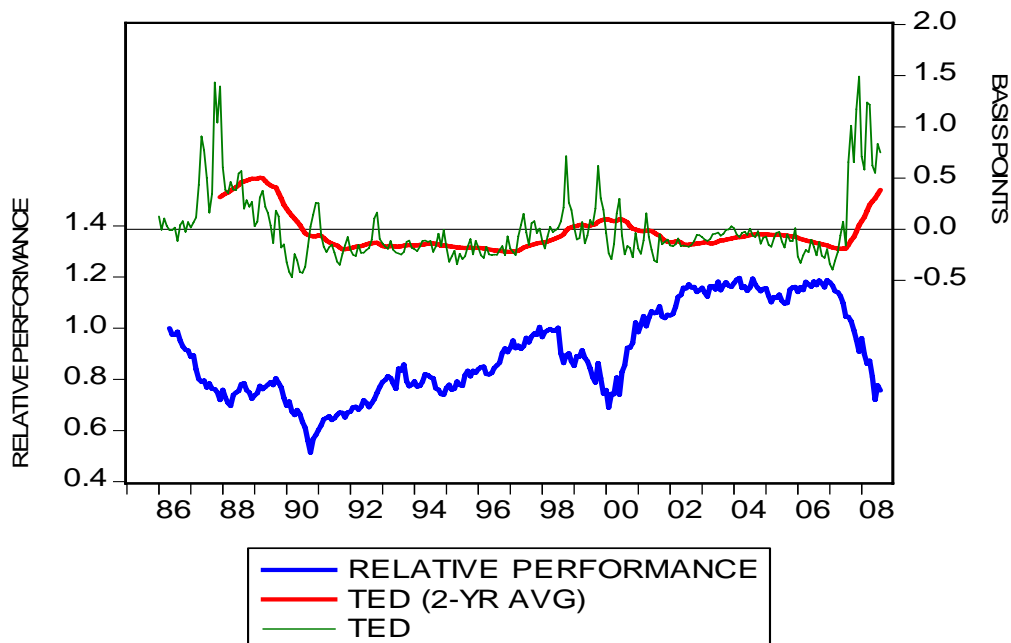


Revisiting Financials

- The equity markets suffered greatly this week; what is interesting is that the focus of investors has shifted from worrying about inflation to economic growth. Since mid-April, a stronger dollar and weaker commodity prices have tended to support equities. Last week, equities failed to rally despite sharp declines in commodities and a lift in the dollar. A retest of the July lows in the major indices appears increasingly likely. Probably the key to future market direction lies in the health of the financial sector.
- In the April 14 report of *The Week*, we examined the performance of the financial sector. In this week's report, we are revisiting this sector. Year to date, Financials are the weakest performer of the 10 S&P sectors, down 29.2% compared to the overall S&P 500 at down 16.7%. However, since July 15, Financials have been the strongest performer, up 19.5% compared to a 0.6% rise in the S&P 500.
- A couple of factors appear to have helped the Financials. First, the declines in commodity prices, especially oil, eased inflation concerns and have dampened expectations; the Federal Open Market Committee (FOMC) was prepared to raise interest rates. In late June, the fed funds futures market had projected a 100% chance of a quarter-point rate hike at the September 16 meeting. Currently, the fed funds futures market is projecting the likelihood of steady policy at over 90%. In fact, the earliest month where the odds of tightening exceed 50% is for the April 29, 2009 meeting. We believe the longer the FOMC can maintain steady policy, the greater the likelihood we will avoid a deep recession. Second, while the "news" from the financial sector remains negative, the market's reaction has been less negative, suggesting investors are nearing the points where they have fully discounted the bearish news coming from this sector.
- Despite the recent recovery, financials still face significant headwinds from the credit crunch. Problems with the Government Sponsored Enterprise firms still need to be resolved. Worries about these quasi-public firms have roiled the mortgage markets and slowed the recovery in housing. Some banks will still require additional capital and it isn't clear where the additional funds will come from. Surveys of lenders suggest tightening credit conditions which should slow recovery as well. Credit spreads are still at levels that suggest problems in the financial sector. The lift in financials suggest there is some improvement, but until the credit issues are resolved and banks restart lending, the economy and the equity markets are at risk.
- Our favorite indicator in measuring financial system sentiment is the T-bill less Eurodollar ("TED") spread. It is the topic of our Chart of the Week.

Chart of the Week:

THE "TED" SPREAD AND FINANCIALS



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, Wachovia Securities

The upper lines on this chart shows the "TED" spread, the difference between three-months Libor (Eurodollar) yields and three-month T-bill yields. The spread is normalized to account for the differences in yield levels. We include a two-year average of the spread to show the underlying trend. The normalized spread measures the degree of stress in the financial system. Historically, during stable periods, Libor yields are modestly higher than T-bill yields; the latter is backed by the Federal government as to the timely payment of interest and principal whereas the former is backed by the strength of the bank behind it. We view Libor as a good measure of bank funding costs and shows how confident banks are in each other. A wide TED spread suggests banks are reluctant to lend to each other; this condition tends to limit capital available to borrowers and slows economic growth. During periods of financial market stress, investors generally flee to the conservative nature of T-bills, lowering their yield. At the same time, they shun Libor deposits due to the lack of government guarantee which raises their yield. This process widens the TED spread.

The lower line of the chart is the financial sector's relative performance to the S&P 500. A rising number indicates financials are outperforming the broader index; a declining number indicates the opposite.

During periods of financial stress, the TED spread historically widens. When this widening occurs, note that the financial sector tends to underperform the broader market. On a normalized basis, the TED spread remains very wide suggesting the financial system remains under pressure. Until this spread begins to persistently narrow (easing to around 0.30% from the current 1.15%), we believe it is too early to begin overweighting the financial sector. Our current recommendation on this sector is evenweight. The recent recovery in financials probably does not signal the bottom for this sector unless we start to see steady improvement in the TED spread.

Bill O'Grady

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