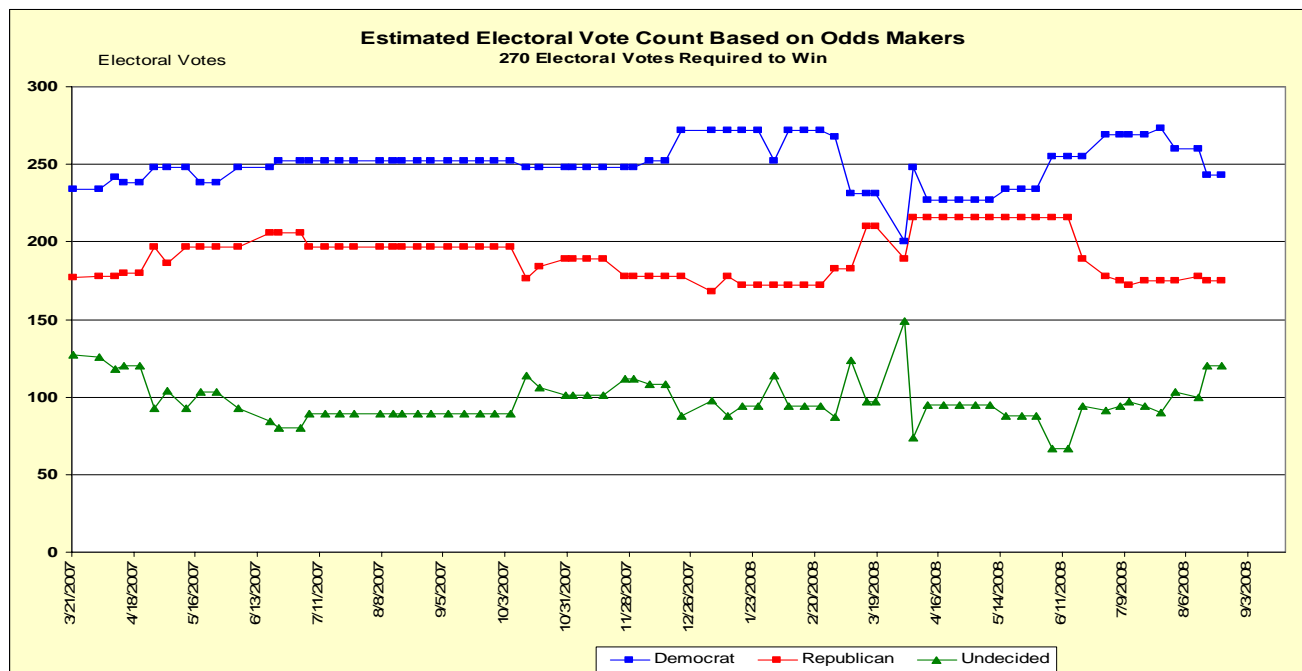


The Elections

- One of the key factors we believe affecting market sentiment going into autumn is the elections. In November, U.S. voters will head to the polls to choose a new president and other elected officials. Elections are important events; they allow for a civilized change in government that some other nations may only perform at the point of a gun. There is a tendency in the media to overplay the importance of a new president; whoever wins in November will inherit economic, political and social conditions that will likely be difficult, if not impossible, to change, at least in short order. On the other hand, changes in regulations, trade policy and tax rates can have a significant impact on the economy and the markets.
- The first order of business is to determine who is likely to win the White House. Instead of polls, we use betting sites, which I believe are a good barometer. There are reasons for this. In polling, the questions can be slightly different between polls and thus distort the trends in attitude towards the candidate. In addition, a poll is a snapshot in time. A poll taken today may not reflect how voters feel a few days after. A betting pool, in comparison, is open 24/7 and poses the same question consistently. Additionally, it is important to remember that U.S. voters don't directly elect a president. Instead, we have 50 state contests that select electors that elect the president. Thus, I feel national polls are of little use; I believe the key is figuring out the electoral map to project how many states each candidate will carry. To do this analysis, I use Tradesports state-by-state betting pools which give a running count of the electoral vote. I used this source in the 2004 election and found that it was very accurate into the election. Like polls, the numbers do move based on the news. However, I believe betting pools give a more consistent insight into the electorate.

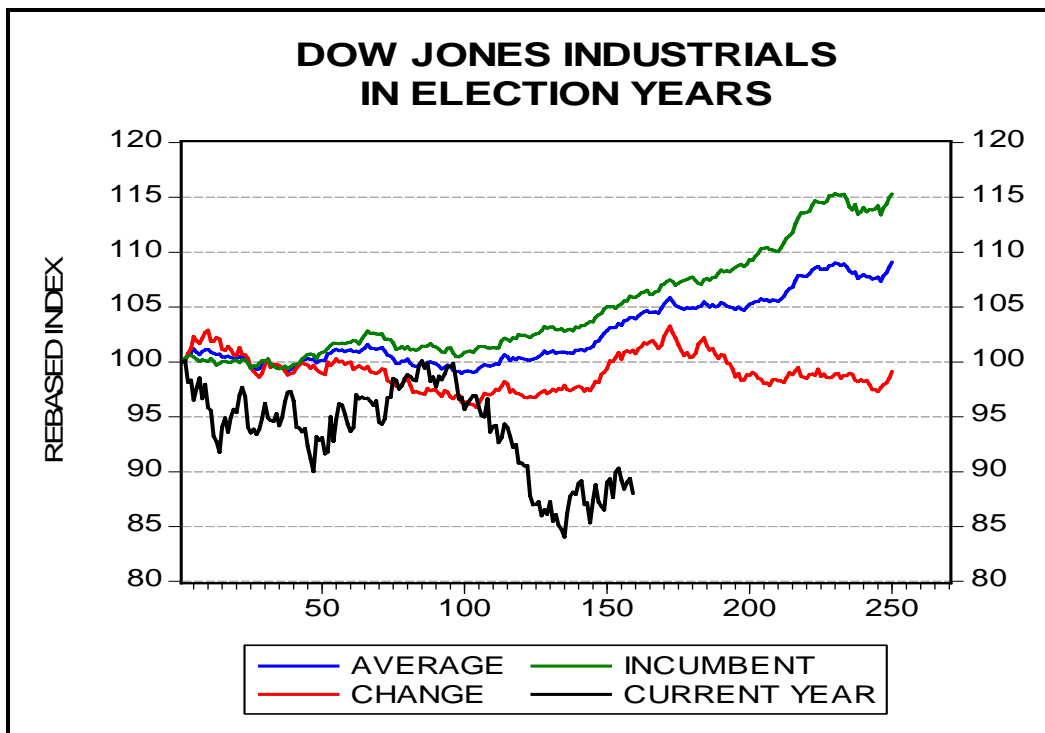


For illustrative purposes only. Past performance is no guarantee of future results

Sources: Tradesports.com, Wachovia Securities

- The chart above shows betting pool data on a state-by-state basis. I filter the results by assuming a state is “safe” when there is a 70% or better bet that the state will vote for a particular party. Based on this measure, the Democrats currently control 243 of the electoral votes, the GOP 175 with 120 votes “undecided.” The undecided, or toss-up states, include Colorado, Florida, Indiana, Michigan, Missouri, Nevada, New Hampshire, Ohio and Virginia. Of these states, 99 electoral votes went to the GOP in the last election. However, in the current pools, 63 of the undecided are leaning towards the Democratic Party. Thus, at this juncture, it appears that the upcoming election is Barak Obama’s to lose.
- However, it is important to note that we are still fairly early in the election process and the two candidates are not typical. Senator Obama is the first African-American to win a major party’s nomination. He is rather young and does not possess a long legislative voting record. Senator McCain is something of a maverick in his own party, often upsetting the GOP establishment. And, in direct contrast to his opponent, he is the oldest candidate from a major party. Thus, typical voting patterns for both parties could be upset in this election. That being said, it appears Senator McCain faces an uphill battle for the Oval Office.
- Assuming Obama wins, it appears that some taxes may be increased. The candidate’s theme on taxation is “fairness” which we believe usually means raising taxes on wealthy Americans. However, investors should be cautious in their expectations that taxes will be significantly increased. First, it is unusual for governments to raise taxes during periods of economic weakness. We doubt an Obama administration would take that step. Second, all governments attempt to make tax cuts visible and obscure increases. Thus, we may see adjustments to exclusions and exemptions, or changes in Social Security taxation. Tax increases are always possible regardless of party, but we wouldn’t presume automatic increases if Senator Obama wins.
- How does the equity market behave in an election year? That is the topic of this week’s Chart of the Week.

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: Reuters, Wachovia Securities

This chart shows the Dow Jones Industrials average, rebased at 100 for the first trading day for each election year since 1904. There are four lines in the chart; the top line (green) shows the average of years when the incumbent party wins the White House. The second (blue) shows the average for the entire series, the third (red) is when the incumbent party loses and the fourth (black) is the current year. The lower axis represents trading days.

Allowing for the fact that there are other factors that affect equity markets, the weakness we are seeing in the current market compared to history, coupled with the betting pool data suggesting the Democratic Party's lead, suggests to us the equity markets have probably discounted a change in party at the White House. Thus, we believe a change in party probably will have little impact on equities; on the other hand, allowing that past performance doesn't guarantee future results, a surprise win by Senator McCain might be a bullish event, based on historical patterns.

Bill O'Grady

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