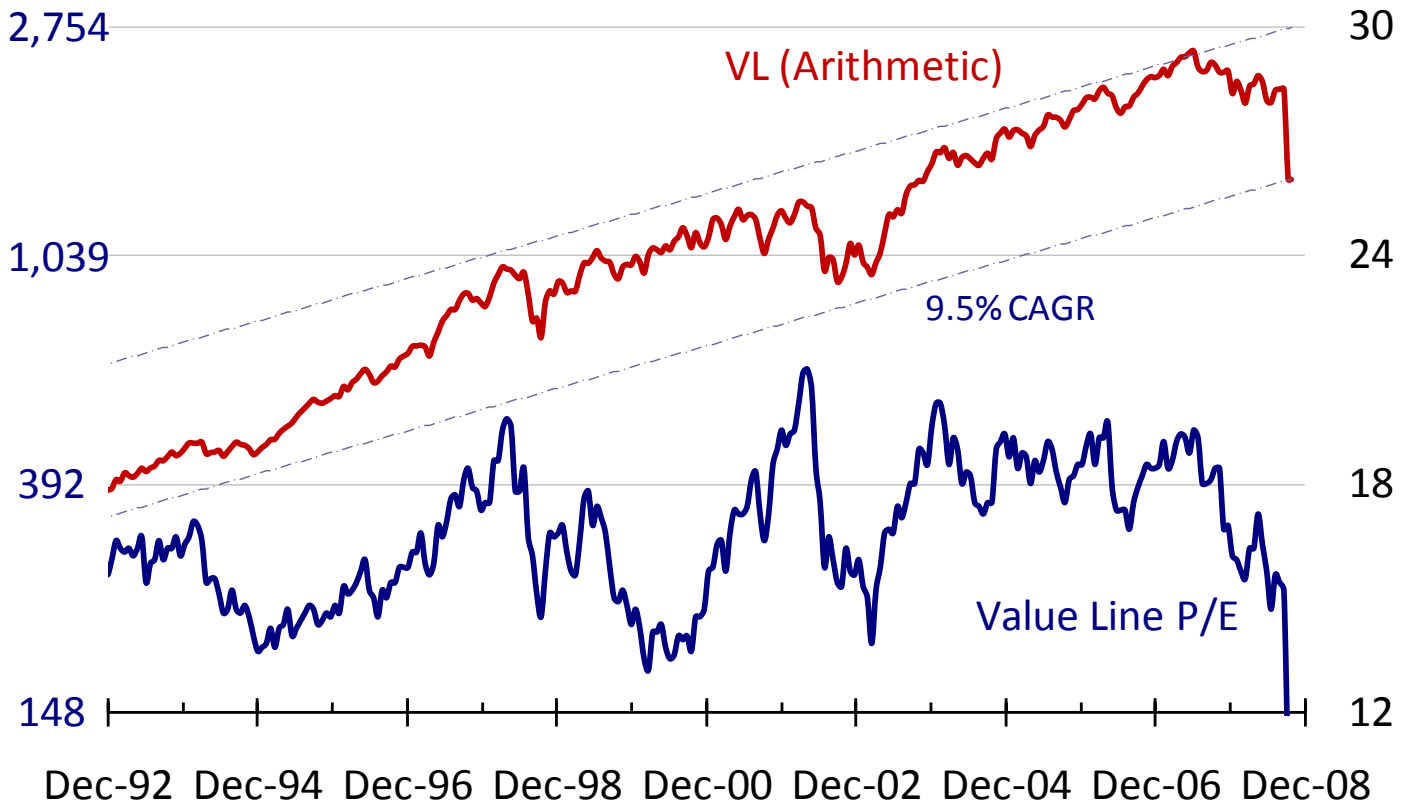


Coordinated Bank Moves: A Path Toward Repair

- Last week's coordinated interest rate cut by the world's major central banks, together with new measures "to improve liquidity in short-term US dollar funding markets", "to accommodate whatever quantity ... is demanded" – as well as cooperation between global financial ministers -- help us to see the latest leg of the recent stock market downturn as a very good occasion to increase equity exposure in opportunistic portfolios to "overweight." Despite valid concerns that the economic recession we sensed had begun near the outset of 2008 is becoming worse, we believe the downdraft has stoked overly bearish sentiment and uncovered significant value.
- After just two days of last week's brutal decline -- when our update, "Defy the Wall of Fear," was published on October 8 -- the S&P 500 index closed at 1000, the Dow Industrials at 9500, and the Value Line at 1570. These levels were undercut by about -15% by midday Friday before a rally ensued. Whether or not last week's lows are ultimately recognized as "a" bottom or "the" bottom – or perhaps just a stopping point to even lower lows -- our models indicate that stocks near current levels offer investors more value than we have seen in many years. Furthermore, we are confident that monetary authorities are 1) acutely aware of the danger to economic growth posed by stuck credit markets, and 2) empowered to take whatever steps are necessary to put credit markets on a path to repair. UK banks are accessing \$75B of new capital with significant government help, and our \$700B package can be used in a number of ways, either to inject new capital into banks or to buy troubled assets from them.
- By many measures, risks are high. The simplest way to visualize this is to monitor the CBOE Volatility index (or "VIX"), a pure indicator of how much investors are willing to pay to insure their stock portfolios. History shows that some investors overpay for portfolio protection after a significant decline, and the trading volume of option contracts indicates that the demand for put options has been extraordinarily high. For sure, the economy and markets are facing problems ... but the problems are no longer invisible. The problems are spread all over the popular press and dominating the attention of our legislative bodies and our upcoming national election... and they are reflected in the elevated prices that traders will pay for insurance. There is no "magic level" for the VIX that equates to a bottom for stocks, but last week's surge indicates a level of fear very rarely seen. From a long-term investor's standpoint, we believe option traders' fear, hedge funds' liquidation and significantly improved valuation combine to make equities a better "investment" (risk-adjusted opportunity) than we have seen in some time.
- We cannot and should not dismiss lightly the challenges our economy currently faces. In the last recession, growth in nominal Gross Domestic Product slowed to an annual rate below +4.0% for nearly 2 ½ years, despite the lowest interest rates in more than a generation. Super low rates prevented two important sectors – autos and housing – from suffering nearly as much in the recession of 2001-02 as they normally had done whenever the domestic economy slowed. The Federal Reserve under former Chairman Greenspan understood the importance of these two sectors in helping to prevent a more serious recession at the time; unfortunately, insulating these groups from the scourge of the prior recession may have increased their vulnerability to the current downturn.
- According to Value Line, the median Price/Earnings multiple of companies with earnings in their index of 1700 companies was 10.8x at Friday's close, indicating an earnings yield of 9.3%. Earnings yields have been more attractive on only 2 occasions since 1985: briefly after the 1987 crash and during the 1990 bear market. We recognize the high earnings yield reflects a lack of confidence in current earnings estimates, which we think will be revised significantly lower. Meanwhile the median dividend yield of the dividend paying companies in the index was 2.5% at the end of September, and thus has risen to 3.3% as of Friday's close. Dividends, too, are subject to downward adjustment, but history shows that dividends – for most companies – are a truer indicator of sustainable earnings power because they mostly reflect decided conservatism of management and boards.

Value Line Index: at the Low End of +9.5% CAGR Range; P/E Ratio Has Fallen Off the Page



Note: Latest P/E reading is 10.8x. Source: Value Line.

We prefer the Value Line Arithmetic index to other popular measures of the market because of its equal-weighted construction and long history. Unlike the S&P 500, the Dow Industrials and especially the Nasdaq, the Value Line did not soar in 1999 and 2000, because the bubble at that time was concentrated in ultra large-capitalization stocks (those that dominate the Dow and S&P 500) and the technology and telecommunications stocks that are prevalent in the Nasdaq.

Why is that important? Investors who looked beyond the popular indexes in 1999-2000 realized there was great value in the broad equity market – even as the Nasdaq was pushing up to the ridiculously overvalued level of 5200. Thus, they benefited greatly in 2000 and 2001 as the bubble unwound and investors embraced the other sectors once again.

We have found the trend appreciation of the Value Line index (shown above) approximates +9.5% per annum, and this rate is equivalent to the long-term trend of earnings growth for the index. Thus, a move to the lower end of the channel corresponds to a drop in the Price/Earnings ratio to 10.8x (a little below the bottom of the chart). We expect the P/E will rise, first as earnings estimates are adjusted downward, but eventually as investors gain confidence in a new earnings recovery, which we anticipate for 2009-2010. *Past performance is no guarantee of future results.*

Tom McManus

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. The Dow Jones Industrial Average is an unmanaged index composed of 30 common stocks. 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.

Additional Information Available Upon Request

Wachovia Securities is the trade name used by two separate, registered broker-dealers and nonbank affiliates of Wachovia Corporation providing certain retail securities brokerage services: Wachovia Securities, LLC, Member NYSE/SIPC, and Wachovia Securities Financial Network, LLC, Member FINRA/SIPC. CAR 1008-101917

Securities and Insurance Products		
Not Insured by FDIC or Any Federal Government Agency	May Lose Value	Not a Deposit of or Guaranteed by a Bank or Any Bank Affiliate