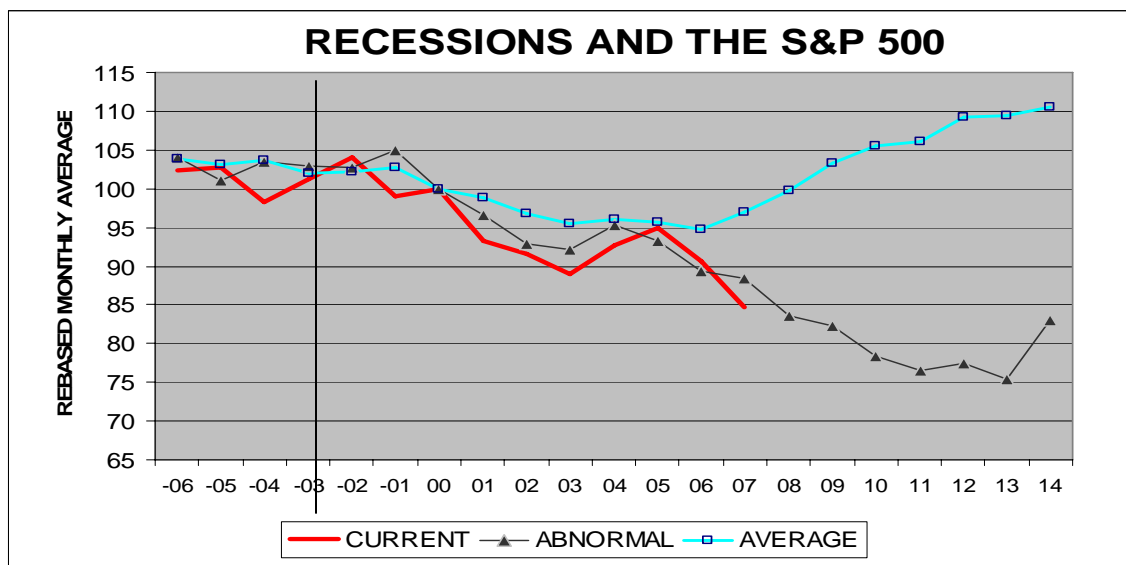


August 4, 2008

Bill O'Grady, Chief Investment Strategist

Should We Feel This Bad?

- We have two charts this week. The first is an update of a chart we first presented in the April 7, 2008 report. It shows the behavior of the S&P 500 in the six months prior to onset of a recession. We include each recession that has occurred in the postwar period. The recessions are divided into the "normal" ones, which are typical downturns and the "abnormal" ones, specifically, the 1973-75 and the 1981-82 recessions. Both of these recessions were unusually deep, characterized by the Federal Reserve being forced to fight both inflation and weak growth simultaneously.

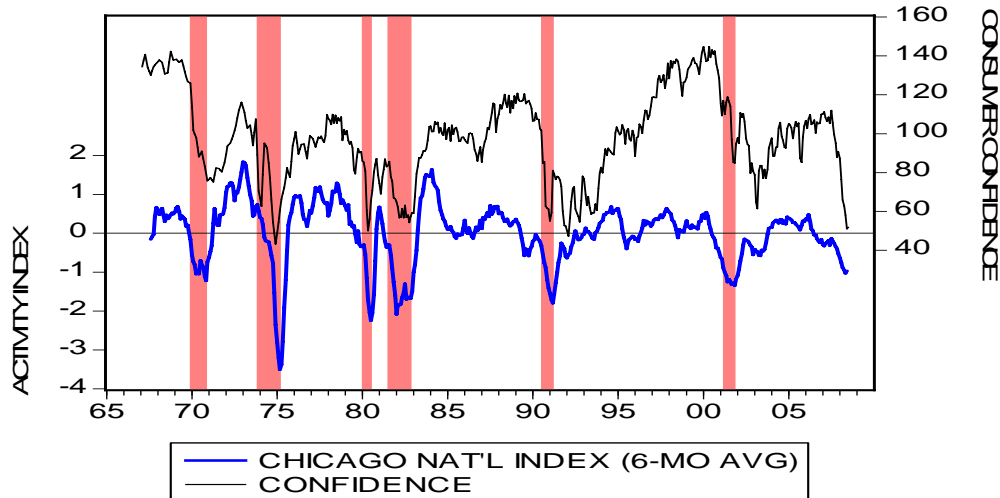


(Sources: Haver Analytics, National Bureau for Economic Research, Wachovia Securities)
Past Performance is No Guarantee of Future Results

- We assume that if a recession is declared, it will have probably started in December. That's when the labor market began to show significant weakness. Until May, the S&P 500 was tracking a typical recession. But, for the past two months, the market was most closely following the two deepest recessions of the postwar period. If we continue to track the abnormal path, our view is that the S&P 500 could decline to 1109 by early next year. On the other hand, a potential return to the normal recession trend would put the S&P 500 at 1479. Thus, we believe market sentiment towards the economy is very important.
- There are clearly a number of problems that could lead to a major downturn. The credit crisis, the problems in housing, and high commodity prices are all candidates that could foster a deep recession.
- The key question is whether the equity markets are forecasting a larger degree economic slowdown over overreacting to the potential of one. It is our position that the latter is the most likely case. Why? Overall, the economy isn't doing all that badly. Manufacturing has held up well, with the ISM manufacturing index showing expansion. Exports have been a bright spot as well. Consumers have benefited from tax rebates and fairly decent labor markets. And, despite rhetoric about fighting inflation, the Federal Reserve has maintained an accommodative monetary policy.
- The key to whether this economic slowdown is typical or not comes down to inflation. We expect overall inflation to ease because we expect commodity prices to fall. Recent price action is supportive of this expectation. If inflation worries ease, monetary policy can remain accommodative and avoid the common problem found in the two deep recessions; namely, premature tightening during an economic slowdown.
- In this week's Chart of the Week, we examine the relationship between consumer confidence and the economy.

Chart of the Week:

CONSUMER CONFIDENCE & THE CHICAGO FED NAT'L ACTIVITY INDEX



For illustrative purposes only. This does not reflect the performance of any specific investment. Past performance is no guarantee of future results

Sources: Chicago Federal Reserve, Conference Board, Wachovia Securities

This chart overlays consumer confidence (the upper line) with the six-month moving average of the Chicago National Activity Index, with the vertical bars on the chart indicating official recessions. The Chicago National Activity Index is a broad-based index that measures overall economic activity. Usually, a reading in this index of negative one is consistent with an economy in recession. The current reading, of -0.97, is very close to recession. Consumer confidence typically declines during recessions, but current levels of confidence are unusually low. In fact, the current levels of confidence are more typical of deep recessions, with a Chicago index near -2 or lower.

The bottom line is that consumers feel worse than the economic data would indicate. Some of this bad feeling is due to high energy and food prices and weak housing. If so, any good news on either of these fronts could boost sentiment. For investors, the key point is that the equity markets are acting as if the current downturn is going to be as bad as what was seen in the two deepest recessions in the postwar period. Consumer confidence is consistent with such a downturn, but the economic data is not. If consumers begin to “feel” better, we believe equities should recover into year’s end and more closely track a normal recession period.

Bill O’Grady

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