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Bill O'Grady, Chief Investment Strategist

Dealing With a Weak Economy

- In this report, we are detailing changes to our tactical tilts in the Asset Allocation Models. Tactical adjustments are made in response to short-term conditions where we move to overweight or underweight our long-term benchmarks.
- In general, we are reducing our commodity exposure due to expectations that extended economic weakness will weigh on commodity consumption and weaken prices. In addition, commodity prices have been very strong and due for at least a period of consolidation.
- We are taking the assets liquidated out of commodities and moving them in two places. First, we are adding to our overweight in short-term investment grade income products. This is being done to protect the portfolio from further weakness in equities. Second, we are reducing our underweight position in small cap equities. Although we are worried that extended economic weakness could continue to pressure equities, if conditions improve, small caps will tend to recover faster.
- Thus, the reallocation is a “barbell” approach to risk; on the one hand, we want to position the portfolio to take into account the potential for further weakness in equity markets if the economy deteriorates further; at the same time, we want to reduce our underweight of small caps in case the economy does better than expected. And, in any case, we believe commodities are due for a “time out” and reducing exposure in this class is warranted.
- The economic picture remains mixed. Housing continues to be very weak and there are growing concerns that problems in the financial system will affect other parts of economy. On the other hand, manufacturing has been holding up remarkably well; the June reading from the ISM manufacturing index was 50.2, which is above the 50 expansion line.
- Although the economy is mixed, consumer and business sentiment is definitely not. Consumer sentiment is at its lowest level since 1991 and has only been lower on two occasions since 1967. Small business sentiment is at its lowest level since 1980 and has been lower on only two occasions as well. At this point, sentiment about the economy appears much worse than the actual economic numbers. What remains to be seen is if the lower sentiment acts to further depress the economy.
- One of the more peculiar circumstances of this slowdown has been the resilience of commodity prices. Although we do believe commodities are in a long-term secular bull market (see *The Week: The Secular Case for Commodities*, 5/12/2008), prices are extended on a cyclical basis, in that as the global economy slows, demand for raw materials usually declines.
- For the past few months, the persistent increase in commodity prices was fueled by a number of factors. Flooding in the Midwest boosted grain prices. The weak dollar supported metals prices. Oil rose on expectations of continued strong demand from the emerging economies and on geopolitical worries. These factors sent prices to all-time highs. However, at present, these bullish factors appear to have been discounted by the market and worries over slower growth are starting to undermine the near-term bullish case for commodities.
- At the same time, equity markets have been under pressure, with financial stocks leading the decline. Fears of weak earnings and another round of capital raising have weighed on this sector and the market in general. If this were a typical recession, we should be seeing improved market action. The trade of the past three weeks raises the possibility that the economy could be facing a deeper slowdown.

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:

ASSET ALLOCATION MODELS

Tactical Tilt as of 7/14/2008 (last adjusted on 7/14/08)

	CONSERVATIVE			MODERATE			LONG-TERM			
	New BM	Tactical	Difference	New BM	Tactical	Difference	New BM	Tactical	Difference	
INCOME	CASH	10.0%	12.0%	2.0%	2.0%	4.0%	2.0%	2.0%	4.0%	2.0%
	TRADITIONAL FIXED INCOME	80.0%	79.0%	-1.0%	57.0%	59.0%	2.0%	32.0%	34.0%	2.0%
	Short-term Inv Grade	40.0%	40.0%		20.0%	23.0%	3.0%		3.0%	3.0%
	Intermediate Inv Grade	40.0%	39.0%	-1.0%	23.0%	24.0%	1.0%	16.0%	17.0%	1.0%
	Long-term Inv Grade				14.0%	12.0%	-2.0%	16.0%	14.0%	-2.0%
	ALTERNATIVE INCOME	10.0%	9.0%	-1.0%	26.0%	25.0%	-1.0%	46.0%	45.0%	-1.0%
	Hi-yield	7.0%	6.0%	-1.0%	18.0%	17.0%	-1.0%	30.0%	29.0%	-1.0%
	Emerging Market Debt	3.0%	3.0%		8.0%	8.0%		16.0%	16.0%	
	REITs									
	COMMODITIES									
	STOCKS				15.0%	12.0%	-3.0%	20.0%	17.0%	-3.0%
	LargeCap Value				10.0%	8.0%	-2.0%	10.0%	8.0%	-2.0%
	Large Cap Growth					1.0%	1.0%	5.0%	6.0%	1.0%
	Mid Cap Blend									
	Small Cap Blend									
International				5.0%	3.0%	-2.0%	5.0%	3.0%	-2.0%	
Emerging Market										
GROWTH AND INCOME	CASH	2.0%	2.0%		2.0%	2.0%		2.0%	2.0%	
	TRADITIONAL FIXED INCOME	48.0%	51.0%	3.0%	27.0%	30.0%	3.0%	10.0%	13.0%	3.0%
	Short-term Inv Grade	14.0%	18.0%	4.0%	7.0%	11.0%	4.0%		4.0%	4.0%
	Intermediate Inv Grade	26.0%	27.0%	1.0%	15.0%	16.0%	1.0%		1.0%	1.0%
	Long-term Inv Grade	8.0%	6.0%	-2.0%	5.0%	3.0%	-2.0%	10.0%	8.0%	-2.0%
	ALTERNATIVE INCOME	14.0%	13.0%	-1.0%	21.0%	20.0%	-1.0%	21.0%	20.0%	-1.0%
	Hi-yield	10.0%	9.0%	-1.0%	15.0%	14.0%	-1.0%	15.0%	14.0%	-1.0%
	Emerging Market Debt	4.0%	4.0%		6.0%	6.0%		6.0%	6.0%	
	REITs									
	COMMODITIES		0.0%	0.0%		0.0%	0.0%		0.0%	0.0%
	STOCKS	36.0%	34.0%	-2.0%	50.0%	48.0%	-2.0%	67.0%	65.0%	-2.0%
	LargeCap Value	20.0%	20.0%		20.0%	20.0%		20.0%	20.0%	
	Large Cap Growth	5.0%	7.0%	2.0%	8.0%	10.0%	2.0%	11.0%	13.0%	2.0%
	Mid Cap Blend	3.0%	2.0%	-1.0%	6.0%	5.0%	-1.0%	13.0%	12.0%	-1.0%
	Small Cap Blend	2.0%	1.0%	-1.0%	4.0%	3.0%	-1.0%	10.0%	9.0%	-1.0%
International	5.0%	3.0%	-2.0%	10.0%	8.0%	-2.0%	10.0%	8.0%	-2.0%	
Emerging Market	1.0%	1.0%		2.0%	2.0%		3.0%	3.0%		
GROWTH	CASH	2.0%	2.0%		2.0%	2.0%		2.0%	2.0%	
	TRADITIONAL FIXED INCOME	35.0%	40.0%	5.0%	15.0%	20.0%	5.0%		4.0%	4.0%
	Short-term Inv Grade	15.0%	20.0%	5.0%	6.5%	11.5%	5.0%		4.0%	4.0%
	Intermediate Inv Grade	16.0%	18.0%	2.0%	7.0%	8.5%	1.5%			
	Long-term Inv Grade	4.0%	2.0%	-2.0%	1.5%	0.0%	-1.5%			
	ALTERNATIVE INCOME	3.0%	2.0%	-1.0%	3.0%	2.0%	-1.0%			
	Hi-yield	3.0%	2.0%	-1.0%	3.0%	2.0%	-1.0%			
	Emerging Market Debt									
	REITs									
	COMMODITIES	2.0%	0.0%	-2.0%	3.0%	1.0%	-2.0%	3.0%	1.0%	-2.0%
	STOCKS	58.0%	56.0%	-2.0%	77.0%	75.0%	-2.0%	95.0%	93.0%	-2.0%
	LargeCap Value	11.5%	11.5%		13.0%	13.0%		16.5%	16.5%	
	Large Cap Growth	13.5%	15.5%	2.0%	15.0%	17.0%	2.0%	17.5%	19.5%	2.0%
	Mid Cap Value	4.5%	4.0%	-0.5%	7.0%	6.5%	-0.5%	9.0%	8.5%	-0.5%
	Mid Cap Growth	4.5%	4.0%	-0.5%	7.0%	6.5%	-0.5%	9.0%	8.5%	-0.5%
Small Cap Value	3.0%	2.5%	-0.5%	5.5%	5.0%	-0.5%	7.0%	6.5%	-0.5%	
Small Cap Growth	3.0%	2.5%	-0.5%	5.5%	5.0%	-0.5%	7.0%	6.5%	-0.5%	
International	15.0%	13.0%	-2.0%	20.0%	18.0%	-2.0%	24.0%	22.0%	-2.0%	
Emerging Market	3.0%	3.0%		4.0%	4.0%		5.0%	5.0%		

Numbers in **bold black** indicate a tactical tilt higher than the benchmark. Numbers in **bold blue** indicate a tactical tilt lower than the benchmark. Blank fields indicate a value of zero.

Asset Class Definitions

(The definitions below are consistent with the asset classification used by the firm's Envision™ planning tool. Please contact your Financial Advisor for further information about this product.)

Short-term Fixed Income: Fixed Income instruments that mature in 1 to 3 years.

Intermediate Term Fixed Income: Fixed Income instruments that mature in 3 to 10 years.

Long Term Fixed Income: Fixed Income instruments whose maturities are longer than 10 years.

High Yield: Non-investment grade fixed income securities (rated Ba1 or lower by Moody's and/or BB+ or lower by S&P). *High-yield bonds, commonly known as junk bonds, are subject to greater risk of loss of principal and interest, including default risk, than higher rated bonds. The prices of these bonds may be volatile, and they are generally only suitable for aggressive investors.*

Emerging Markets: Financial markets in countries with developing economies. These markets are typically immature compared to those of the world's major financial centers, but are becoming increasingly sophisticated and integrated into international markets; they provide potentially higher returns but are intensely volatile. *Investing in foreign securities presents certain risks not associated with domestic investments, such as currency fluctuation, political and economic instability, and different accounting standards. This may result in greater share price volatility.*

REITs: Real estate investment trusts (REITs) trade on the major exchanges and invest in real estate directly, either through properties or mortgages. *There are special risks associated with an investment in real estate, including credit risk, interest rate fluctuations and the impact of varied economic conditions.*

Large Cap Growth: Stocks that have a market cap greater than \$8 billion and a price-to-book ratio greater than 3.3.

Large Cap Value: Stocks that have a market cap greater than \$8 billion and a price-to-book ratio less than or equal to 3.3.

Mid-Cap Growth: Stocks that have a market cap between \$1.87 - \$8 billion and a price-to-book ratio greater than 3.3.

Mid-Cap Value: Stocks that have a market cap between \$1.87 - \$8 billion and a price-to-book ratio less than or equal to 3.3.

Small-Cap Growth: Stocks that have a market cap less than \$1.87 billion and a price-to-book ratio greater than 3.3.

Small-Cap Value: Stocks that have a market cap less than \$1.87 billion and a price-to-book ratio less than or equal to 3.3.

The prices of small-cap and mid-cap 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.

Commodities: Basic goods used in commerce that are generally interchangeable with other commodities of the same type. Commodities are most often used as inputs in the production of other goods or services. *Buying commodity based investments allows for a source of diversification for those sophisticated persons who wish to add commodities to their portfolios and who are prepared to assume the risks inherent in the commodities market. Any purchase represents a transaction in a non-income-producing commodity and is highly speculative. Therefore, commodities should not represent a significant portion of an individual's portfolio.*

Our Asset Allocation Model Benchmarks

Traditionally, asset allocation models have focused primarily on the needs of growth investors. We believe that our asset allocation models fill the gap by defining a more comprehensive set of client objectives. As a result, our new models include allocations specifically tailored for Income and Growth & Income objectives as well as Growth.

In the past, investors requiring cash flow have sometimes been encouraged to make systematic withdrawals from a growth-oriented portfolio. We think this can be dangerous because systematic withdrawal strategies are subject to significant risks in a volatile market environment. When asset prices decline, systematic withdrawal may result in selling at

depressed prices, requiring the liquidation of a larger amount of assets to meet cash flow needs. Assets sold near market cycle lows will not participate when the market recovers. Repeating this process through several market cycles could significantly erode portfolio value. Thus, investors may fail to meet their goals even if assets' average returns are close to expectations.

We believe that a growing number of our clients will need comprehensive income strategies in the coming years. Given the potential risks we perceive in systematic withdrawal plans, we believe that income clients should be able to use portfolio-generated interest and dividends to provide a significant proportion of their cash flow needs. Since we believe an income investor's optimal asset allocation is different from the optimal asset mix for a growth investor, we designed asset allocation models that are optimized for the specific needs of three different investor objectives:

Income: Income investors need the maximum amount of income given their risk tolerance from their portfolio and are willing to forgo a portion of capital appreciation and growth of income in order to seek maximum current income.

Growth & Income: Growth & Income investors need to receive current income, but they are equally concerned that income and capital grow over time. These investors are typically willing to forgo a portion of current income in order to provide for longer term growth.

Growth: Growth investors generally have little need for account income. These investors seek the maximum capital appreciation consistent with their risk tolerance.

We recognize that investors with similar investment objectives may have substantially different risk tolerances. Although all investments involve some degree of risk, including the potential loss of principal, some securities, such as emerging market equities and high yield bonds, have more risks than other alternatives. Higher risk investments have a greater potential for losses, but usually offer the potential for higher long-term returns. Investors with lower risk tolerance give up some of the potential for higher returns in exchange for lower risk. Investors with a higher risk tolerance pursue higher returns through investment in higher risk securities. Consequently, our new asset allocation models provide allocation recommendations for investors across three degrees of risk tolerance — Conservative, Moderate and Long-term — for each of our three investment objectives (Income, Growth & Income, and Growth).

Our asset allocation models are detailed in the table above. Moving left to right or down the table shows allocation recommendations with higher levels of portfolio risk and correspondingly higher levels of expected return.

Asset Categories

Traditionally assets were allocated between Stocks, Bonds and Cash. Since our models are tailored to better serve the needs of income-oriented investors with differing levels of risk tolerance, we segregated Traditional Fixed Income, which includes all investment-grade debt, from a new category called Alternative Income. Alternative Income includes Hi-Yield Debt, Emerging Markets Debt and REITS. These three assets classes offer greater income potential, but they also entail higher levels of investment risk. Historically, they have tended to have some degree of correlation with both the stock and bond markets, but are not closely correlated with either. Portfolios that require income and can tolerate greater risk have higher Alternative Income weightings in our models.

Tactical Allocations

Our model portfolio benchmarks incorporate our strategic capital market assumptions for each asset's five- to ten-year return and risk characteristics. Thus these benchmarks already reflect our strategic preference for stocks over bonds and small/mid caps over large caps. Against these benchmarks we make tactical tilts that reflect our current preference for certain assets.

Bill O'Grady (314) 955-3064

Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. The S&P 500 is an unmanaged, weighted index of 500 stocks providing a broad indicator of price movement. Individual investors cannot directly purchase an index. Technical analysis is based on the study of historical price movements and past trend patterns. There are no assurances that these movements or trends can or will be duplicated in the future.

Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline of the value of your investment.

Additional Information Available Upon Request

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