

October 17, 2007

### **BRANDING**

On September 30, we rolled out a new logo and tag line “Personal. Local. Global.” The tag line reflects our commitment to providing high touch service, strategically locating offices close to our clients, and taking a global perspective to offering services that are second to none. We believe this branding effort will help bring our offices and employees together with a focus on helping our clients achieve their goals.

### **COMMENTARY**

GDP growth increased 3.8% in the second quarter, well above the disappointing 0.6% in the first quarter. Consumer spending increased at a modest 1.4% in the quarter, but overall GDP was boosted by surging exports and increased government spending. The US dollar’s slide versus other currencies led to increased exports as domestically produced products have become cheaper for foreign buyers. Exports of goods and services increased 7.5% in the second quarter.

Again, economic data were mixed in the second quarter. Despite rising oil and food prices, core inflation, which strips out volatile energy and food price changes, dropped in the quarter. The PCE price index, year over year, rose 1.8% in August - the lowest rate since February 2004. Employment numbers weakened as the quarter ended. Economists anticipated job growth of approximately 110,000 in August, but were surprised by a decline of 4,000 jobs. Job losses in manufacturing, construction, and government education offset gains in health care and food services.

The biggest drag on economic growth was again housing. The slowdown in housing reduced U.S. GDP growth by about 0.50% in the second quarter. Pending home sales fell 10.7% in July and 6.5% in August and sales were down over 21% in the last twelve months. New home sales slide 8.3% in August and over 21% for the trailing 12 months. The supply of single family homes jumped to nearly 10 months of inventory at the end of September and further price reductions will likely be required to clear excess inventory. Over the last twelve months the median home price dropped 3.9%.

On September 18<sup>th</sup>, the Fed lowered the fed funds rate for the first time since June 2003. The 0.50% cut was in response to a weak housing market and this summer’s credit crunch. The Fed expressed concerns that the financial market disruptions could have a negative impact on the broader economy and possibly lead to recession. The economic impact of the rate cut will not be known for several quarters, but it seemed to ease some of the credit pressures that emanated from the sub-prime and collateralized mortgage markets.

### **EQUITIES**

Considering the headwinds of \$80 per barrel oil, a U.S. housing market in recession, a global credit crisis, and weak employment number, domestic stocks posted very impressive gains in the third quarter. However, it wasn’t without volatility. Stock prices dropped significantly in July, with the S&P 500 falling 3.1%, the index’s largest decline in three years. Stocks recovered in August and made up roughly half of July’s losses. Stock prices surged in September, with the S&P 500 increasing 3.7%, its largest monthly gain since November 2005. Most of September’s gain came on the heels of the Fed’s rate cut on the 18<sup>th</sup>. The market was anticipating a 0.25% rate cut and after the Fed dropped rates by

0.50% the market reacted very positively. The aggressive cut lent support to the belief that the Fed was well aware that the economy was struggling and they were willing to step up and add liquidity if needed.

Large cap stocks finally took a leadership position. Large cap stocks typically hold up better than small and mid cap stocks if the U.S. economy slows. They have a higher percentage of revenues from foreign sales and also have lower borrowing costs relative to smaller cap stocks. For these reasons, investors gravitated toward large cap stocks and large cap returns responded positively. For the second consecutive quarter, growth stocks outperformed value stocks. The Financials sector struggled during the quarter and dragged down returns among value indices. Growth indices were propelled higher by strong returns in the Technology sector.

International stocks performed similarly to domestic stocks. Large cap stocks outperformed smaller cap stocks and growth stocks outperformed value stocks. As was the case last quarter, countries that are large exporters of oil and gas did well, with Canada, Finland, and Norway leading the way. The Japanese yen strengthened nearly 7.0% in the quarter, putting pressure on Japanese exporters. The Yen's appreciation vs. the U.S. dollar again contributed to Japan's poor performance versus the rest of the developed markets. However, the rest of the Pacific region performed well, particularly Hong Kong and Australia.

Emerging market stocks were the best performers in the quarter, with the MSCI EM index increasing 14.4%. Emerging Asia posted a gain of 18.8% in the quarter and finished the quarter up over 40% year to date. Strong performance in the quarter was primarily driven by returns of over 20% in two of the larger markets, China and India. Investors rewarded growth stocks and the fastest growing companies around the globe reside within the emerging markets.

#### **FIXED INCOME**

Bond yields hovered near multi-year lows as the third quarter started. Investors searching for yield bid up prices of spread products (non-government guaranteed), pushing the risk premium normally received for investing in riskier investments to historically low levels. In July, problems within the sub-prime market resurfaced. Billions of dollars in bad loans were written off and the impact on the banking system was huge. Bank lending nearly came to a standstill and even good collateral wasn't enough to secure loans. Without a clear picture of who held sub prime loans, investors indiscriminately dumped riskier assets and credit spreads widened quickly. Investors subsequently moved funds to Treasuries and other safer government secured issues. Spreads stabilized a little in August, but investors still preferred Treasuries and yields dropped in response. The 10-yr. Treasury yield dropped from 5.03% on June 30<sup>th</sup> to 4.54% on August 30<sup>th</sup>. Treasury yields remained flat in September, but earlier gains propelled the LB Aggregate index up 2.9% for the quarter.

Credit quality was the most important determinant of return in the quarter. The highest quality government backed securities were clearly the winners for the quarter. Within government backed securities, longer duration bonds posted the highest returns, although the separation was fairly tight between short and long term bond returns. The opposite occurred among spread products. Lower quality and the longer duration bonds posted the poorest performance. Hit particularly hard were bonds collateralized with non-conventional mortgages.

#### **2007 MARKET OUTLOOK AND TACTICAL IMPLICATIONS**

The Fed's rate cut undoubtedly boosted stock returns in the third quarter. Domestic stocks appear to be fairly priced, but price-earnings ratios recently rose as equity returns outstripped earnings growth. The increase in price-earnings ratios could be supported by lower borrowing costs associated with the Fed's rate cut. However, intermediate and longer term rates have remained fairly stable. Absent any upcoming rate cuts, we have modest expectation for the remainder of the year. Strong equity returns in September will likely reduce returns in the fourth quarter. At this stage, we don't see a clear catalyst to push the market much higher in the last quarter of the year. In fact, stock prices may have risen above

fundamentally supportable levels in response to the Fed's rate cut. The domestic economy still faces substantial risks to growth and the stock market seems to have discounted these risks considerably.

Growth outside the U.S. remains the driver for the global economy. Global GDP growth in 2007 is projected at 5.2%, while the U.S. is projected to grow at 2.0%. The emerging market countries continue to be the leaders in global growth. This growth has not gone unnoticed as emerging markets stocks have performed very well so far this year. The MSCI EM Index posted a gain of over 32% YTD. Although we are generally bullish on the emerging markets, we remain cautious given the recent run up in stock prices. Overall we believe the growth potential of international stocks looks favorable in comparison to domestic stocks.

The fixed income market was rocked by this summer's flight to quality. Treasury yields were subsequently pushed lower as investors flocked to safety. Barring any additional credit shocks or Fed rate cuts, yields will likely move higher in the near term. In addition, credit spreads may narrow a little under this same assumption. However, we do not expect credit spreads to drop back to the tight levels from earlier this year. The recent market volatility resulted in higher longer term yields versus shorter term yields (steeper yield curve). Until recently, the incremental yield investors received for holding longer term bonds was insignificant compared to shorter term bonds.

As of September 30, 2007, portfolios' were positioned with the following tactical allocations.

- Bias toward low duration and floating rate bonds relative to intermediate bonds.
- Overweight international equities (developed and emerging markets) relative to domestic equities.
- Overweight large cap domestic stocks relative to mid and small cap stocks.
- Underweight real estate.
- Underweight high yield bonds.

The Investment Committee is currently evaluating implementing the following tactical shifts.

- Increase the weighting to intermediate bonds and reduce exposure to short term bonds.
- Increase exposure to growth stocks in relation to value stocks.

We continue to work diligently to help you achieve your investment goals. Please call us if you have any questions.

Very truly yours,

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