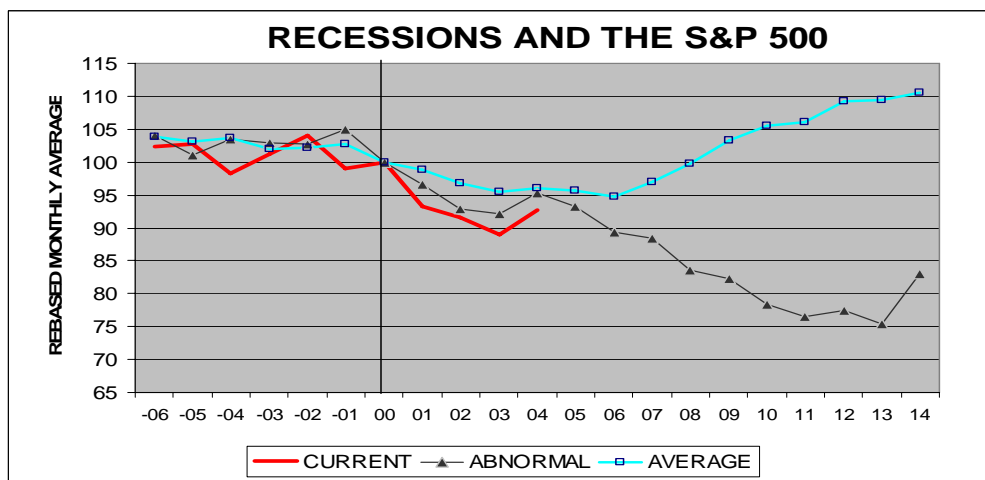


May 19, 2008

Bill O'Grady, Chief Investment Strategist

Building a Base

- In the April 7, 2008 issue of The Week, we argued that the equity markets were building a base after a severe pullback from the late October highs. We based that opinion on two factors, a stronger dollar and weaker commodity prices. So far, we were half right—the NYBOT dollar index has risen 3.7% from its March 17, 2008 low, but the CRB index has moved into new high ground. Still, missing on commodities didn't undermine the overall forecast. The S&P 500 has consolidated, holding below resistance at 1430-1440, but above support at 1380-1360. In the very short term, the S&P 500 is a bit extended, up over 11% from the recent low on St. Patrick's Day. We believe this impressive rise may suggest a period of digesting these gains could be in the offing.
- The economic data has not been necessarily robust, but it is coming in better than expected. First quarter GDP rose 0.6% suggesting that growth is weak, but not negative. The ISM manufacturing index is 48.5; a reading below 50 indicates a contraction in activity, but usually readings in the low 40's are observed in recessions. In general, it is my position that the preponderance of the evidence still suggests the economy is in a mild recession that probably started in December, when the two-year change in the unemployment rate became positive.
- In the April 7 article, we put in a chart showing the relative performance of the S&P 500 over the past 10 recessions. We have updated this chart below:



Sources: Haver Analytics, National Bureau for Economic Research, Wachovia Securities

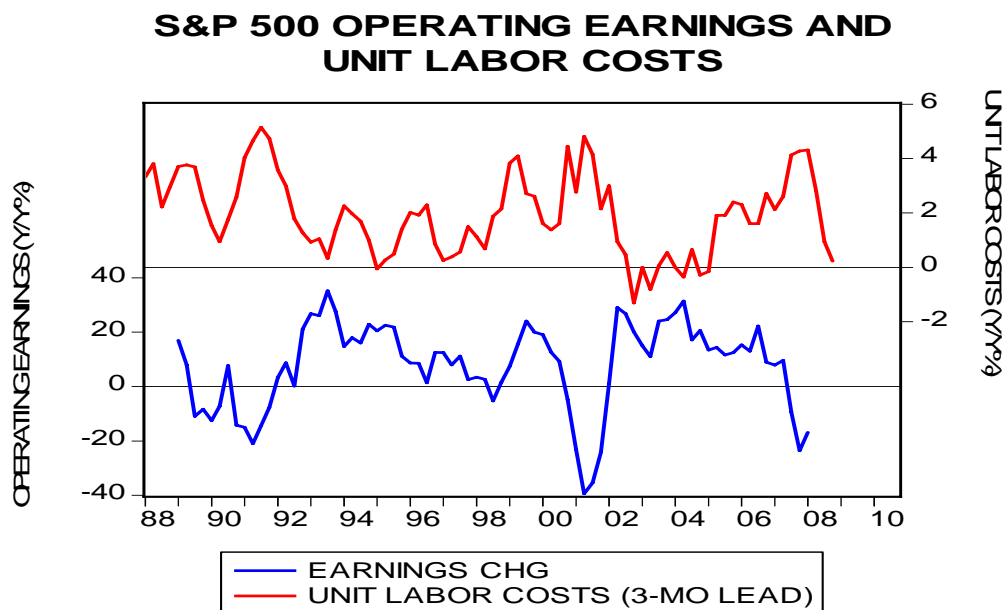
Past performance is no guarantee of future results

- On this chart, we have rebased the monthly average S&P 500 index to the 10 post WWII recessions. We base the start of each recession event a "00" on the x-axis, representing the start of the recession. The vertical line on the chart shows the start of the recession. The period six months prior to the recession are shown with negative numbers, the post recession period with positive numbers. The light blue line (with boxes) shows the average rebased performance of the index for the eight "normal" recessions. This average excludes the 1973-75 and the 1981-82 recessions, which we have averaged under the "abnormal" line, shown in black with triangles. These two recessions were unusually severe.

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.

- The wide, solid line (in red) shows the current situation, assuming the recession began in December. The chart indicates that, at least so far, the S&P 500 is following historical patterns. If we assume we are in a garden-variety recession, we are still looking at a couple of months of consolidation, with a stronger recovery developing later this summer.
- A critical issue for the market is earnings. Recent news on unit labor costs suggests an earnings recovery later this year and is the subject of the Chart of the Week.

Chart of the Week:



Sources: Haver Analytics, National Bureau for Economic Research, Wachovia Securities
Past performance is no guarantee of future results

On this chart, the lower (blue) line shows the yearly change in S&P 500 operating earnings. We have included Q1 earnings and assumed a 16.9% decline. This estimate is based on the 92% of the index companies that have reported at the time of this writing. The upper (red) line on this chart shows the yearly change in unit labor costs from the inception of this data in 1988. This data measures productivity-adjusted labor costs and is a very important series, in my view, in that it shows the impact of labor costs on profit margins after productivity is taken into account. This number tends to lead earnings by three quarters.

Historically there has been an inverse 66% correlation between unit labor costs and earnings over this time period. On average, when the yearly change in unit labor costs is less than two percent, earnings growth averages 11.2%. When unit labor costs are less than 2%, earnings growth averages 11.2%. When unit labor costs are greater than 2% but less than 4%, average earnings growth falls to 3.2%. And, when unit labor costs rise in excess of 4%, earnings growth falls to 1.5%.

After easing to 0.9% in the fourth quarter, unit labor costs fell to 0.2% in the first quarter, suggesting that by the third quarter, earnings growth should materially improve. This would tend to support the contention that the equity markets will likely recover later this year.

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