

January 16, 2008

COMMENTARY

GDP growth increased 4.9% in the third quarter, reaching its fastest level in four years. Consumer spending increased by a stronger than expected 2.8% in the quarter. The biggest surprise came from a 19.1% increase in exports. The US dollar's continued slide versus other currencies led to a dramatic increase in exports as US produced goods became cheaper for foreign buyers.

Despite very strong economic growth in the third quarter, a majority of the economic data released in the fourth quarter was negative. Oil continued its upward climb and spent most of November and December over \$90 a barrel. The PCE price index, the Fed's preferred measure of inflation, rose at an annual rate of 2.2% in December, above the Fed's stated 2.0% ceiling. Higher inflation makes it more difficult for the Fed to cut rates because lower rates may spur additional inflation growth. Employment numbers weakened in the fourth quarter. The 4-week average initial unemployment claims figure jumped from just over 300,000 in October to 345,000 at the end of December.

As has been the case since the first quarter of 2006, housing was again a significant drag on US growth. Residential construction reduced US GDP growth by 1.1% in the third quarter, the largest amount since third quarter 2006. Pending home sales fell 2.6% in November and was down 19.2% in the last 12 months. New home sales slid 9.0% in November and 34.4% for the trailing 12 months. The US homebuilders index, initiated in 1985, hit a record low in December. The market continued to struggle with tighter lending standards, rising defaults, and a growing supply of homes.

The Fed lowered the Fed Funds rate by 0.25% at both meetings during the quarter. The reductions, in addition to the 0.50% cut in September, pushed the Fed funds rate down to 4.25%, the lowest level in two years. Perhaps more important, the December Fed meeting minutes stated that risks to growth had risen since the last meeting in large part due to deteriorating credit markets. The question is did the Fed act quickly and aggressively enough to prevent a recession?

EQUITIES

Stocks fought off much of the bad news in the third quarter and prices pushed higher. The stresses of a weakening economy, higher oil prices, a depressed housing market, tight credit, and a slowing job market proved to be too much in the fourth quarter. Stocks succumbed to economic pressures and prices fell. Small, mid, and large cap stocks as well as value and growth stocks all suffered losses. Larger cap stocks held up better than smaller cap stocks. Larger cap stocks benefitted from reasonable valuations, globally focused revenue sources, easier access to credit, and a history of relative outperformance during economic slowdowns.

Growth indices, which have minimal exposure to the Financials sector and heavier exposure to Technology and Healthcare, outperformed value indices. Financials' stocks were hammered due to huge write-downs in subprime mortgages, minimal M & A activity, and an overall seizure of the credit markets. Healthcare and Technology stocks were basically flat in the quarter. Technology stocks are generally able to grow earnings even in the face of slower economic growth. Healthcare stocks held up relatively well as they are perceived to be defensive and less economically-sensitive.

For the second quarter in a row, developed international stocks performed similarly to domestic stocks. International large cap stocks outperformed smaller cap stocks and growth stocks outperformed value stocks. Returns were helped by continued dollar weakness. The US dollar dropped 2.7% versus the Euro and 2.8% versus the Yen in the fourth quarter. Many European countries posted losses due to spillover from the US credit crunch and subprime crises. In addition, there was heightened concern that a US recession and a rising Euro would dramatically slow exports. Japan notched the weakest major market performance as a US recession would significantly hurt Japanese exports. Although the EAFE index was down 1.8% in the quarter, it still outperformed domestic indices.

Emerging market stocks provided stability and positive returns during a period of economic weakness and global stock price declines. Historically, weakness in the US economy generated a sell off in this volatile asset class. Strong domestic economic growth and rising commodity prices provided support and the MSCI EM index responded by rising 3.6% in the quarter. Resource rich countries in Latin American and Europe were the top performers while export focused countries, such as China and Taiwan, struggled. Investors clearly favored growth stocks in the quarter and for the year. The MSCI EM index was the top performing index in 2007, rising 39.4%.

FIXED INCOME

Strong returns in the fourth quarter pushed the LB Aggregate Bond's return above the S&P 500 Index for 2007. During the fourth quarter Treasury bond yields dropped to levels not seen since late 2004, when the Fed Funds rate was below 3.0%. Investors were not buying Treasuries for their yield, but rather safety amid increasing economic uncertainty. The Treasury curve steepened sharply as short term yields fell in response to slower economic growth and the prospect of future Fed rate cuts. Longer term Treasury yields didn't fall as much due to continued inflationary concerns. Longer term bonds are more sensitive to inflation expectations.

Financial institutions were pressured during the quarter with additional write downs, rating agency downgrades of holdings, and liquidity issues. Several large banks were forced to raise additional capital from sovereign wealth investors. The Fed responded to banking problems and slowing growth by injecting liquidity into the market and reducing the Fed Funds rate from 4.75% to 4.25% by quarter end. In addition to rate cuts, The Fed worked collectively with global central banks to pump cash into the banking system by reducing borrowing costs and loosening acceptable collateral standards. The Fed also held two auctions in December and injected \$40 billion into the cash strapped market.

Credit quality was again the most important determinant of return in the quarter. The highest quality government backed securities had an outstanding quarter as investors bid prices higher. The LB Government Bond Index jumped 3.7% in the quarter as investors flocked to safety. Within government backed securities, longer duration bonds posted the highest returns. High yield bonds posted a loss, with the LB High Yield Index dropping 1.3%. Securities with any default risk were punished as credit spreads (extra yield versus comparable Treasury bonds) widened.

2008 MARKET OUTLOOK

The US economy enters 2008 on shaky ground! The housing decline that started in 2006 shows no immediate signs of recovering. Financial institutions are struggling with huge write offs of subprime and collateralized loans and credit has become increasingly scarce. Consumer confidence fell sharply as the unemployment rate jumped to 5.0% and oil and other commodity prices pushed living expenses higher. The likelihood of a recession has increased dramatically over the last few months. However, even if the US enters a recession, we don't think it will be very deep or prolonged. The Fed has been actively reducing rates and has indicated it will continue to do so if the economy stumbles. US corporate balance sheets are in great shape and the global economy looks to enjoy another solid year.

Growth expectations outside the US have fallen, but they remain relatively attractive. The World Bank projects global growth of 3.3% in 2008, while growth in the US is projected between 1.0 and 2.0%. Growth among the developed countries is projected to slow primarily due to the global credit crises.

The emerging market countries are again projected to lead global growth. Despite a multi-year run of strong stock price performance, emerging market stocks still look compelling from a growth perspective. Overall we believe the growth potential of international stocks looks favorable in comparison to domestic stocks. However, aggressive easing by the Fed could help the US economy avoid recession and could lead to higher stock prices as investors have pushed stock prices lower in response to a potential recession.

Bond yields moved in two distinct directions in 2007. High quality government-backed bond yields fell and credit (non government secured) bond yields increased. Throughout the first half of 2007 investors gravitated toward credit securities and spreads were very tight with Treasuries. This trade was reversed in the second half of 2007 and spreads widened significantly. Entering 2008 the yield on government backed bonds is very low by historical terms and the upside potential for further price appreciation seems limited barring any major economic decline. However, until liquidity returns to the market, it is likely that spreads will remain elevated. If the US avoids recession, Treasury bond yields will likely rise and credit spreads will tighten.

TACTICAL POSITION

As of December 31, 2007, portfolios' were positioned with the following tactical allocations.

- **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.**
- **Increased weighting to intermediate bonds and reduced exposure to short term bonds.**
- **Intermediate bond exposure split between domestic and international bonds.**
- **Overweight growth stocks in relation to value stocks.**

During the first week of January the Investment Committee determined that given the economic outlook it is prudent to reduce equity exposure and increase fixed income exposure. Given the low yields available in the fixed income market, proceeds from the sale of equities will be held in short term cash accounts until a better option is identified.

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

Very truly yours,

AKT WEALTH ADVISORS, LP INVESTMENT COMMITTEE

Darin Richards
Doug Davison

Scott Barchus
Julie Robinson

Toby Daniels
Carl Pinkard

Charlie Zieky