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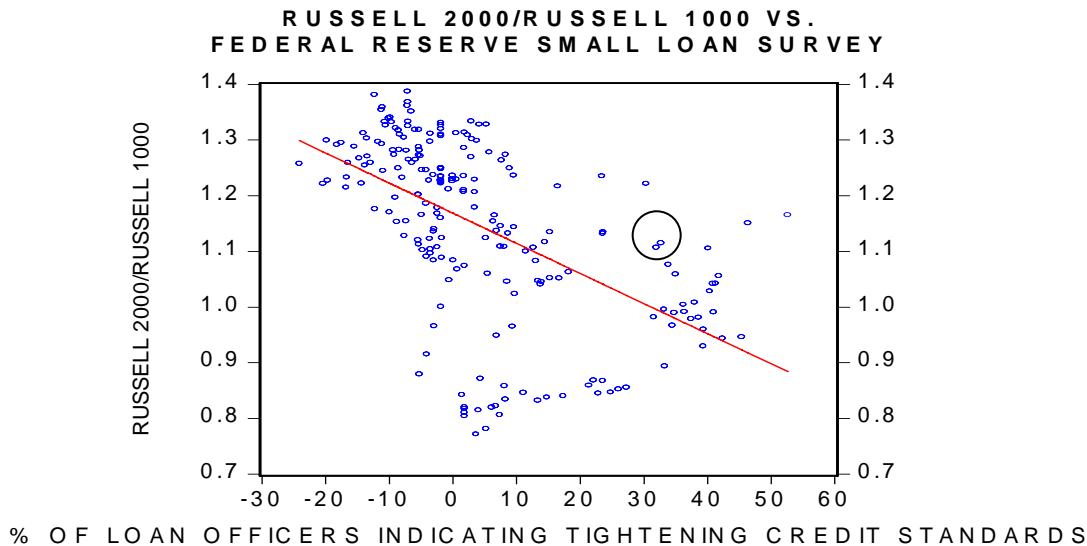
Bill O'Grady, Chief Investment Strategist

More Problems for Small Caps?

- Our bias has favored large capitalization over small capitalization stocks. There are a number of reasons for this position.
- The weak dollar tends to support large cap stocks. Large companies are more apt to participate in the global economy whereas smaller companies tend to focus on the domestic economy. When the dollar weakens, exports become more competitive, which tends to boost overseas sales. Since large caps tend to dominate this arena, they gain on a relative basis. Although it is our position the dollar is undervalued and recent comments from the G-7 are consistent with policy steps to stabilize the greenback, it will likely take months (if not years) for the dollar to rally to fair value. We believe this factor will tend to support the relative value of large caps.
- Economic weakness tends to support the relative performance of large caps. Historically, large caps (as measured by the Russell 1000) start to gain on small caps (as measured by the Russell 2000) two months before the onset of recession and bottom six months after the recession begins. While past performance does not guarantee future results, the average decline is around 3.5%, but the deviation is rather wide. Thus far, declines have been relatively modest, which may be evidence of a relatively mild recession. In any case, the historical trends would suggest another month or two of relative underperformance. In addition, it is still too early to determine the actual course of this downturn. Given the possibility that this economic downturn is worse than typical, we think it makes sense to maintain a bias toward large caps.
- In general, easier monetary policy does tend to support small caps compared to large caps. However, there is a lag. If one looks at the relative performance of small to large caps, the three year moving average of inflation-adjusted Fed funds tends to signal turns in this relationship. In our opinion, inflation-adjusted Fed funds is likely near its peak, which means that in the next few months this indicator will likely signal a more favorable scenario for small caps...just not yet.
- Tied to the issue of monetary policy are the problems in the banking system. Small companies are usually more dependent on bank funding and so the attitudes of lenders are important to the relative performance of these to equity classes. In this week's Chart of the Week we use a scatter gram to show the relative performance of small caps to large caps compared to a tightening of credit standards.

Bill O'Grady has been named Chief Investment Strategist for the combined firm, responsible for providing broad-based macro analysis of domestic, foreign and commodity markets. Since joining A.G. Edwards in 1989, he has covered the debt, foreign exchange and energy futures markets as director of Futures Research, as well as performed short-term technical analysis of equities and monitored the effect of geopolitical, political, economic and social events on the equity markets as assistant director of Market Analysis. Bill was previously the Chief Global Investment Strategist at A.G. Edwards and is frequently quoted in the major media, including the Financial Times, the Wall Street Journal, CNBC and Bloomberg.

Chart of the Week:



For illustrative purposes only. This does not reflect the performance of any specific investment.

Past performance is no guarantee of future results

Sources: Haver Analytics, Federal Reserve, Wachovia Securities

This scatter gram shows the intersection of the ratio of the Russell 2000 stock index (a small cap index) to the Russell 1000 (a large cap index) to the Federal Reserve's survey of loan officers. The plotted series is the percentage of loan officers indicating tightening lending standards for small businesses. We have plotted these data from 1990 to the present. In general, as the down sloping regression line indicates, there is an inverse relationship between tightening lending standards and the relative performance of small cap stocks. We have circled the last data point for March, 2008. Note this point is well above the regression line, implying that, at current lending standards, small caps are richly valued compared to large cap stocks.

Bill O'Grady (314) 955-3064

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The prices of small company stocks are generally more volatile than large company stocks. They often involve higher risks because smaller companies may lack the management expertise, financial resources, product diversification and competitive strengths to endure adverse economic conditions.

The Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000® Index representing approximately 10% of the total market capitalization of that index.

The Russell 1000 Index measures the performance of the large-cap segment of the U.S. equity universe. It is a subset of the Russell 3000® Index and includes approximately 1000 of the largest securities based on a combination of their market cap and current index membership.

The indices are presented to provide you with an understanding of their historic long-term performance and are not presented to illustrate the performance of any security. Investors cannot directly purchase any index.

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