

What We Have Here...Is Failure to Communicate*

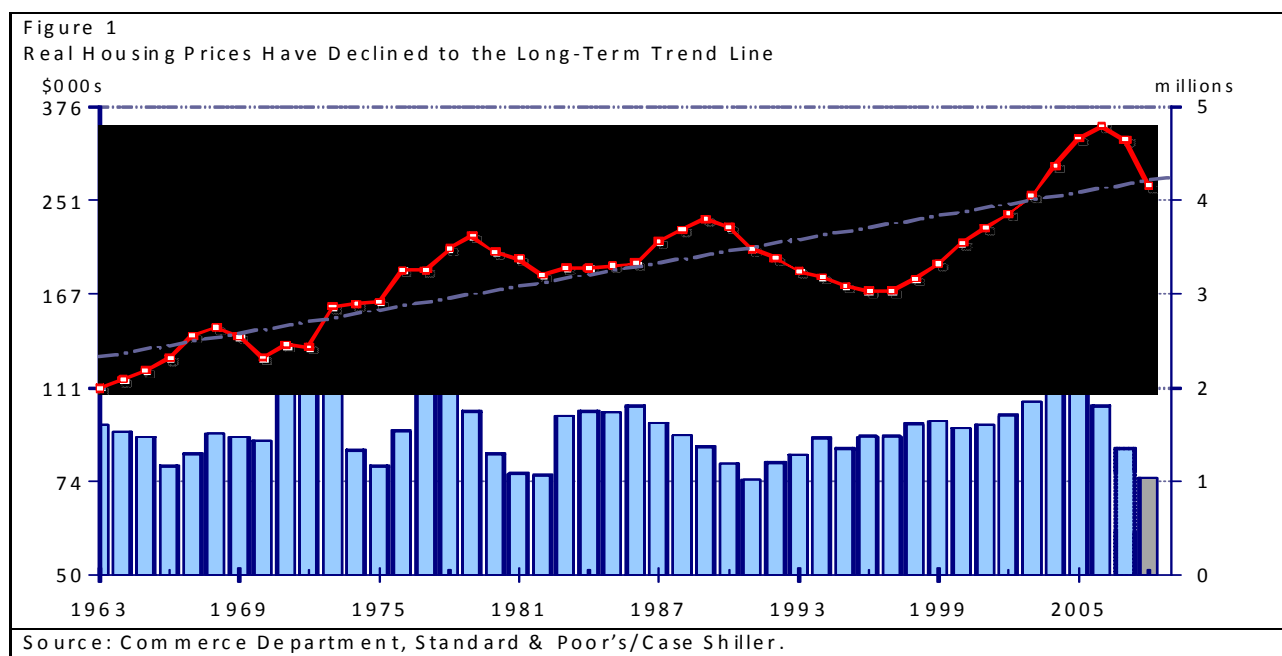
- Yesterday's defeat of the Emergency Economic Stabilization Act of 2008 in the House of Representatives helped trigger a sharp fall for stocks, erasing \$1.3 trillion in equity market value for the Standard & Poor's 1500 companies alone. While some of that loss is borne by foreign investors, further declines in foreign stock markets reacting to the stunning result in the House will likely compound the aggregate one-day wealth loss for U.S. investors to an amount potentially three times the entire amount of the investment program proposed by Treasury Secretary Paulson.
- Surveys of public opinion still indicate broad opposition to the Bush/Paulson plan, despite an overwhelming majority (74%, according to USA Today/Gallup) that expect the U.S. economy to worsen over the next year if Congress were to avoid the issue. In our view, "what we have here is a failure to communicate," as those who concluded that a drastic program was essential became too mired in the debate and details to object to the terminology applied by its detractors. We are puzzled as to why even supporters of the program are referring to it as a "bailout." Such is the power of the media, we suppose.
- Even when (if) Congress eventually approves this plan -- or any other that requires legislation to authorize policymakers to take drastic steps to deal with the credit crunch -- it is probably important for Bush, Paulson, Bernanke and Congressional leaders to educate the public more fully as to what assets they plan to buy, how and when they were created, and why they have become a problem on financial institutions' balance sheets. An important new precedent was set by posting the draft publicly for 24 hours before the vote, but it is still not likely to be popular reading among the electorate. The bill now comprises 106 pages of legalese, up sharply from the 3 ½ page "bare bones" version of a week ago.
- While the ultimate passage of the Emergency Economic Stabilization Act, together with the President's signature, should help market participants breathe a collective sigh of relief, we believe that the volatile, near-crisis atmosphere that prevailed over the past several weeks will probably not abate quickly. However, since troubled mortgage assets -- such as those that the Treasury proposes to buy -- are simply the underlying ownership interests in residential real estate after values have already declined significantly, we see the Act as a way (assuming Treasury constructs a diversified portfolio) for taxpayers to invest efficiently in America's housing stock.
- Two of our longer-term measures indicate that value has returned to residential housing market -- relative to incomes, and relative to a broad index of consumer goods and services. Unfortunately, the availability and cost of short term funding are too high, and continuing to pressure homeowners and buyers of a wide range of big ticket items that require financing. An eventual easing of credit conditions will likely contribute to a better investment climate for residential housing and for common stocks, in our opinion.

The steep decline of residential housing prices (the Case Shiller index has fallen nearly -20% over the past 2 years), coming on the heels of a multi-year bull market (the index rose +13% per year -- about +160% in total -- over the prior 8 years) has been the underlying cause of shattered dreams for those -- both homeowners and their lenders -- who borrowed more than they could repay. In just one month, formerly powerful institutions -- Fannie Mae, Freddie Mac, AIG, Lehman Brothers, & Merrill Lynch among them -- have been sold or undergone drastic change in their operations.

* RIP Paul Newman

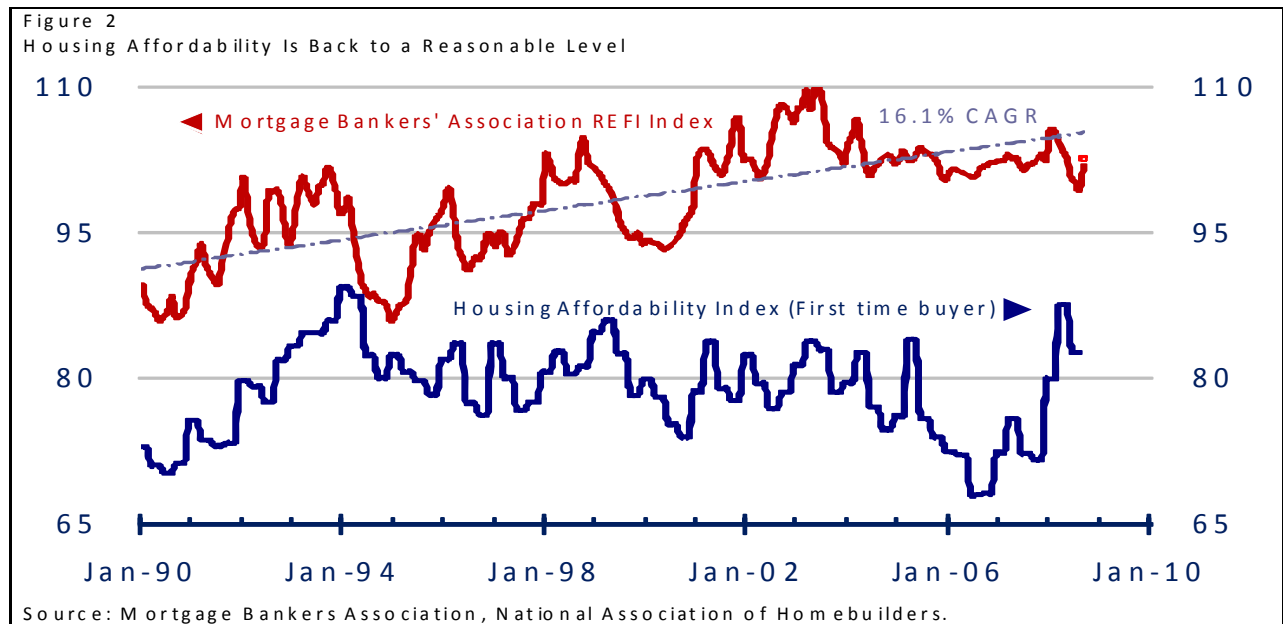
Everyone -- young or old, actively working or retired, domestic or foreign, consumers, manufacturers, service-providers and/or vendors – is invested in the underlying growth of our global economy. As U.S. taxpayers, we are especially invested in the growth of our domestic economy. There is no way to escape this; economic growth is a necessity, if we are to meet our savings and retirement goals. Despite all of the dramatic changes in the structure and ownership of our financial institutions, we continue to depend on economic growth to expand wealth over time, whether it is through increases in the value of the residential housing stock or in the value of good businesses.

When we first developed the simple model (figure 1) shown here [a few years ago], we posited that the tug of the economy’s “invisible hand” would eventually pull housing prices down until equilibrium was reestablished. Little did we know how quickly the adjustment would occur. We were concerned that once a downturn in housing prices got underway and gathered momentum, equilibrium (or “fair value”) would not provide any real “support.” Currently, the Case Shiller index appears to be close to its “real” long term trend. Unfortunately, depending on the amount of the prior overvaluation, prices often undercut the fair value level by a significant amount before rebounding.



The affordability ratio (figure 2) gives another perspective on the value of homes. This measure computes the ability of a worker who is earning a median income to afford (assumes 25% of pre-tax income is devoted to servicing a standard fixed-rate mortgage) a median-priced home. Recent declines in house prices have caused a dramatic improvement in affordability – to levels that appear to be in-line with the average over the past 15 years -- from the extreme “unaffordable” levels seen in the spring of 2006.

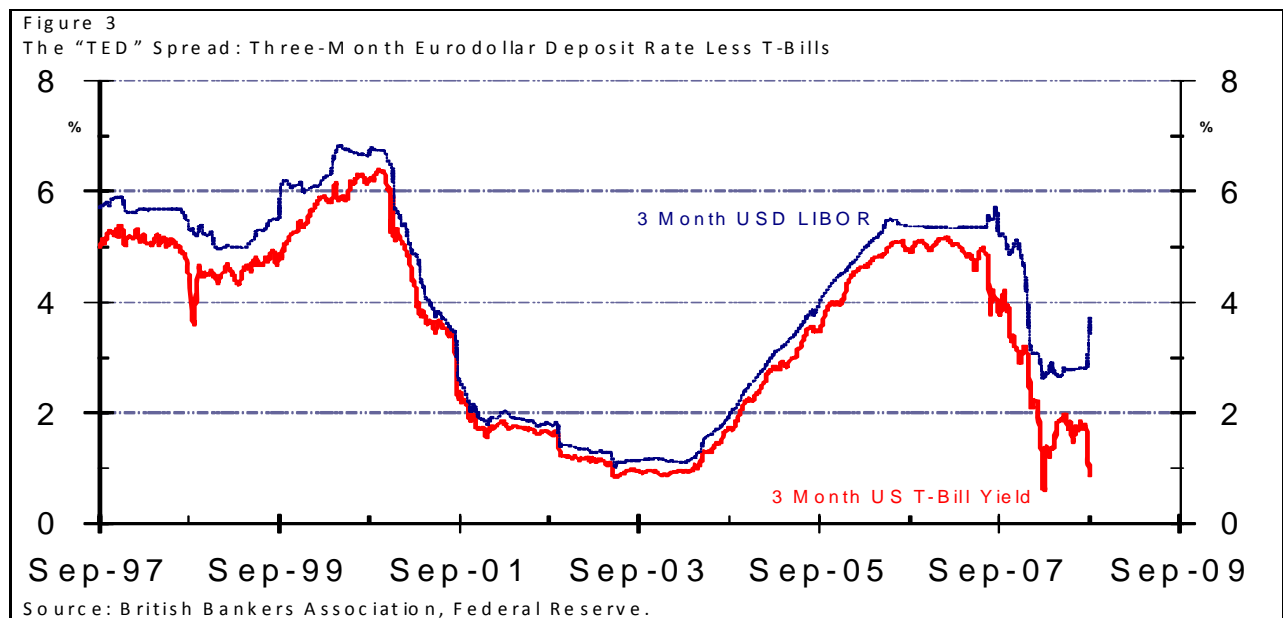
Note how the plunge in affordability started in mid-2004, improved briefly in early 2005, and continued for another year. We believe the Federal Reserve’s “measured pace” of tightening monetary policy during this period – while there were numerous indications of unsustainably high expectations of house price appreciation – will ultimately be recognized as an important error that helped inflate the bubble.



One indication of great stress in today's environment is the wide spread between Treasury bills – which reflect a severe risk aversion by investors seeking to flee from credit exposure at a very high cost – and the LIBOR (London InterBank Offered Rate, which, when quoted in U.S. dollars, is called the Eurodollar rate). The LIBOR represents an average rate that banks are paying to attract short term deposits, in the European money market.

The chart (figure 3) shows that 3-month USD LIBOR has risen 125 bps (basis points) to 3.75%/yr. since August, while Treasury bills of the same maturity are priced to yield a little less than 1%/yr. Clearly, this spread is wider than we have seen in a very long time, if ever. Unfortunately, the LIBOR is the reference rate upon which a wide range of adjustable-rate mortgages -- and trillions of dollars of derivative contracts -- are based.

Credit concerns are increasing the spread around LIBOR for the banks contributing to the calculation, as strong banks are likely funding at a meaningful discount to the average while weaker ones are paying a good deal more. We will be watching the LIBOR rate closely for signs of improvement in the availability and price of credit.



At the outset of 2005, the Bush Administration proposed a privatization of Social Security, a plan which would have allowed taxpayers to take control of the asset allocation decisions for their retirement portfolios. In our view, it made little

sense at the time, given the prevailing complacency regarding equity risk, and the fact that stocks had already recovered mightily from the bear market of 2000-2002. In 2003-2004, the average stock advanced +73% (+31%/yr.) according to Value Line, as compared to a long-term trend return of 9% to 10%. In the 45 months since the end of 2004, the average stock has advanced another +2.5% (+0.7%/yr.). Over the same period, the S&P 500 has provided a total return of -2.4% (-0.7%/yr.).

Every five years or so, it seems the market provides patient investors an opportunity to purchase stocks on sale. While we do not see current levels as an extraordinary opportunity worthy of aggressive overweighting, the values are clearly more attractive than existed when the Social Security plan was put forth. According to Value Line, the median dividend yield of dividend-paying stocks was 1.6% in January 2005, and the Price/Earnings ratio of companies with earnings was 19.6x. After yesterday's drubbing, we figure the comparable figures are 2.5% and 13.8x.

The Bush/Paulson plan – as modified and improved by a bipartisan team of Congressional leaders – is designed to move a substantial amount of housing-related loans away from the balance sheets of our financial institutions onto our collective balance sheet at fair market value, and thus socializes an investment in residential housing. Given the recent declines in the housing and stock markets, we now feel more comfortable with a substantial portion of our retirement assets invested in troubled mortgage-related debt, together with a diversified portfolio of common stocks. Given the attractive entry levels after significant market declines and the Treasury's low cost of funds, we humbly suggest this allocation would make sense for a large number of younger individuals who have at least 10 years until retirement.

Tom McManus

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