year. The pace of existing home sales is now 20% below last year's levels.

Manufacturing: While the sector had experienced 10 consecutive months of growth, that streak looked to be nearing an end. The November ISM index barely registered expansion (and the December index that was released in early January indicated sector contraction).

Labor: The one positive in the economy throughout 2007 had been the labor market. With unemployment standing at 4.7%, the workforce remained intact and employers reported solid jobs growth month after month. GDP soared by 4.9% in the 3rd quarter, before much of the subprime effect began to work its way through the economy. Projections for the 4th quarter are dismal at best (1.5% growth or less). Then again, with Bernanke at the helm, 2008 may just prove to be better than expected (and, hopefully, crisis-free).