



Weekly Market Commentary

Your weekly update on risks and opportunities in the financial markets.

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Fourth Quarter Fireworks

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- The S&P 500 has experienced a fourth-quarter rally in 17 of the past 19 years. Even more impressive is that the rallies have averaged an explosive gain of 7%. We believe investors are likely to enjoy fireworks again this year, as the 9% rally in the S&P 500 since the trough in mid August extends into the fourth quarter.
- We expect the gains in the fourth quarter to be led by large-cap growth stocks. On average, growth stocks have outperformed value in the fourth quarter.
- We are recommending changes to the tactical asset allocation. We recommend a further shift toward growth over value to an approximate 60%/40% bias in favor of growth (up from 55%/45%), a shift to overweight large-cap stocks relative to small caps among both U.S. and foreign asset classes, and lower exposure to REITs.

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Does the market face any potential misfires between now and yearend? Investors generally anticipate October with trepidation, because some of the worst one-month performances ever occurred during that month (in 1929 and 1987). But the truth is that September has actually been the worst month for stocks. On average, September has usually resulted in a 1.5% loss for the S&P 500. This September has been different — the index posted a September gain of 4%. Even more noteworthy is that the S&P 500 has retraced its way back to within about one percent of all-time highs.

We expect the 9% rally in the S&P 500 since the recent trough of mid-August to extend into the fourth quarter – led by large-cap growth stocks. On average, growth stocks have outperformed value in the fourth quarter, and conditions are supportive of another fourth quarter growth-led rally:

- key measures of crisis are fading fast: LIBOR has retreated, high yield credit spreads are narrowing, and the strength in the yen has stalled;

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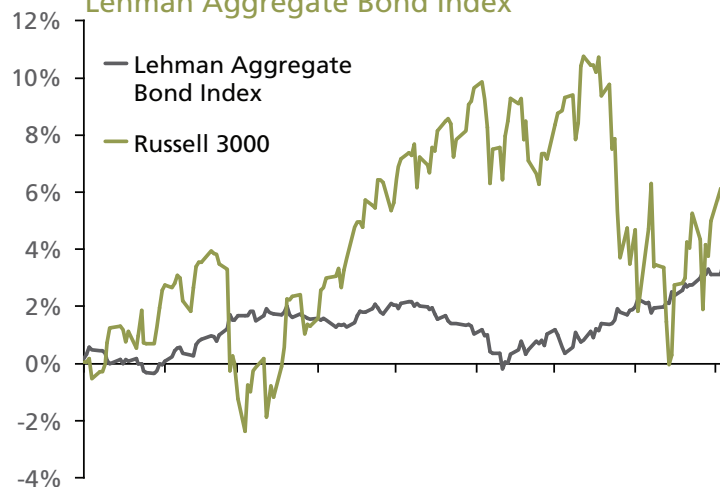
- in general, the S&P 500 has posted strong performance in the 12 weeks following the start of rate cuts by the Federal Reserve – the Fed cut the Federal Funds rate target by 50 basis points on September 18;
- ongoing corporate profit growth is supported by solid global economic growth much more than by the mere 15% of profits tied to U.S. consumer discretionary spending – about 40% of S&P 500 profits are derived from overseas or are driven by globally set commodity prices;
- relatively low and rising stock market valuations are a key driver of growth stock performance, and cash rich companies make it likely that merger and acquisition activity will continue and help to lift valuations – the vast majority of deals (roughly 85%) have been mergers or acquisitions outside of leveraged buyouts, and the bulk of that activity (75%) was financed with cash and not debt;
- many companies are implementing aggressive share buyback programs.

If these conditions occur in the coming months, they could help launch the fourth-quarter fireworks. In fact, as we noted in the *Weekly Market Commentary* in recent weeks, the fireworks may have started early, given the rally since mid-August.

Looking back, the third quarter provided similar returns for U.S. stocks and bonds of around 2–3%. These modest gains mask the 9% peak-to-trough decline in the stock market, measured by the S&P 500, and a rally in the bond market. The quarter sustained the trend of rising volatility with 13 days where the S&P 500 experienced a 1% or greater move – the largest number of such moves in any 90-day period in four years. The bond market also experienced above-average volatility in the third quarter.

Diversification Benefits

Year-to-Date Total Return of Russell 3000 and Lehman Aggregate Bond Index



Source: Bloomberg, LPL Financial Services

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returns for the quarter while reducing overall portfolio volatility. We expect this relationship to continue in the fourth quarter.

While the impact of the credit and liquidity crisis triggered by the meltdown in subprime mortgage debt has been painful for some market participants, and the housing sector's weakness is likely to linger, these negatives are offset by key positives that include a backdrop of strong global economic growth, the best corporate balance sheets in 40 years, and an inflation environment that grants the Fed more flexibility in managing monetary policy. In general, patient investors who remained fully invested during the quarter were rewarded with gains, despite the heightened volatility.

In general, our recommended tactical asset allocation was rewarded during the third quarter:

- Growth outperformed value.
- Large caps outperformed small caps.
- U.S. stocks outperformed international stocks.

The relative performance of asset classes is best measured from a longer-term perspective. We believe the markets have started a multi-year shift in the relative performance of asset classes.

We are recommending changes to the tactical asset allocation. We recommend a further shift toward growth over value to an approximate 60%/40% bias in favor of growth (up from 55%/45%), a shift to overweight large-cap stocks relative to small caps among both U.S. and foreign asset classes, and lower exposure to REITs. For more details and support of our tactical asset allocation recommendations see 4Q Discussion of Tactical Asset Allocation Changes 9/28/07.

In the fourth quarter, we believe investors will most likely be rewarded by following these tactical asset allocation weightings:

- Overweight to Growth relative to Value
- Slight overweight to Large Caps relative to Small Caps
- Underweight to International stocks relative to our strategic weighting

We recommend investors stay fully invested. We think the markets will provide investors with solid gains in the fourth quarter and 2008. While there have been a large number of 1–3% dips in the S&P 500 over the past three years, there have been just six notable pullbacks similar to that experienced in the third quarter. Each pullback was in the range of 5–9%, lasted three to six weeks, and preceded a 4–7 month market rally. While such pullbacks are likely from time to time, we believe a substantial correction that would justify holding excess cash is unlikely at this time.

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Investing in international and emerging markets may entail additional risks such as currency fluctuation and political instability. Investing in small-cap stocks includes specific risks such as greater volatility and potentially less liquidity.

Stock investing involves risk including loss of principal

Past performance is not a guarantee of future results.

Indices are unmanaged and cannot be invested into directly.

High yield/ junk bonds are not investment grade securities, involve substantial risks, and generally should be part of the diversified portfolio of sophisticated investors.

REQUIRED DISCLOSURES

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INDEX DESCRIPTIONS

Dow Jones Average - 30 Industrial

Prepared and published by Dow Jones & Co. It's one of the oldest and most-widely quoted of all the market indicators. The Dow Jones Industrial Average is comprised of 30 stocks that are major factors in their industries, and widely held by individuals and institutional investors. These 30 stocks represent about a fifth of the \$8 trillion-plus market value of all U.S. stocks and about a fourth of the value of stocks listed on the New York Stock Exchange.

NASDAQ Composite Index

The Nasdaq Composite Index measures all Nasdaq domestic and non-U.S. based common stocks listed on The Nasdaq Stock Market. The Index is market-value weighted. This means that each company's security affects the Index in proportion to its market value. The market value, the last sale price multiplied by total shares outstanding, is calculated throughout the trading day, and is related to the total value of the Index

S&P 500 Index

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. The index was developed with a base level of 10 for the 1941-43 base period.

Russell 3000 Index

Russell 3000® Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market. As of the latest reconstitution, the average market capitalization was approximately \$4.8 billion; the median market capitalization was approximately \$944.7 million. The index had a total market capitalization range of approximately \$386.9 billion to \$182.6 million.

This research material has been prepared by Linsco/Private Ledger Corp. (LPL).



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