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# Market Insight

A quarterly review of the world's capital markets  
1<sup>st</sup> Quarter 2008

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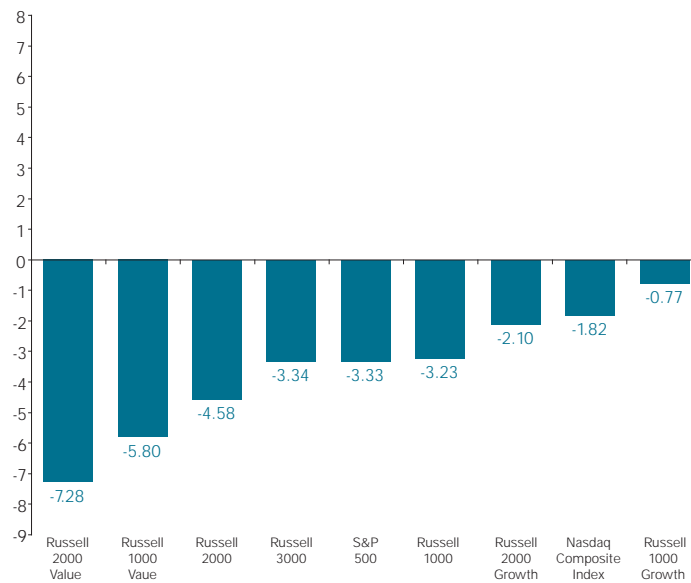


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# Index Returns - Fourth Quarter 2007

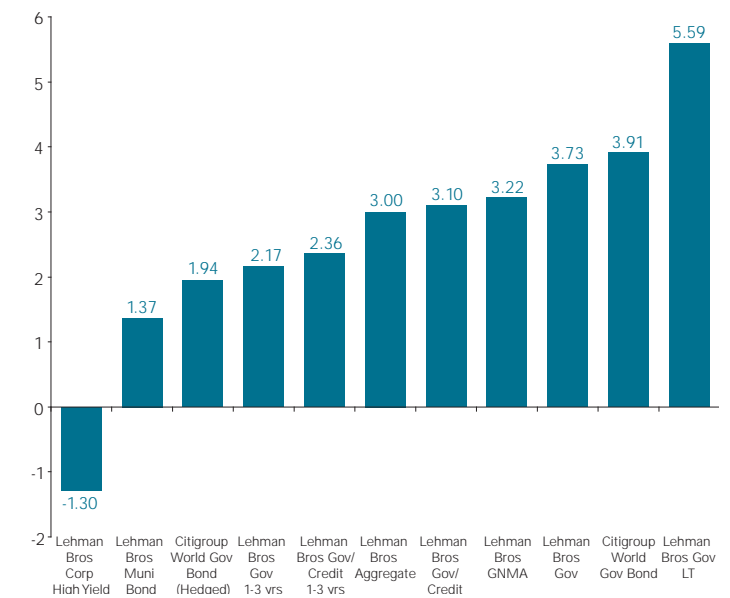
## Benchmark Indices

### Domestic Equities



Source: FactSet

### Fixed Income

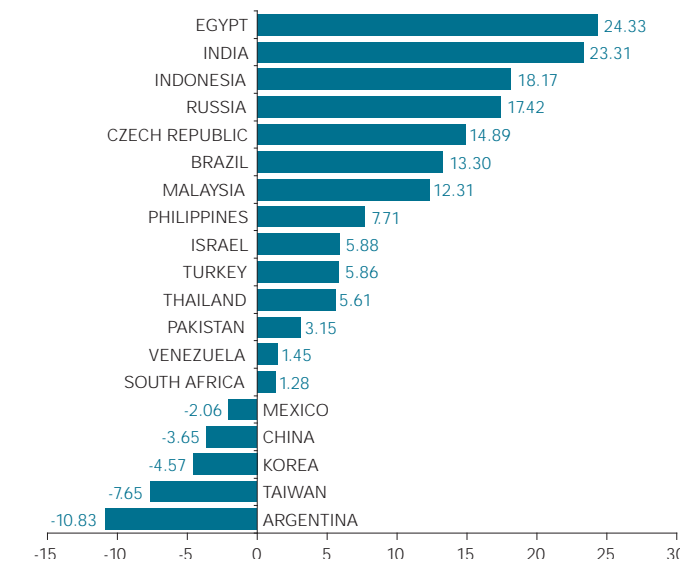


Source: FactSet

Please see last page for index descriptions. All indices are unmanaged and include reinvested dividends. One cannot invest directly in an index. Past performance is no guarantee of future results.

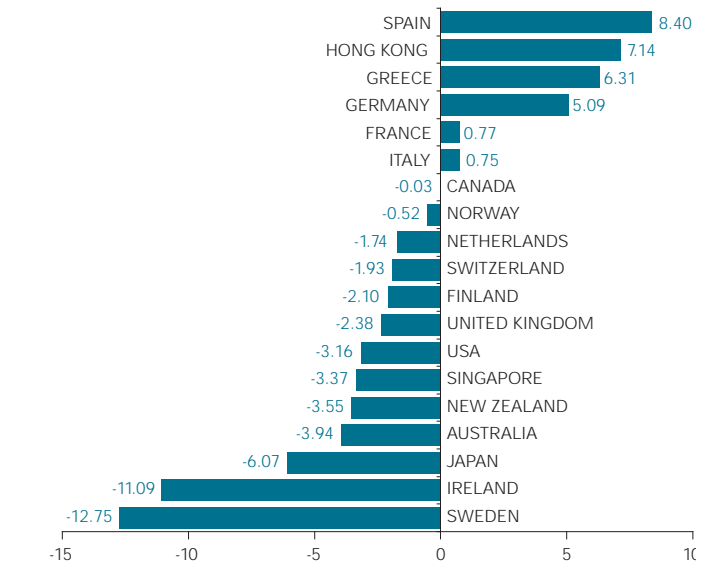
## Emerging and Developed Market Indices

### Emerging Markets



Source: FactSet

### Developed Markets



Source: FactSet

Please see last page for index descriptions. All indices are unmanaged and include reinvested dividends. One cannot invest directly in an index. Past performance is no guarantee of future results.

## Economic/Financial Market Overview

### THE U.S. ECONOMY DECELERATED IN Q407, WEIGHED DOWN BY HOUSING AND CONSUMER SPENDING; POISED TO SLOW IN 2008, BUT AVOID RECESSION

- The fourth quarter of 2007 saw the slumping housing market finally spill over into the other sectors of the economy.
- The weak housing market and a continued deceleration in the labor market combined to slow consumer spending in Q4 after a torrid pace in Q3.
- Business capital spending accelerated in Q3 2007, but some caution on the part of business likely contributed to a slowdown in Q4.
- The value of the dollar compared to major trading partners' currencies declined to all-time lows during the fourth quarter, helping to boost exports and limit imports.
- While the risk of recession has moved up considerably, we think timely and aggressive action from the Fed along with still solid corporate balance sheets will allow the U.S. economy to avoid a recession in 2008.

### U.S. STOCKS SUCCUMB TO MORTGAGE AND CREDIT TURMOIL; DRIVERS TO COMBINE FOR ABOVE AVERAGE PERFORMANCE

- U.S. stocks fell in Q4 as the subprime mortgage crisis brought massive write-downs from financial companies and exacerbated recession concerns.
- Large Caps and Growth continued to outshine Small Caps and Value; Consumer and Financials stocks led the major averages lower.
- We are forecasting that U.S. stocks, measured by the S&P 500, will post a gain of 10–16% in 2008.
- We expect contributions from all drivers of total return: a rebound in earnings growth, rising valuations, and double-digit dividends per share growth.
- We expect 6–8% EPS growth in 2008 for S&P 500 companies, exceeding 2007's pace, reversing the trend from slowing to accelerating.

### FOREIGN STOCKS FOLLOW U.S. MARKETS DOWN, WITH EXCEPTION OF EMERGING MARKETS; SLOWER GLOBAL GROWTH ON TAP FOR 2008

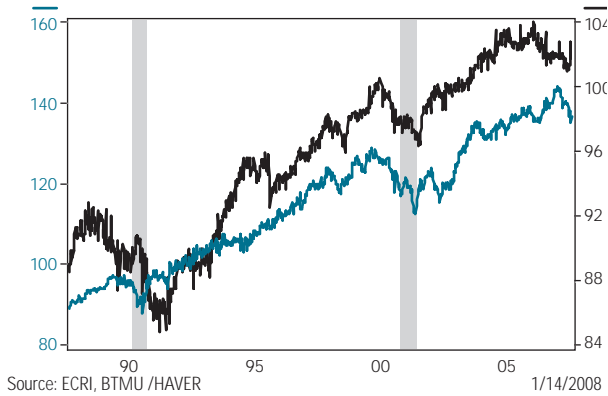
- The MSCI EAFE Index fell modestly in Q4, falling prey to the global credit squeeze and snapping a streak of nine consecutive quarters of gains.
- Like the U.S., Large Caps and Growth beat Small Caps and Value; Financials were a drag, as was Technology.
- Emerging Markets capped off a very strong year with Q4 gains, benefiting from robust growth and strong commodity markets.
- Economists see a convergence of Gross Domestic Product (GDP) forecasts around the world for 2008, with a global mid-cycle slowdown and rate cuts by many of the world's central banks.
- Developed economies are expected to slow to 2% real GDP growth in 2008; for emerging economies, real growth of 6-7% over the next 12 months is likely.
- We expect developed foreign markets to lag those in the U.S. and Emerging Markets in 2008.

### FLIGHT-TO-SAFETY RALLY POWERS BOND MARKET TO BEST PERFORMANCE SINCE 2002; WITH RECESSION WORRIES BUILT IN, WE EXPECT LOWER RETURNS IN 2008

- Heightened risk aversion stemming from subprime related losses helped push bonds to their best performance since 2002, led by Treasuries.
- Performance in non-Treasury sectors was more muted. Long-term bonds outperformed short-term bonds. Municipal underperformance persisted.
- We continue to focus on high quality intermediate bonds as the economy slows and the Federal Reserve continues to cut interest rates.
- Treasuries look overvalued following safe haven buying; good relative value can be found in non-Treasury sectors.
- On aggregate, we expect lower bond market returns in 2008, reflecting lower yields and limited potential for additional price appreciation.

## Key Economic Charts

**ECRI Weekly Leading Index 1992=100**  
**Dow Jones-Bank of Tokyo Mitsubishi UFJ:**  
**U.S. Business Barometer Index 2000=100**

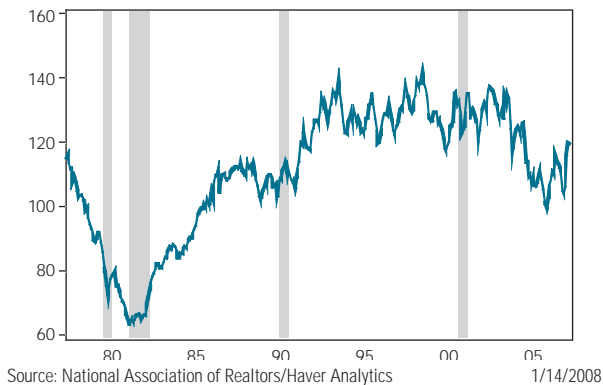


### Recession Odds are Rising, but Economy will Avoid Recession

Both the Dow Business Barometer and the Economic Cycle Research Institute (ECRI) leading index faltered during Q3 2007, and continued to move lower in Q4 as the liquidity crisis brought on by the subprime mess intensified. On balance, the Dow Business Barometer index has been subdued due to its home purchase index component, while the ECRI index moved sharply lower in the second half of 2007 as all the financial components came under pressure and jobless claims moved higher through year end. Only a sharp rise in industrial prices helped to boost this index in Q4. We have raised our odds of a recession in 2008, but with aggressive action from the Federal Reserve, the economy can skirt a recession.

(In all charts, the shaded areas represent recessions.)

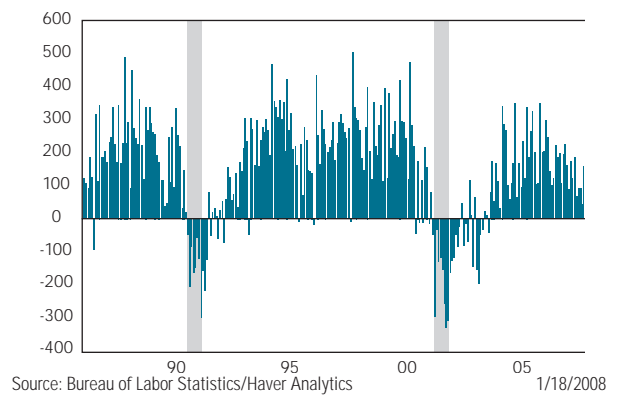
**Composite Housing Affordability Index**  
**Median Inc=Qualifying Inc=100**



### Sharp Rebound in Affordability in 2007, but Availability is Now the Key

A strong labor market, rising incomes, falling home prices, and more recently falling mortgage rates have driven the housing affordability index higher since the beginning of 2006. Despite the rebound, housing affordability remains well below its early 2000s peak, and the subprime crisis has led to a restriction of mortgage lending in some areas of the market, which will offset the recent rise in affordability. In addition, the recent sharp slowdown in employment may jeopardize any further improvement in the affordability index. Thus, we now expect housing will continue to be a drag on GDP growth well into 2008, but by the second half of the year, housing may begin to move off the bottom.

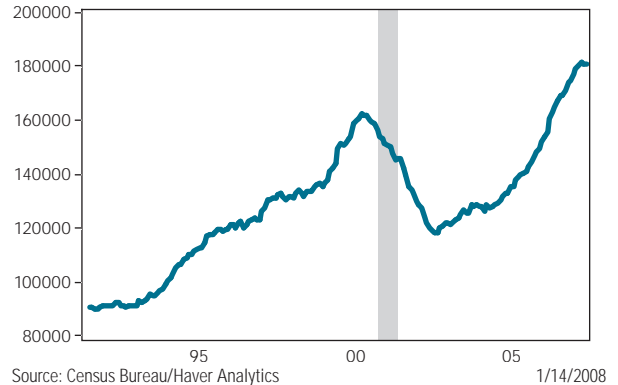
**All Employees: Total Nonfarm**  
**Difference - Period to Period SA, Thous**



### Job Growth was Solid, Not Spectacular, in 2007

While job growth in the U.S. economy has been decelerating over the past 18 months, this is not an atypical trend for this point in the business cycle. Despite the deceleration, the U.S. economy has still created nearly two million jobs over the past year. Strong job growth has kept wage growth running at a solid pace, which in turn has provided a solid backdrop for consumer spending, even as housing activity declined. However, the weak December jobs report – including the uptick in the jobless rate to 5.0% – called into question the underlying strength of the labor market. But, the good news is that the report seemed to jolt awake the Federal Reserve, which now stands ready to prove “substantive” stimulus to the economy.

**Mfrs' Unfilled Orders: Nondefense Capital ex Aircraft**  
**EOP, SA, Mil.\$**

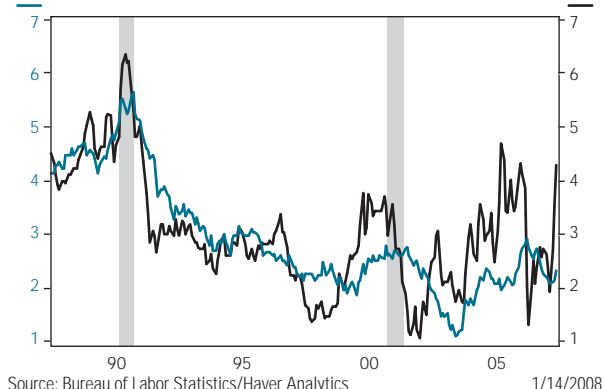


### Business Capital Spending may Have Paused in Q407, Poised to Move Higher in 2008

Unfilled orders for non-defense capital goods – a good proxy for future business capital spending – leveled off a bit in Q4, suggesting that capital spending may not be a big contributor to GDP growth in late 2007 and early 2008. Looking ahead however, aggregate corporate cash balances remain very high by historical standards, funding for capital expenditures is now extremely cheap given the recent drop in Treasury yields, and improving productivity remains a key way to survive in the increasingly competitive global marketplace. Over the course of 2007, capital spending on technology soared, while spending on transportation and industrial equipment stagnated. We expect that a sustained uptick in business capital spending will help to offset a slowdown in consumer spending in late 2007 and early 2008.

## Key Economic Charts

**CPI-U: All Items Less Food and Energy**  
 % Change - Year to Year SA, 1982-84=100  
**CPI-U: All Items % Change - Year to Year SA, 1982-84=100**

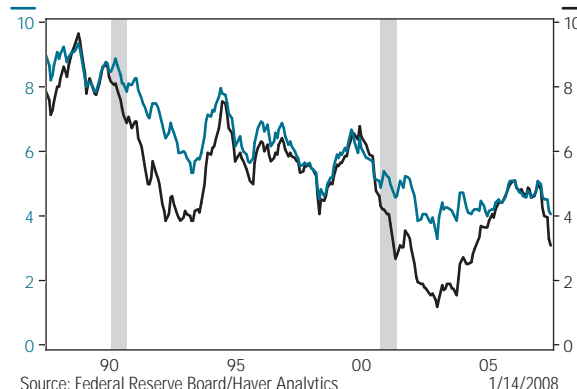


Source: Bureau of Labor Statistics/Haver Analytics 1/14/2008

### Core Inflation Appears to be Under Control

The total CPI (Consumer Price Index) inflation rate reaccelerated sharply in mid-to-late-2007, and now stands 4.1% above the rate a year ago. However, the "core" CPI (excluding food and energy) continued to head in the right direction over the course of 2007, moving down to 2.4%, down from nearly 3.0% in the fall of 2006. Headline inflation continues to be driven higher by food prices (+4.9%yoy) and energy prices (+17.6%yoy). The benign core inflation backdrop gave the Fed ample room to cut rates further in 2008.

**10-Year Treasury Note Yield at Constant Maturity % p.a.**  
**2-Year Treasury Note Yield at Constant Maturity % p.a.**



Source: Federal Reserve Board/Haver Analytics 1/14/2008

### Bond Market Breaks Out of Trading Range as Risk of Recession Rises

The subprime driven liquidity crisis in July and August drove yields on the 10 year note down to lower end of the 4.25% to 5.25% trading range it has occupied since late 2005. As the crisis re-intensified in late 2007 and early 2008, bond yields fell further and recession fears rose. The yield curve has steepened, suggesting that the market is pricing in aggressive rate cuts from the Fed to help shore up the economy. At the end of Q4, the yield curve – as measured by the spread between the yield on the 10 year note and 2 year note – was at its steepest since late 2004.

(In all charts, the shaded areas represent recessions.)

**Nominal Trade-Weighted Exch Value of US\$ vs Major Currencies Avg, 3/73=100**

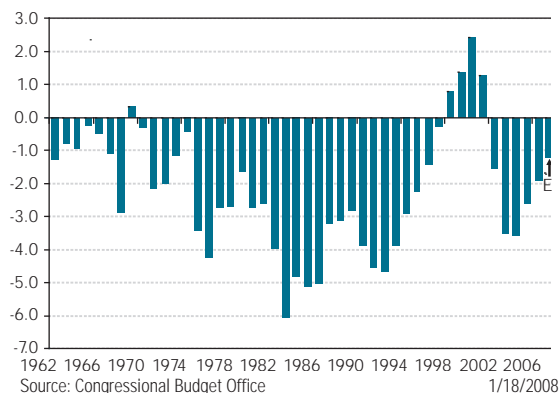


Source: Federal Reserve Board/Haver Analytics 1/14/2008

### The Dollar Exchange Rate Declined Again in Q4 to a New All Time Low

Over the course of Q4 2007, the US dollar exchange rate moved lower, falling to a new all time low versus the currencies of its major trading partners in late November. The dollar managed to rally off those lows through yearend, but the downward slide resumed in 2008. On balance, the US dollar declined about 10% against the currencies of its major trading partners in 2007, and since hitting an all time high in early 2002 is down 35%. However, the "orderly adjustment" (5% or so per year) in the dollar over the past six years has not been detrimental to the U.S. economy. In fact, the weaker dollar has helped to boost exports – U.S. exports of goods and services are up 13%yoy, and have been running at a 10%+ yoy pace for almost four years – and has also helped to slow import growth, boosting U.S. economic growth. This narrowing of the trade deficit has helped to offset some of the weakness in the housing market.

**U.S. Budget Deficit (Fiscal Years, % of GDP)**



Source: Congressional Budget Office 1/18/2008

### U.S. Budget Deficit Improved Again in FY 2007

The deficit for FY 2007 (which ended September 30) came in at \$163 billion, roughly \$90 billion below the FY 2006 deficit of \$248 billion. Just a year ago, the deficit in 2007 was projected to come in at \$286 billion, but a stronger than expected economy, and in particular stronger corporate profits, helped to drive the deficit lower. At 1.2 % of GDP, the FY 2007 budget deficit was the lowest since 2001, when the U.S. government ran a budget surplus.

## The U.S. Economy

### U.S. Economy decelerated in fourth quarter, weighed down by housing and consumer spending

The fourth quarter of 2007 saw the slumping housing market finally spill over into other sectors of the economy. So, economic activity as measured by inflation adjusted growth in gross domestic product (GDP) is likely to have slowed considerably from the torrid 4.9% pace of growth seen in Q3. We currently expect Q4 real GDP growth in the range of 1.5% to 2%. Housing indicators continued to deteriorate in Q4, while offsets from net exports, consumer spending, and business spending on real estate and capital goods weren't as strong in Q4 as they were in Q3 2007.

Consumer spending in Q4 also slowed relative to the pace seen in Q3 due to the combination of the weak housing market and continued deceleration in the labor market. Core retail sales rose at just a 3% annualized pace in the quarter, after posting a 5% annualized gain in Q3, suggesting a lackluster Q4 for nondurable spending. Light vehicle sales rose at a 6.4% annualized pace in Q4 after a 4.4% annualized decline in Q3, signaling a decent

quarter for durable goods spending. On balance, with wage and salary growth rising nearly 7%yoy, solid support remains in place for consumer spending, though the deceleration in employment over the final few months of 2007 is a concern.

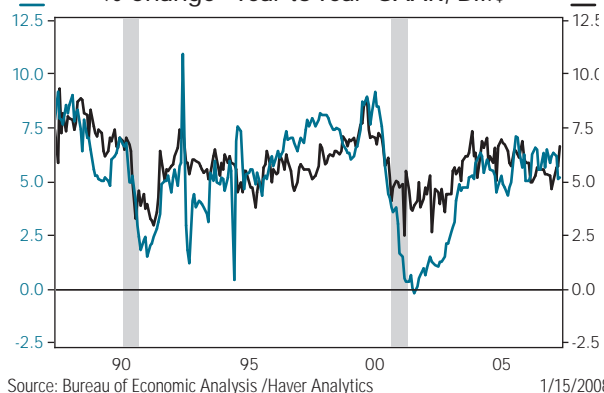
Even though business capital spending accelerated in Q3 2007, some caution around the health of the economy contributed to a slowdown in business capital spending in Q4, despite healthy balance sheets and record low interest rates. Signaling this modest deceleration in Q4, shipments of capital goods excluding aircraft – a good proxy for business capital spending– rose just 3% in Q4 after the 6% gain in Q3.

The bad news is that the housing market did not find a bottom in Q4, and will most likely continue to be a drag on the economy through early 2008. The good news is that the housing sector accounts for just 5% of U.S. GDP. Housing related data in Q4 was awful. Existing home sales, new home sales, housing starts, building permits, new home prices, existing home prices, and residential housing construction spending all fell at a double digit pace between Q3 and Q4, and in many cases the declines steepened over the course of Q4.

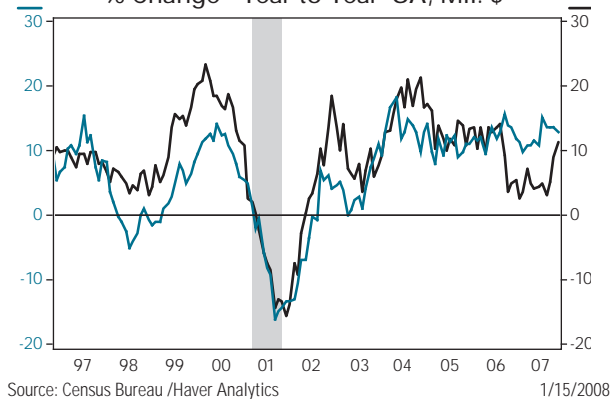
One item that has been largely overlooked is the extraordinary strength in non residential construction – i.e., business capital spending on real estate – over the past few years. As homebuilding has languished, business spending on construction has boomed, up 19% over the past 12 months, while housing construction is down 18%yoy. However, there have been a few tentative signs that even this heretofore solid component of the construction market was slowing as 2008 began.

The value of the dollar declined to all-time lows during the fourth quarter, helping to boost exports and limit imports. U.S. exports of goods and services are up 13%yoy, and have been running at a 10%+ yoy pace for almost four years. Though imports surged 11.4%yoy in late 2007 as oil prices shot higher, they had been running in the 3 to 5% range for most of 2007, reflecting the slowing U.S. economy and the price impact of a weaker dollar. Soaring exports and decelerating imports combined to allow the trade deficit to narrow over the past 12 months, helping to offset some of the weakness in the housing market, but oil prices hovering stubbornly near \$100 threaten this ongoing improvement in the trade imbalance in 2008.

**Wage and Salary Disbursements**  
% Change - Year to Year SAAR, Bil. \$  
**Personal Consumption Expenditures**  
% Change - Year to Year SAAR, Bil. \$



**Exports: Goods and Services, BOP Basis**  
% Change - Year to Year SA, Mil. \$  
**Imports: Goods and Services, BOP Basis**  
% Change - Year to Year SA, Mil. \$



## Outlook for the U.S. Economy

### U.S. poised to slow in 2008, but will avoid recession

While the risk of recession has moved up considerably over the latter part of 2007, we think timely and aggressive action from the Fed along with solid corporate balance sheets will allow the U.S. economy to avoid a recession in 2008. The housing market recession is likely to persist well into 2008, and prospects for consumer spending are clouded by the weak housing market, stubbornly high oil prices, and slowdown in job growth. However, the outlook for the export sector and business capital spending look quite promising, aided by a weak US dollar and strong corporate balance sheets. On balance, we see the U.S. economy slowing in 2008, but avoiding an outright recession. Our forecast for low and stable inflation provides the Federal Reserve (the Fed) the leeway to continue to cut interest rates as needed.

The housing recession in place in the U.S. for two years will likely persist into early 2008. While the inventory of new homes for sale has diminished in 2007, and housing affordability has risen sharply, the availability of mortgage credit has been compromised somewhat in recent quarters, suggesting to us that the backdrop for the housing market will continue to be challenging in the medium term.

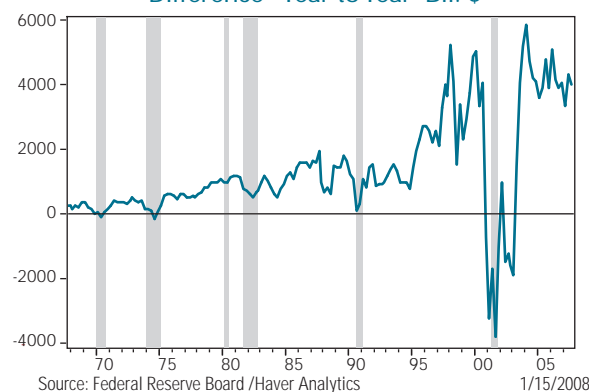
Until the fourth quarter of 2007, we had seen only limited “spillover” from the subprime crisis into other areas of the economy. However, our thesis that low unemployment, solid wage gains, and rate cuts by the Fed would serve as a favorable backdrop to consumer spending was called into question in December 2007 as oil prices remained stubbornly high and the unemployment rate spiked up to 5%. Thus, it is now likely that consumer spending growth will slow from the torrid pace of the past several years to a 1.5 to 2% pace over the course of 2008. While slower job growth, high oil prices, and a difficult environment for housing may well constrain consumer spending, massive housing price gains – 60% since the end of the recession in 2001 and more than 100% over the last 10 years – provide a solid floor for consumer spending. While it’s true that recent house price declines have modestly eroded some of these gains in housing wealth, household wealth is still growing at a brisk pace. The net worth of U.S. households – measured by their wealth minus their debt – rose by \$4.0 trillion in the 12 months through Q3 2007, up 7.3%.

We continue to expect that business capital spending will surpass consumer spending as a driver of the economy in 2008. Although we expect a slowdown in profit growth in the first half of 2008, corporate balance sheets reveal overall cash levels and debt-to-net-worth ratios that are very healthy, providing support for a solid pace of business spending. Availability of credit is a concern

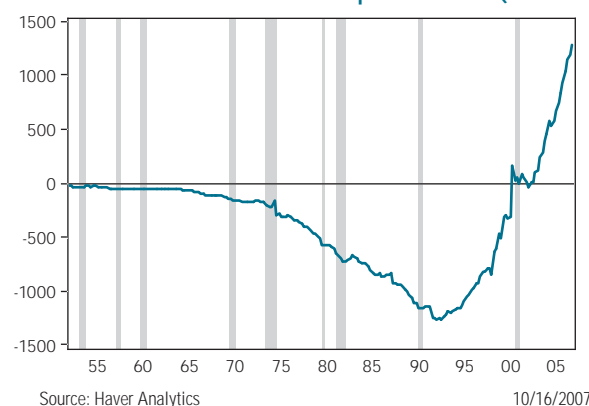
among a very small subset of firms, but on balance, the banking sector is still willing and able to lend to those corporations looking to expand their businesses and become more competitive.

In early January, Fed Chairman Ben Bernanke strongly hinted that the Federal Open Market Committee (FOMC) is likely to start to become more aggressive in its rate cuts. That the Fed now seems to understand the severity of the crisis and is willing to act to forestall further deterioration in the economy supports our thesis that the economy will avoid a recession in 2008, but still grow slowly until the cumulative effects of the rate cuts begin to work their way through the economy.

### Households, Non-profit Organizations: Net Worth Difference - Year to Year Bil. \$



### Financial Assets Less Liabilities of All U.S. Nonfinancial Corporations (billions)



## The U.S. Equity Markets

### U.S. stocks succumb to mortgage and credit turmoil

U.S. equity markets fell in the fourth quarter as the subprime mortgage crisis brought massive write-downs on financial company balance sheets and exacerbated concerns that the economy was headed for recession. Uncertainty surrounding the severity and duration of the mortgage problems and magnitude of spillover effects offset the market's tendency to finish calendar years with gains. Financial services stocks bore the brunt of the selling pressure, due to write-downs from some of the largest firms on Wall Street and sharp declines in the sector's profits and profit growth expectations.

Though some factors limited the magnitude of the quarter's declines, the S&P 500 was unable to avoid its first "correction" since early 2003 (defined by most Wall Street strategists as a 10% or greater decline). The S&P 500 fell 10.1% from the October 9 market peak through November 26. The Fed provided some support for stocks with liquidity injections and 50 basis points of cuts to the fed funds rate, which helped stabilize the credit markets and encouraged some intermittent bargain hunting. At the same time, hopes increased that the Fed would cut more aggressively going forward. Sizable investments into the financial sector from the private sector and sovereign wealth funds to take advantage of attractive valuations provided some support for equity values. Finally, strong earnings growth from companies insulated from the mortgage turmoil and housing market downturn supported some of the market's other sectors, preventing the broad averages from falling further.

Quarterly returns for the Dow Jones Industrial Average, S&P 500 Index and NASDAQ Composite were -3.91%, -3.33% and -1.82%, respectively. The lackluster finish led to modest returns for the major averages for the year. The NASDAQ's 9.77% return led the way,

Sector Performance (%) through January 11, 2008				
	Q3 2007	Q4 2007	2007	2008 YTD
Energy	9.8	4.4	34.4	-4.4
Technology	6.3	0.1	16.3	-9.5
Industrials	5.9	-4.6	12.0	-6.6
Materials	4.9	0.1	22.5	-3.9
Consumer Staples	4.8	3.8	14.2	-1.2
Health Care	1.1	0.0	7.2	3.5
Telecom Services	2.1	-5.1	11.9	-6.1
Utilities	2.0	7.6	19.4	1.8
Financials	-4.3	-14.3	-18.6	-5.3
Consumer Discretionary	-6.3	-10.0	-13.2	-7.9
<b>Total (S&amp;P 500)</b>	<b>2.0</b>	<b>-3.3</b>	<b>5.5</b>	<b>-4.5</b>

Source: FactSet, LPL Financial Research

Past performance is no guarantee of future results.

followed by the 8.85% and 5.49% returns for the Dow and S&P 500.

In terms of style performance, Growth and Large Caps continue to shine during the fourth quarter. Growth investments outperformed their Value counterparts across the entire market cap spectrum. The Value benchmark was dragged down by sharp declines in financial services stocks, mostly classified as Value, while Growth investments garnered support from the resilient performance of traditional Growth sectors. Based on the Russell 3000 style indices, Growth outpaced Value by about 680 basis points for the quarter and 1240 for the year.

Credit concerns led investors to increasingly favor stronger balance sheets that tend to be associated with larger capitalized companies. Larger companies also tend to perform better during the latter portion of business cycles when the economy slows. These mostly multi-nationals continue to benefit from greater exposure to more favorable growth prospects in overseas markets. The large cap Russell 1000 Index outpaced its small cap counterpart, the Russell 2000 Index, by more than 130 basis points for the quarter and by over 730 basis points for full year.

The sector story can be characterized as the good (Utilities, Energy, Staples), the bad (Consumer Discretionary), and the ugly (Financials). Though the Financials sector suffered the biggest fourth quarter decline among the 10 economic sectors due to the subprime crisis, returning -14.33% based on the S&P 500 Financials sector index, it was not the only weak spot. Evidence that consumers were tightening their belts and further deterioration in housing pressured the Consumer Discretionary sector, which returned -10%. Financials and Consumer Discretionary were the only two sectors in negative territory in 2007, with declines of -18.63% and -13.21%. Substantial declines in housing and mortgage related stocks took a major toll on these two sectors last year.

On the plus side, high energy prices lifted the Energy sector to a 4.42% return for the quarter, finishing off another year in the top spot of the sector rankings with a 34.4% return in 2007. Utilities was the top-performing sector during the fourth quarter, benefiting from investors' preference for defensive income investments and from higher energy prices. Strength in metals and mining and agricultural products companies led the Materials sector to a 22.53% return for the year, despite a flat fourth quarter. The influential Technology sector, also flat during the quarter, returned a solid 16.31% for the year and helped to offset some of the declines in consumer and financial stocks.

## Outlook for the U.S. Equity Markets

### Drivers combine for above average performance

We expect 2008 to be a rewarding year for investors. We are forecasting that U.S. Stocks, measured by the S&P 500, will post a gain of 10–16% in 2008 with contributions from all drivers of total return: a rebound in earnings growth, rising valuations, and double-digit dividends per share growth.

- Earnings - S&P 500 operating earnings per share growth in 2008 is likely to match or exceed the pace of 2007, as the trend in growth is reaccelerating after slowing in 2007. The year-over-year growth rate went from nearly 20% in the third quarter of 2006 to negative in the fourth quarter of 2007.
- Valuations – as measured by the 12-month forward price-to-earnings ratio for S&P 500 companies, are expected to rise in 2008 from the 2007 average of about 15. We expect the P/E ratio to extend the gain from the trough of just below 14 in mid-2006 to near 16 by the end of 2008. At current levels, each point that the P/E rises adds about 6–7% to the total return of the S&P 500.
- Dividends per share growth has remained in the double digits even as EPS slowed in 2007. In fact, dividends per share for S&P 500 companies has been growing at a double-digit pace over the past 15 quarters, setting a new record. We expect this double-digit pace to continue in 2008, extending the record-breaking streak.

Focusing on earnings per share growth, we expect 6–8% EPS growth in 2008 for S&P 500 companies, exceeding 2007's pace, reversing the trend from slowing to accelerating, and setting the stage for a return to double-digit growth in 2009. Historically, EPS growth has averaged 7%. But over the course of the business cycle growth varies considerably, falling 20% during a recession, rebounding 20-30% following the recession, pausing during the mid-cycle slowdowns ('84 – '86 and '96 – '98), and then reaccelerating as the cycle draws to a close. The mid-cycle slowdown in economic and profit growth has once again unfolded in 2006–07. We believe we experienced the trough in year-over-year growth at the end of 2007 and that growth will begin to reaccelerate in the first quarter of 2008.

How can profits begin to reaccelerate? Revenue growth should start to rebound. In addition, profit margins may remain near record highs and actually begin to expand by yearend 2008. Only the Energy, Industrial and Material sectors are at extended margins – net profit margins for most other sectors are average or low relative to their history.

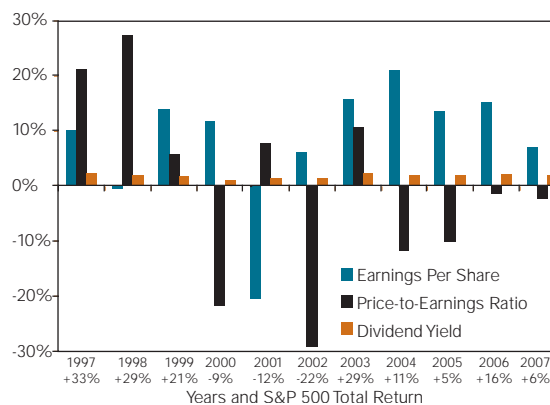
What are investors willing to pay per dollar of earnings in 2008? We expect the 12-month forward price-to-earnings ratio for the

S&P 500 companies (the current price of the index divided by the expected EPS of the companies in the index over the next 12 months) to rise from the average of about 15 in 2007 to about 16 in 2008. A look back at valuations for the S&P 500 confirms that P/Es have actually expanded historically as earnings growth slowed during the middle stage of the business cycle and also as earnings reaccelerated. The forward P/E bottomed in mid-2006 at about 14. Our outlook for just one point of P/E expansion from the current 15 to about 16 by yearend 2008 is modest compared to the rapid expansion of two to three points a year that took place in the second half of the 1980s and 1990s business cycles. Helping to drive higher valuations is a shift in earnings growth from low to high P/E sectors. Overall valuations should rise as high P/E growth sectors, such as Information Technology, continue to post above average earnings growth, and low P/E sectors, such as Financials, reflect below average growth. At current levels, each point that the P/E rises adds about 6–7% to the total return of the S&P 500.

The four-quarter sum of dividends per share for S&P 500 companies has been growing at a double-digit pace over the past 15 quarters, setting a record. With the percentage of earnings paid out in the form of dividends at all time lows of about 30%, there is plenty of room for DPS to exceed the pace of EPS in 2008, as they did in 2007. This rapid pace of dividend-per-share growth is the result of high corporate cash balances, lean spending on acquisitions and capital, changes in executive compensation, and a renewed emphasis on corporate governance and shareholder interests.

When all three drivers of total return (earnings growth, valuation expansion, and dividends per share growth) are moving in the same direction, the results have been very positive for stock market performance, as we saw in 1997, 1999, and 2003. We expect above average total returns in 2008 of 10–16%.

### Total Returns are Above Average When All Three Drivers are Positive Contributors Contribution to Total Return by Component of S&P 500 Performance



Source: Standard and Poors, Bloomberg, Factset Research Systems, LPL Financial

## Fixed Income Markets

### Classic flight-to-safety rally powers bonds to strong quarterly performance

Heightened risk aversion stemming from sub-prime related losses persisted in the fourth quarter and helped push bonds to their best performance since 2002. A steady flow of negative headlines including big write-downs at large banks and recession worries extended the flight-to-safety rally that began mid-year. Treasuries led the bond market to its best performance since 2002 in this rally.

Unfortunately, performance in non-Treasury sectors was much more muted and made for a difficult environment. Both corporate and mortgage-backed bonds underperformed Treasuries by a wide margin. The same was true of asset-backed (ABS) and commercial mortgage-backed securities (CMBS). As an example, the average A-rated bond underperformed U.S. Treasuries by 5.5% on a duration-adjusted basis. In many respects, this disparity made 2007 a more difficult environment than 2002, which was plagued by WorldCom and Enron fraud and 10% default rates. As a result, many mutual fund managers underperformed their benchmarks despite being invested in high quality securities.

Although 2- to 5-year Treasury yields declined 1.2% to 1.8% in 2007, compared to a 0.4% to 0.6% decline in the 10-year and longer maturity Treasury yields, long-term bonds outperformed short-term bonds. Treasury yields finished the year at their lowest levels since late 2003.

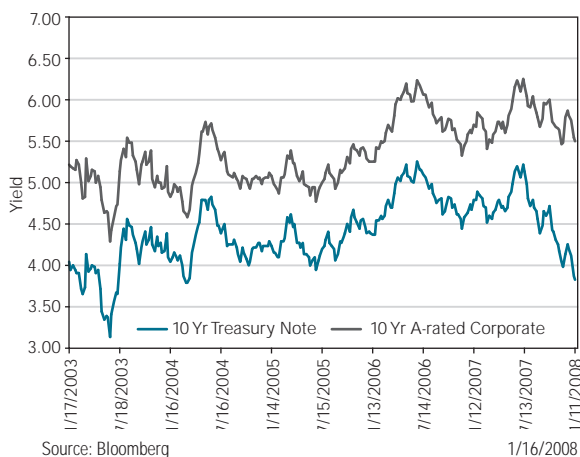
The opposite was true in the municipal bond market, where short and intermediate bonds outperformed long-term bonds. Two- to 10-year municipal yields declined, while yields on 15-year and longer maturity bonds actually increased as their prices dropped. This disparity with the Treasury market on longer-term bonds (Treasury prices higher, municipals lower) was unprecedented and led to underperformance of tax-free bonds.

The supply/demand imbalance that prompted municipal underperformance in Q3 persisted in Q4. New issuance for 2007 was 10% higher than 2006 and eclipsed the prior record in 2005 by almost 5%. Institutional investors, who had become a major source of demand, remained sidelined, as capital was needed to address margin calls and sub-prime related investments. Similarly, major Wall Street trading firms continued to keep inventories light as result of being capital restrained. Federal Reserve data shows Wall Street firms pared municipal inventories by 16% during Q3. A smaller investor base was simply not able to cope with increased supply, and prices declined on long-term issues, where the bulk of supply resided.

Both municipal and taxable high yield markets were among the worst performers last year, as lower rated bonds underperformed high quality bonds. After a brief bounce in October, November initiated another round of selling as risk aversion increased. The weakness occurred despite the default rate declining to 0.9% by the end of 2007. The average yield advantage of high yield bonds to Treasuries closed 2007 at 6.1%, slightly above the historical average.

Foreign bonds hedged for currency movements lagged their U.S. counterparts. In addition to the flight-to-safety buying, the Fed interest rate cuts aided U.S. bonds, while most foreign central banks held benchmark rates unchanged. Un-hedged foreign bonds were the top-performing fixed income asset class in 2007, due to currency gains resulting from a sharp drop in the US dollar. Emerging market bonds, which had begun 2007 on a strong note, finished on a weak note as investor risk aversion finally affected the sector in Q4.

Taxable Bond Yields



## Outlook for Fixed Income Markets

Recession worries already built into bond yields; we expect lower returns in 2008

On aggregate, we expect lower bond market returns in 2008, reflecting lower yields and limited potential for additional price appreciation. In fact, yield levels reflect a bond market that has for the most part already priced in a recession. As of mid-January, the 2-year Treasury note was yielding 2.6%, well below the current 4.25% Fed Funds rate and suggestive of multiple Fed Rate cuts. Fed Fund futures indicate a similar, although slightly less extreme, view and imply a 2.75% terminal Fed Funds rate. Furthermore, the yield on the 5-year Treasury Inflation Protected Security (TIPS) is below 1.0%, indicating a grim view of economic growth over the next five years.

We disagree with such pessimistic pricing but continue to focus on high quality intermediate bonds as the economy slows and the Fed continues to cut interest rates. Additionally, we believe that inflation is not a threat and that a now steeper yield curve also supports our rationale to maintain an intermediate focus. In sum, we see little downside risk to holding intermediate bonds, and they continue to play a key role in a diversified portfolio.

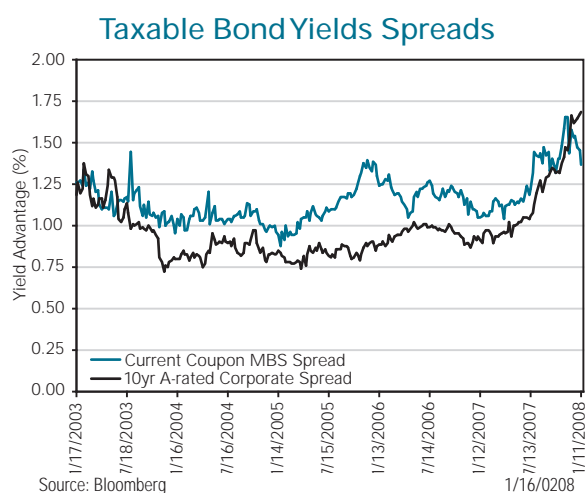
Among high quality intermediate bonds, Treasuries remain quite overvalued following safe haven buying. However, good relative value can be found in non-Treasury sectors, such as mortgage-backed bonds and corporate bonds, which lagged in 2007 but now possess some of the widest yield spread differentials to Treasuries in many years. As of mid-January, the average yield of an investment grade corporate bond finished 2007 2% above comparable Treasuries, and the average par priced mortgage-backed bond offered a yield 1.7% above comparable Treasuries. Both yield spread measures are at their widest levels of the past five years.

In the municipal market, the supply/demand imbalance appears to be correcting, thanks in part to nearly all segments of the municipal market offering at similar rates to those of U.S. Treasuries. Investors could essentially purchase AAA rated municipals and get the tax benefit for free. The cheaper valuation coupled with a decline in new issuance has helped municipal bonds get off to a positive start. New issuance is projected to decline 5% in 2008. Institutional interest will likely be slow to pick up, so any meaningful richening versus Treasuries will likely take several months. On a longer-term basis, the prospect of potentially higher taxes would bode very well for municipal bonds. We find municipals offering good relative value as we enter 2008.

We view high yield bonds as fair to cheaply valued; however, we do not expect a sharp improvement over the coming two quarters. We expect prices to stabilize and the now much higher income

to benefit investors, particularly in light of more expensive high-grade bond valuations. High yield bonds face headwinds of a heavy new issuance calendar (an overhang from postponed LBO related deals) and a reduced investor base still reeling from credit losses. Damage to the high yield sector occurred so quickly last year that a substantial rise in defaults is already priced into the market for 2008. Later in the year, economic improvement may foster yield spread narrowing from the current level of 6.75% above Treasuries.

We continue to avoid foreign bonds both hedged and un-hedged for currency gains. Un-hedged foreign bonds performed very well in 2007, but the bulk of performance resulted from a depreciating US dollar. Hedged foreign bonds, on aggregate, now exhibit yields roughly equivalent to domestic bonds, but we prefer to wait for a yield advantage to develop.



## Foreign/Emerging Markets

Foreign stocks follow U.S. markets down; emerging markets the exception

Foreign developed markets followed the U.S. lower during the fourth quarter. The MSCI EAFE Index fell 1.7%, snapping the streak of nine consecutive quarters of positive returns. A falling dollar boosted dollar-based returns by 120 basis points. Broadly, international stocks fell prey to the same challenges facing the U.S. markets, as the credit squeeze and mortgage mess affected financial services companies abroad. The U.K., the largest country weight in the developed foreign benchmark, fell 2.4% as the country battled housing and mortgage problems of its own. The second largest component of the benchmark, Japan, fell 6.1% during the quarter on weak consumption and export pressures from the strong yen and U.S. slowdown. Germany, Spain and Greece generated positive returns.

Foreign developed markets beat the S&P 500 for the sixth straight year. The MSCI EAFE beat the S&P 500 Index for the sixth consecutive year with its 11.6% overall return in 2007. The boost from currency effects was over 700 basis points – the EAFE returned just 4.0% in local currency. For the year, eleven countries in the index produced returns over 20%, including Germany at 35.9%. The only countries within the index that posted negative returns were Japan, which declined 4.1%, Ireland and Belgium. For Japan, it was the first loss in five years.

Style trends overseas looked a lot like those in the United States. Large cap stocks continue to outperform their smaller counterparts in the international markets. International Large Caps outperformed their smaller counterparts, as measured by the MSCI EAFE Large Cap and Small Cap Indexes, by 310 basis points for the quarter and 980 for the year. In addition, as in the U.S., Growth outpaced Value for both the quarter and the year, by 300 and 1030 basis points, based on the MSCI EAFE Growth and Value Indexes.

Surprisingly, Financials were not the worst international sector performer. The Technology sector was actually the worst performer in the developed foreign markets during the fourth quarter, with its 7.6% decline, though Financials, with its much bigger weighting in the index, was a bigger detractor to market returns. Financials, which compose nearly 27% of the benchmark, fell 5.2% for the quarter. The international markets are more value-oriented collectively than the U.S., partly due to a lower Technology weighting. Consumer Staples, Energy, Telecom and Utilities were the only positive sectors during the quarter, as more defensive names came back in favor and energy prices continued to climb.

For the year, the only sector unable to finish in positive territory was Financials, which fell 2.3%. Sub-prime mortgage and credit turmoil plagued global markets through much of the second half of the year. Materials, the best performing sector in 2007 with a nearly 30% return, moved higher as many commodity prices rose.

### MSCI EAFE Sector Performance (%) Through December 31, 2007

	Q4 2007	2007
Energy	3.5	21.9
Technology	-7.6	6.7
Industrials	-3.7	17.2
Materials	-3.5	30.3
Consumer Staples	5.4	24.0
Health Care	-2.5	0.9
Telecom Services	6.8	28.8
Utilities	8.3	23.3
Financials	-5.2	-2.3
Consumer Discretionary	-3.4	4.5
<b>Total MSCI EAFE</b>	<b>-1.7</b>	<b>11.6</b>

Source: LPL Financial Research, FactSet, and Morgan Stanley

Emerging Markets capped off a very strong year with solid fourth quarter gains. The MSCI Emerging Markets Index returned 3.7% during the fourth quarter, outpacing the developed foreign markets by about 540 basis points. Developing markets continue to benefit from robust economic and profit growth and strong commodity markets. These markets have, by and large, remained insulated from the U.S. slowdown and credit squeeze. Russia, Brazil and India were the leading countries contributing to positive index returns in the fourth quarter, while declines in Asian countries including China, South Korea and Taiwan detracted from index performance. Energy and Telecom were the top-performing sectors during the quarter, while Technology and Materials suffered the biggest declines.

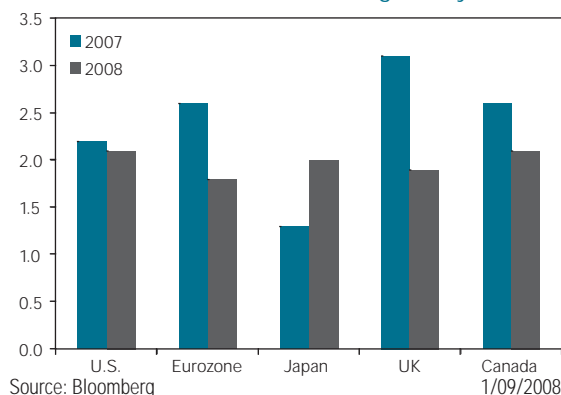
The 39.8% return for the MSCI Emerging Markets Index in 2007 marked the fifth consecutive positive year and seventh consecutive year ahead of the large cap developed markets, measured by the S&P 500 and the EAFE. Brazil, India and China each had returns greater than 50%, while the miniscule Argentina and Luxembourg markets were the only two in the index that posted negative returns for the year. Materials, Energy and Industrials led, while Technology lagged.

## Outlook for Foreign/Emerging Markets

### Slower global growth on tap for 2008

The outlook for international markets is increasingly linked to the U.S. Economists see a convergence of GDP forecasts around the world for 2008, with a global mid-cycle slowdown and period of rate cuts by many of the world's central banks.

**GDP Growth Rates Converging in 2008**  
GDP Growth Rate Consensus of Bloomberg Survey of Economists

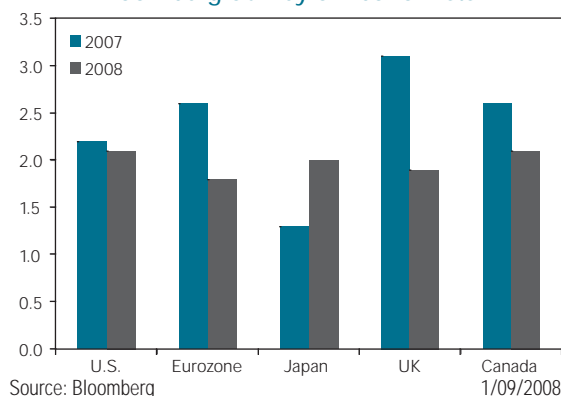


the credit crisis, and the strong euro. The Japanese economy remains troubled by the combination of weak consumer spending, slow corporate reform, political uncertainty, soaring raw material prices, and a strengthening yen.

While the developed industrial economies are expected to slow to a 2% real GDP growth in 2008, continued strength is likely for the emerging economies, with real growth of 6-7% over the next 12 months. Given the emerging economies' robust, internally-generated demand, they should be able to grow despite a typical mid-cycle slowdown in the developed economies. China is forecast to enjoy another year of double-digit economic growth. Latin America and Emerging Europe are both forecast to see healthy economic growth in 2008, if not as strong as 2007. However, this "de-coupling" would be unlikely to persist in the event of a recession among the world's major economies. Earnings growth is likely to remain resilient in the emerging markets in 2008. While the developed world has experienced downgrades to growth expectations in recent months, the less financially exposed Emerging Markets continue to enjoy earnings growth upgrades.

With our expectation of continued aggressive rate cuts by the world's central banks and strengthening global economic activity likely in the second half of 2008, we believe that developed foreign equity markets will provide investors with gains in 2008. We expect stock market performance will be similar to relative earnings growth in 2008, with developed foreign markets lagging those in the U.S. and Emerging Markets.

**Year-End Central Bank Policy Rates Expected to be Lower in 2008 across Most Countries and Regions**  
Year-End Central Bank Policy Rates from Consensus of Bloomberg Survey of Economists



The deterioration in developed world GDP forecasts and in leading economic indicators has important implications for corporate profits. The earnings growth rates of non-U.S. equities have been more economically sensitive than U.S. companies' in the past, which makes sense given their higher weightings in economically sensitive manufacturing-based industries compared to their relatively more service-oriented U.S. counterparts. While Wall Street analyst expectations tracked by IBES reflect EPS growth rates in developed foreign markets similar to those of the U.S. in 2008, we believe the economic slowdown will be more of a drag for the non-U.S. markets.

It is not simply the slowdown in exports to the U.S. that is weighing on international economies. The European economy is slowing with a lag, reflecting the impact of past policy tightening,

# World Market Returns

MSCI Mexico + 12.15%    MSCI Canada + 30.24%    MSCI USA + 6.03%    MSCI United Kingdom + 8.39%    MSCI France + 14.03%



MSCI Venezuela + 3.06%

MSCI Argentina - 4.02%

MSCI Brazil + 79.99%

MSCI South Africa + 18.14%

# World Market Returns



Source: MSCI  
YTD through December 31, 2007  
\*Gross Returns

Please keep in mind that past performance is no guarantee of future results and that investment return and principal value fluctuate with changing market conditions.

**IMPORTANT DISCLOSURES**

There are risks involved with investing, including possible loss of principal. In addition to the normal risks associated with equity investing, narrowly focused investments, investments in smaller companies and investments in single countries typically exhibit higher volatility. International investments may involve risk of capital loss from unfavorable fluctuations in currency values, from differences in generally accepted accounting principles or from economic or political instability in other nations.

Indices are unmanaged and cannot be invested into directly.

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

Selling bonds prior to maturity may make the actual yield differ from their advertised yield and may involve a loss or gain. Bond values will decline as interest rates rise and are subject to availability and change in price.

Investing in real estate/REITS involves special risks such as potential illiquidity and may not be suitable for all investors. There is no assurance that the investment objectives of this program will be attained.

Municipal Bonds are subject to market and interest rate risk if sold prior to maturity. Interest income may be subject to the alternative minimum tax. Federally tax-free but other state and local taxes may apply.

**INDEX DESCRIPTIONS**

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 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. It is not possible to invest directly in an index.

The Russell 1000 Index measures performance of 1000 large cap, US companies.

The Russell 2000 Index measures performance of 2000 small cap, US companies.

The Russell 3000 Growth and Value Indices measure the performance of growth and value stocks respectively.

Russell 2000® Growth Index measures the performance of those Russell 2000 companies with higher price-to-book ratios and higher forecasted growth values.

Russell 2000® Value Index measures the performance of those Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values.

Russell 1000® Growth Index measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values.

Russell 1000® Value Index measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values.

MSCI EAFE is an index of approximately 1,045 equity securities issued by companies located in 21 countries and listed on the stock exchanges of Europe, Australasia, and the Far East. All values are expressed in U.S. dollars.

The Lehman Brothers 1-3 Year Government/Credit Bond Index is a market value weighted performance benchmark for government and corporate fixed-rate debt issues with maturities between one and three years.

The Lehman Brothers Municipal Bond Index includes investment-grade, tax-exempt, and fixed-rate bonds with long-term maturities (greater than two years) selected from issues larger than \$50 million.

Lehman Brothers Aggregate Bond Index is made up of the Lehman Brothers Government/Credit Bond Index, Mortgage-Backed Securities Index, and Asset-Backed Securities Index, including securities that are of investment-grade quality or better, have at least one year to maturity, and have an outstanding par value of at least \$100 million.

Lehman Brothers Government Bond Index is made up of the Treasury Bond Index and the Agency Bond Index as well as the 1-3 Year Government Index and the 20+ Year Treasury Index.

The Lehman Brothers Government/Credit Index (The Index) is an unmanaged index presented for comparative purposes only. The Index represents securities that are U.S. domestic, taxable, and dollar denominated. The Index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities. The Lehman Brothers Government/Credit Index is the most appropriate performance and style benchmark for our Market Duration product. This Index is used because it most closely resembles the characteristics possessed by the Market Duration composite.

The Lehman Brothers U.S. Corporate High Yield Bond Index is an unmanaged index that measures the performance of intermediate (1 to 10 year) U.S. high yield issues. It includes fixed-rate, non-investment grade debt issues rated Ba1 or lower by Moody's, rated BB+ or lower by S&P, rated below investment grade by Fitch Investor's Service or if unrated previously held a high yield rating or have been associated with a high yield issuer, and must trade accordingly. Investors cannot invest directly in this index.

The Lehman Brothers Long-Term Government/Credit Bond Index is an unmanaged index that includes fixed rate debt issues rated investment grade or higher by Moody's Investors Services, Standard & Poor's Corporation or Fitch Investor's Service, in order. Long-term indices include bonds with maturities of ten years or longer. Investors cannot invest directly in this index.

The Lehman Brothers Government National Mortgage Association (GNMA) Index consists of all fixed-rate, single family, securitized mortgage pools backed by GNMA.

Lehman Brothers Treasury Long Term Bond Index is composed of all bonds covered by the Lehman Brothers Treasury Bond Index with maturities of 10 years or greater. Total return comprises price appreciation/depreciation and income as a percentage of the original investment. Indexes are rebalanced monthly by market capitalization.

Citigroup Non-\$ World Govt Bond Hedged: The Citigroup Non-US Government Bond Index is calculated on a market-weighted basis and includes all fixed-rate bonds with a remaining maturity of one year or longer and with amounts outstanding of at least the equivalent of US \$25 million. The index excludes floating or variable rate bonds, securities aimed principally at non-institutional investors and private placement-type securities.

Citigroup Non-\$ World Govt Bond Unhedged: The Citigroup Non-US Government Bond Index is calculated on a market-weighted basis and includes all fixed-rate bonds with a remaining maturity of one year or longer and with amounts outstanding of at least the equivalent of US \$25 million. The index excludes floating or variable rate bonds, securities aimed principally at non-institutional investors and private placement-type securities.

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Not Guaranteed by any Government Agency		Not a Bank/Credit Union Deposit