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THE FSAG ADVISOR

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Market and Economic Update

2007 In Review

- The U.S. economy slowed to 2.5% growth as non-U.S. growth remained relatively robust.
- Earnings growth in the United States was below trend for the first time since 2001. The long-term trend for earnings growth is around 7%.
- Short-term rates fell more than almost anyone expected in 2007, and while long rates did not rise, the yield curve steepened.
- Equities experienced another good year with increased volatility. Stock prices advanced more than earnings, so P/E ratios expanded during 2007, particularly in non-U.S. markets.
- The average stock underperformed the broad market averages as large-cap and high-quality stocks outperformed small-cap and low-quality stocks.
- The energy, healthcare, utilities and information technology sectors outperformed.
- The U.S. trade-weighted dollar moved to its lowest level in a decade.
- Volatility and return spreads increased from historically low levels.
- Discussions about issues such as trade policies and tax reform heated up, and we expect such issues to remain at the forefront of political discussions as the 2008 campaign season progresses.

2008 Outlook

Argus' Director of Economic Research, Rich Yamarone, thinks that the U.S. economy will avoid recession in 2008. Rich argues that a fully employed consumer, benefiting from low inflation and interest rates, will increase consumption at a 2.0%-2.5% pace next year. Given the fact that the consumer sector accounts for 70% of GDP, this should keep the economy out of recession.

Argus' Director of Market Strategy, David Ritter, once again anticipates that returns from the stock market will be in the single-digit range. While the falling dollar is expected to help export-based industries such as energy, industrial and technology, the cracks in the credit market and the lack of clarity in the pricing of derivatives suggests to us that the financial services sector will struggle until at least the second half of the year.

Richard Berner of Morgan Stanley thinks the U.S. is headed for a mild recession and that much slower growth is likely in the industrial world.

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2007 Returns

DOW	*8.88%*
S&P 500	*5.49%*
Russell Mid-Cap	*5.60%*
Russell Small-Cap	*-1.57%*
MSCI EAFE	*11.17%*
Lehman US Agg.	*6.97%*
Lehman Muni.	*3.36%*
10 Year Treasury Yield	*4.03%*

2008 Election

An increasing number of American voters are also American investors. As we follow the debates and consider which hopefuls may make their way onto this year's ballot, many of us also wonder how the political season might impact the economy, the markets and our own investment portfolios. This special report takes an early look at this year's political contests, with a particular eye toward providing some thoughts about issues that could potentially affect the markets.

Predicting how financial markets may react to this year's elections, especially at this early juncture, can be tricky business. While the occupant of the White House and his or her policies, together with the makeup of Congress, certainly can affect how markets perform, at the end of the day, market fundamentals historically have proved to be far more important. We believe that asset allocation, valuations, earnings, yields and the other basic determinants of performance will have far more influence on an investor's portfolio than will election outcomes. With that in mind, however, we can make some observations based on the prevailing political landscape and the candidates'

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"Of primary concern to investors is whether the current favorable tax treatment of capital gains and qualifying dividends will be retained. The 15% tax treatment currently is set to expire in 2010..."

stated positions, and can forecast some possible consequences.

One of the reasons that this campaign season has been so intense so early is that it is highly unusual by historical standards. The last time a general election occurred without either an incumbent president or vice president on the ballot was in 1952, after Harry Truman dropped out during the Democratic primaries. You would have to look all the way back to 1928 (when Herbert Hoover defeated Al Smith) to find a time when neither the president nor the vice president was even in the running. This scenario has led to a broad field of candidates from both parties vying for the presidency, which has contributed to the unusually early focus.

From a market perspective, this has meant that the "uncertainty effect" is increased. The candidates have released numerous policy proposals (most lacking in details) involving healthcare plans, trade policies, changes to tax structures, etc., all of which would have some sort of impact on the economy and the markets. Regardless of who wins the primaries and who eventually winds up in the White House, debate and discussion of these issues does create "headline risks" for the markets, a situation that will intensify as we move through 2008. While we believe it is too early to focus on potential market reactions to any of these proposed policies, there are a few specific issues that we believe warrant a closer look at this point.

As the election season has been heating up, we have seen candidates attempting to rally their constituencies with a variety of hot-button issues on both the social and economic fronts. One issue receiving increased attention throughout the year has been trade policies and, in particular, a rise in the call for protectionist policies in the form of increased tariffs, regulations and, in some cases, sanctions. Many Americans, to at least some degree, feel threatened by international competition and the possible job losses that tend to be associated with globalization. These concerns have been exacerbated by a generally slow-growing U.S. economy and stagnant real wages. While these concerns certainly are valid and represent real issues that need to be addressed, we believe politicians have done a poor job of explaining the net benefits that globalization brings to the U.S. economy. As a prime example, many politicians talk about threats to American manufacturing that are caused by cheaper foreign goods, but they fail to discuss the fact that the availability of such goods has allowed consumer spending to remain on track. Overall, we believe the benefits of increased global competition and the lowering of trade barriers outweigh the negatives from an economic and market perspective. While calls for increased protectionism can sound attractive, they also run the risk of slowing the overall economy and adding to inflation concerns via wage pressures. As we enter 2008, we expect trade to remain a hot-button issue and one that could have an impact on the markets.

In addition to trade issues, tax policies have been in the news, with candidates from both parties discussing how they would enact tax reform if elected. Of primary concern to investors is whether the current favorable tax treatment of capital gains and qualifying dividends will be retained. The 15% tax treatment currently is set to expire in 2010, and it remains an open question whether the next president and Congress will extend that date, allow the provision to expire or eliminate it completely prior to 2010. The conventional wisdom suggests that a Democratic president would be inclined to eliminate this tax treatment, while a Republican president would push to keep it. Such discussions bear close watching since tax levels on investments obviously influence the relative attractiveness of equities.

More broadly, tax policies have been in the news lately in the form of discussions surrounding the possible elimination of the Alternative Minimum Tax (AMT). House Ways and Means Chairman Charles Rangel (D, N.Y.) recently proposed legislation that would eliminate the AMT and add a "replacement tax" on higher-income Americans. This particular piece of legislation highlights the ongoing debate about what the appropriate U.S. tax structure should be, although it is unlikely to become law. (It will not be voted on until at least some point in 2008, and even if it is passed, it would certainly be vetoed by President Bush.)

Democrats are arguing that current tax policies benefit the rich at the expense of the mid-

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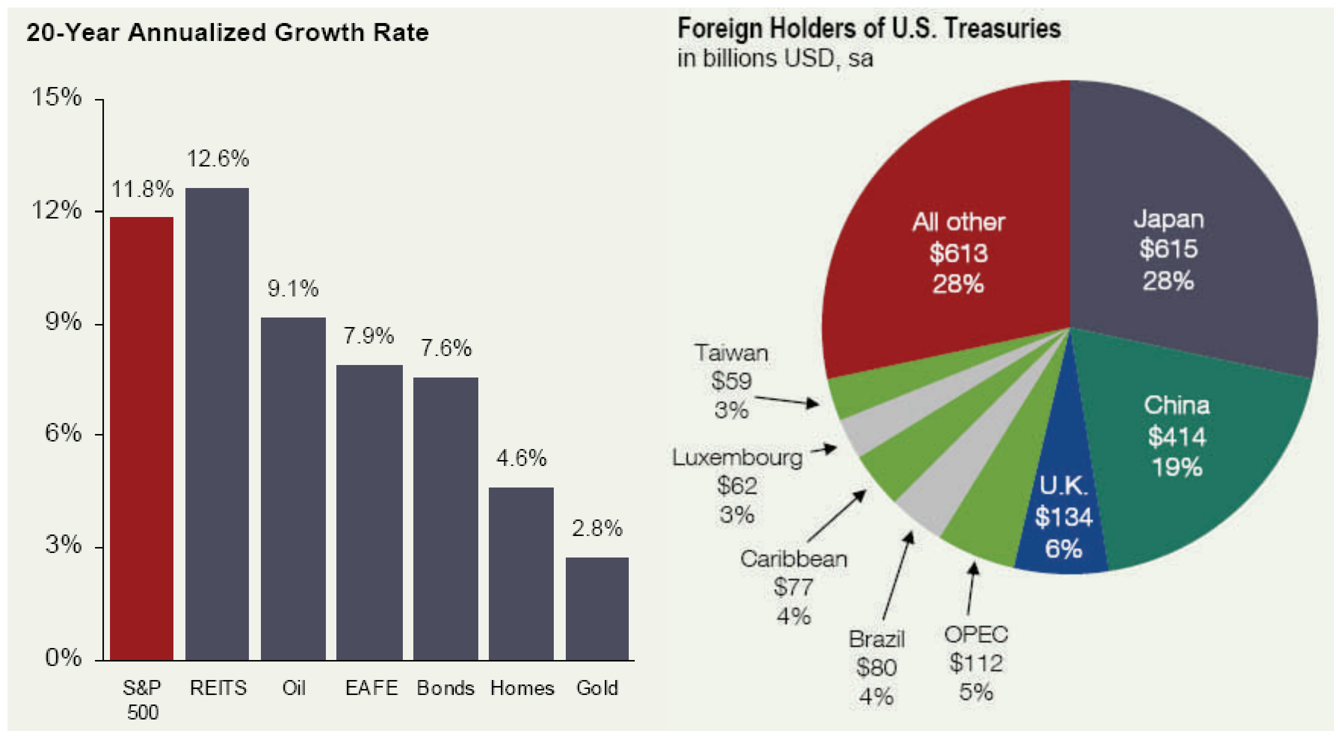
Charts of Interest



2008 Election

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dle class and that the tax cuts enacted under President Bush's watch have increased budget deficits and resulted in the under funding of healthcare and education. Republicans, on the other hand, generally would like to make permanent (and perhaps augment) the Bush tax cuts, arguing that they have stimulated investment and economic growth. We expect that the next president (whoever he or she may be) will likely take the opportunity to attempt to push through some sort of tax restructuring, which would likely have some broad implications for the economy and markets.

One final issue we believe warrants mentioning relates to the potential (or lack thereof) for fiscal stimulus. As candidates discuss broad plans for healthcare reform, new education initiatives and changes in foreign policy, one necessary component of those discussions is cost. Government spending does serve to boost economic growth, but we think it is important for investors to recognize that there is not a lot of room for additional fiscal stimulus in the near term.

The ongoing housing recession, potential decreases in tax receipts from property and sales taxes and, to some degree, declines in income tax revenues have put pressure on government coffers, not only at the federal level, but, in some cases, at the state and local levels as well. The deterioration in government budgets, combined with broadly slower rates of economic growth, point to the reality that, no matter what the candidates are promising, additional government funds will be hard to come by, meaning that investors should not count on a dose of fiscal stimulus to jolt the economy.

Of course, all of the above is speculation at this point, and there undoubtedly will be unforeseen political surprises over the next year that will cause us to reassess our views. At this point, all we can say with any certainty is that the upcoming political season promises to be an interesting one, and one that will bear close watching by market observers.

Source: Bob Doll, Vice Chairman and Director of BlackRock, December 2007

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Stocks in the News: Flextronics International Ltd (FLEX)

Headquartered in Singapore, FLEX is a provider of vertically-integrated advanced design and electronics manufacturing services (EMS) to original equipment manufacturers (OEMs) in industries, including computing; mobile communication devices; consumer digital devices; industrial, semiconductor and white goods; automotive, marine and aerospace; telecommunications infrastructure, and medical devices.

The company provides a range of vertically integrated global supply chain services, through which it designs, builds and ships a packaged product for its OEM customers. The Company's services include printed circuit board (PCB) and flexible circuit fabrication; systems assembly and manufacturing; logistics; after-sales services; design and engineering services; original design manufacturing (ODM) services, and components design and manufacturing.

The trend toward outsourcing should continue as firms recognize the benefits of virtual manufacturing, which allows them to speed up the product cycle, make manufacturing costs more flexible and enjoy lower production costs.

We view FLEX as having favorable industry position, scale advantages and an attractive valuation. Moreover, based on what we see as the company's leadership position, breadth of service offerings and low cost production facilities, we believe it will be able to gain a disproportionate share of future outsourcing contracts.

Key Statistics: FLEX	
Price	*$12.12*
Estimated EPS	*$0.95*
Forecast P/E Ratio	*12.80x*
PEG Ratio	*1.06x*
Dividend	*$0.00*
Market Cap	*$10.08B*
52 Week High	*$13.60*
52 Week Low	*$10.64*
Beta	*1.05*
Expected Annual Growth Rate	*15%*
ROE	*9.4%*

Sources: Argus Research Company, Standard & Poor's, Morningstar

Market and Economic Update

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He also believes that equities have yet to fully discount the bad news and is cautious on the asset class.

Jan Hatzius of Goldman Sachs says that despite the reasonably resilient data, the mood surrounding the U.S. economy is poor. In recent weeks, several prominent forecasters – including some who until recently had taken a relatively optimistic line – have moved to a full-blown recession view. And this sentiment is echoed in most surveys of business and consumer confidence. What would improve the outlook for 2008? A sharp drop in energy prices, an easing in consumer lending conditions, a sharp rally in equities and/or stabilization in house prices.

Merrill Lynch recently unveiled a new recession probability indicator that uses the shape of the yield curve and corporate spreads to predict the probability of a recession. The model is flashing a 100% chance of a recession in the next year. Another model that incorporates the shape of the yield curve and the level of the Fed funds rate is now showing a 50% chance of a recession.

Based on the differences of opinion of these and many other prominent forecasters, no one knows what is going to happen to the markets and economy in the short-run. Over the years, there have been economic recessions, market corrections, horrific natural disasters, attacks on the US, financial crises and many presidential elections. Each time the stock market has experienced corrections, over the long-run, the market has rebounded to new highs. The recent volatility we've been experiencing in the market isn't a first and shouldn't necessarily be cause for alarm, especially if you have a long-term investment strategy in place.

We recommend investors take profits in high flying sectors such as emerging markets, gold and energy, and prepare for volatility in 2008. After 5 years of an up market, a little bit of cash and a defensive posture seems prudent. Given the potential for a democratic presidency and higher taxes and the ongoing credit crisis, we believe now is an opportune time for municipal bonds and closed-end bond funds.

Our clients have long-term investment strategies in place and their portfolios are diversified, balanced and well-positioned for this volatile market and economic environment.

Sources: The Argus Update, Morgan Stanley, Goldman Sachs, Merrill Lynch

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