



4th Quarter 2007-Stock Market Overview

No Rest for the Weary

Heading into the last week of December as this article is being written, we were thinking about headlining this section, "Whew!" as in, "Whew, we are glad this year is over." By far the number one economic (and maybe overall) news story of the year was the sub-prime mess which caused the stock market to round trip from 0% gain to double-digit returns and back due to widespread angst about the future state of the economy. The daily volatility was extraordinary as the stock market overreacted to one news story after another both positive and negative.

As the year ends, we are extremely satisfied [thrilled?] to be where we felt we would be heading into 2007—at high single digits for our equity performance, which is well ahead of the performance for the S&P 500. As a bonus because of the sub-prime mess, bond market performance is better than it has been in five years and we are ahead of our fixed income benchmark this year as well.

Although it appears the year will end on a positive note for stocks and bonds, there is no time to take a breather because we still have many concerns heading into 2008.

L'Volatility, Encore l'Volatility, Toujours de l'Volatility

With apologies to Georges Jacques Danton of French Revolution fame, the theme for 2007 might have been "Volatility, More Volatility, Always Volatility." The only constant during the year was a big move by the stock market either up or down. There were 69 trading days this year with at least a 100-point move in the Dow Jones Industrial Average, 48 of them which occurred since July 1st.

2007 began with the S&P Index at approximately 1416. The S&P 500 rose dramatically and then fell below a positive return for the year three separate times. In early March when investors first became aware of the sub-prime issue and in July and August when the sub-prime issue hit the stock market with full force. Finally in the last quarter in mid-November another downturn occurred when banks continued to write-down assets and reports made it clear that the sub-prime issue was continuing to be serious, widespread and might push the economy into depression.

The stock market rebounded quickly after each downturn because investors seemed to take an ostrich-like approach to the future always choosing to believe that the worst of it was over. In March, investors chose to ignore the warning signs when the mortgage company New Century went out of business and Countrywide struggled. In September the stock market recovered simply because the Federal Reserve cut rates one half of one percent even though the extent of the damage to banks and brokerage companies with exposure to the sub-prime market was unknown. And now the market has partly recovered because investors are buoyed by the hope of future rate cuts and the hope that the slowdown in the economy will not be as bad as previously thought.

We performed well in 2007 because, although we were not perfect, we avoided most of the pitfalls that befell many other investment firms. Between 2003 and 2006 when the bond market was not returning much, we resisted the temptation to compromise the credit quality of our fixed income portfolios. Early this year, we became concerned about the impact of the sub-prime issue and we reduced our weighting in financial corporate bonds especially bonds of banks and brokerage firms that were most likely to be hit. On the equity side of the portfolio we used the same information and we avoided most of the problems in the financial sector as well, either by selling or refusing to own those financial companies that bore the brunt of the pain.

A Look Ahead

We remain concerned about the headline risk for the stock market near term as banks and brokerage firms continue to wrestle with the issue of sub-prime loans. We also remain concerned about the economy slipping into recession because of the problems in the financial sector. Economies do not tend to function well when there are crises in the banking system such as during the Savings and Loan crisis in the early 1990's or the non-existent economic growth in Japan that lasted for an entire decade that stemmed from issues in their banking industry. Because of these concerns, after the stock market recovered in mid-December, we made the decision to underweight equities in our balanced accounts after beginning the year overweighted in equities and slowly reducing throughout the year.

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AT A GLANCE

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What we wish for in the New Year is a slow and steady rise in the stock market to give us a breather from the excitement of 2007.

Longer term we are less concerned about the stock market struggling than we are in the near term despite dire predictions from many prominent financiers including Larry Summers, former Treasury Secretary under Bill Clinton, who puts the odds of a recession at more than 50% and who was quoted as saying that "there is a distinct possibility of a more serious recession that will lead to the worst economic performance since the 1970's." We believe that further rate cuts by the Fed and other Central Banks combined with the liquidity being added around the world to help stimulate bank lending will stave off serious recession. The rate cuts may not catch the economy before there is a mild recession (Fed easing failed to prevent the last two recessions in 1990 and 2001, both of which began after the Fed started cutting rates) but we believe it should be mild at worst.

Election Impact

As anyone not currently in a coma knows, 2008 is a presidential election year. We frequently get asked what impact that may have on the stock market. We will address this in more detail in a future newsletter.

Election years tend to be the best performing years of the four year election cycle with an average gain of 8.4%. Post-election years tend to be the worst. The theory is that the incumbent and the party of the incumbent tend to promote policies that are more economically stimulative

during election years. However, the stock market performance in election years is the worst when the incumbent party (Republicans in 2008) loses the election. The uncertainty of new policies keeps the market nervous and in the 12 years when the incumbent party has lost, the stock market has only gained 1.6% on average. So when you are thinking about whom to pull the lever for in November, please keep this in mind—in the 17 election years in which the incumbent party has won, the S&P has gained a mean of 14%. And the gain has been 18% when the winning party has been Republican. (For all of us Democrats, we are just kidding about trying to influence the elections).

As we demonstrated through our actions and performance this year, we will react as necessary to changing market conditions attempting not to overreact when the situation calls for patience and attempting to act boldly when the situation calls for that as well. Although it can be difficult to make a decision when the market is moving against you, we believe there may come a point in 2008 when it will be time to buy the financial companies that will be the strongest survivors of the current financial crisis. And what we wish for in the New Year is a slow and steady rise in the stock market to give us a breather from the excitement of 2007.

Schiller to Head New H&R Nashville Office

H&R is proud to announce the opening of a new office in Nashville, Tennessee. Stephen M. Schiller has been hired as Vice President in the "Client Wealth Management" department and will manage the new Nashville, TN branch. Schiller will expand Howe & Rusling's client base in the Nashville area.

Schiller comes to Howe & Rusling with over 22 years of military service. He is a retired Colonel in the U.S. Army, with combat tours that include Operations Desert Shield/Storm, Enduring Freedom, and Iraqi Freedom, as well as numerous classified special operations missions. His combat awards include the Silver Star, two Distinguished Flying Crosses, three Bronze Stars, seven Air Medals including one for Valor, and the Purple Heart.

The Tennessee branch is located at: 209 10th Avenue South, Suite332, Nashville, TN, 37203



4th Quarter 2007-Bond Market Overview

Bond Market Rally—Continued signs of economic weakness and the “R” word

Once again, on the heels of an impressive 3rd quarter performance some fixed income sectors continued to rally. Actually, the Lehman Brothers Intermediate Government/Credit index has outperformed the S&P 500 index of equities for the quarter and year to date¹. The following table illustrates that relative performance has been better for U.S. Treasury Notes and U.S. Agencies. The continued uncertainty in the financial sector of the markets (equities and bonds) has extended the “flight to quality” into the safety of sovereign debt obligations.

Start Date: 9/28/2007 End Date: 12/20/2007

Index	Return for Period	Annualized Return
Intermediate U.S. Government / Credit	2.81%	12.97%
U.S Treasury: Intermediate	3.50%	16.32%
U.S. Agency: Intermediate	2.79%	12.84%
Intermediate: Corporate	1.87%	8.50%
Invest. Grade: Industrial - Intermediate	2.47%	11.31%
Invest Grade: Financial Institutions - Intermediate	1.25%	5.64%
Intermediate Utility	2.50%	11.46%
Municipal Bond: 1-10 Yr Blend (1-12)	1.75%	7.91%

Source: Lehman Brothers, 2007

The table below to the left shows the worst performing sectors this past quarter are some of the same ones we identified in the 3rd quarter; Asset-backed securities of Home equity loans & Auto loans, and the financial institutions that provide these loans and Asset-Backed Securities. Not surprisingly the best performing sectors shown on the right below are all related to Government securities (U.S. and Foreign). Additionally, securities of longer maturities have outperformed. The continued shift downward in the Treasury yield curve has benefited longer bonds more than short or intermediate ones.

Worst Performing Sectors

Start Date: 9/28/2007 End Date: 12/20/2007

Index	Return for Period	Annualized Return
ABS Home Equity	-5.24%	-21.06%
Invest. Grade: Financial Institutions - Long	-0.84%	-3.62%
Asset - Backed Securities	-0.28%	-1.23%
ABS Auto	0.84%	3.73%
Invest. Grade: Financial Institutions	0.93%	4.15%

Source: Lehman Brothers, 2007

Best Performing Sectors

Start Date: 9/28/2007 End Date: 12/20/2007

Index	Return for Period	Annualized Return
U.S. Treasury: 20+ Year	6.41%	31.40%
Supranational Long	6.05%	29.46%
U.S. Treasury: Long	5.66%	27.39%
U.S. Government: Long	5.57%	26.94%
U.S. Agency Long	5.24%	25.17%

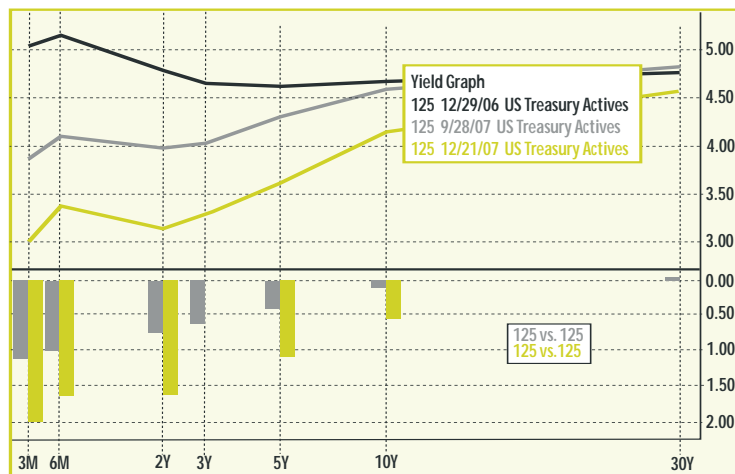
Source: Lehman Brothers, 2007

The following graph shows how significantly Treasury interest rates have decreased year-to-date and for the 4th quarter (as of this writing—12/21/2007). The very short end of the curve has decreased approximately 2% (200 basis points), while the longest part of the curve only 0.25% (25 basis points) year-to-date.

While a big contributing factor to these lower rates is undoubtedly the “flight to quality” that we mentioned earlier, another factor is based on the fundamental belief that our economy’s potential for growth has greatly diminished. The expectation for slower growth in the first half of 2008 is already reflected in the markets (if not totally, close to it). However, based on the current Treasury interest rates above, investors may be pricing in more than just slower growth.

The debate which began two quarters ago continues today; slower growth or recession? We too have addressed the question

YIELD CURVE GRAPH



Source: Bloomberg, 2007

¹Quarterly & YTD returns have been 2.81% and 7.29% versus S&P returns of -3.92% and 4.85% as of 12/20/07.

We believe that further rate cuts by the Fed and other Central Banks combined with the liquidity being added around the world to help stimulate bank lending will stave off serious recession.

in the recent past. Recessions are not easily predictable and most economists are reluctant to forecast recessions because their "track record" to anticipate them has not been good. The forecasting difficulty does not exclude the economists which establish monetary policy at the Federal Reserve. If the FOMC (Federal Open Market Committee) were better prognosticators of impending recessions, in many instances they could be avoided altogether.

The Federal Reserve's job is to balance economic growth against higher prices (inflation). This is a difficult job and requires a fair amount of trial and error to get the "recipe" for monetary policy just right. However, monetary policy (setting short-term interest rates) is not the only ingredient needed to maintain economic stability. The market is a better barometer of future economic conditions. Right now the market seems to be "dictating" terms to the Federal Reserve. It's saying short-term interest rates are still too high. The difference between the Fed funds rate of 4.25% and the current yield on the 2 year Treasury note of 3.19% is very telling. Under normal conditions the two rates should be much closer, with the Fed funds rate being lower. If the market is right, then ultimately the Fed funds rate should be closer to 3% than 4%.

So why is the Federal Reserve not more aggressive in lowering short-term interest rates? Simply put, they're concerned about maintaining balance. While current inflation expectations are moderate, there is the risk that putting more money into circulation to stimulate economic growth could cause prices to increase. Prices could increase because the value of the money (or its "purchasing power") has diminished. This is the difficult dilemma facing our central bank and the health of our economy.

Not all economic news is negative, regardless of what is reported in the media. Unemployment is still relatively low at 4.7%, although higher than the average unemployment rate of 4.5% in the 2nd quarter of 2007. The U.S. foreign trade balance is improving. While we still import more than we export, the net difference is decreasing; that is good news. Many of our corporations are still forecasting earnings growth for 2008. The consumer may be slowing his/her expenditures but they are still a very resilient sector of the economy. So long as employment remains healthy, we believe they will continue to contribute to economic growth. The final chapter in this developing financial market "crisis" is still being written. We are aware of the potential difficulties that lie ahead, but are encouraged that the varied problems are being addressed and that measures are being taken to remedy them.

Recent Developments – Subprime Mortgages and the Contagion Effect

Just this past week S&P (Standard & Poor's) made public the results of a detailed analysis of the subprime exposure of financial guarantee companies. These are the same companies that insure a variety of financial securities, but whose principal business has historically been insuring municipal bonds. It is through this insurance that many municipal bond issues attain the highest credit rating of AAA which in turn allows the very same municipalities and local governments to reduce their cost of borrowing.

The resulting analysis has moderately negative implications for all municipal bonds and could change the role which insurance plays in the municipal market. Briefly, almost all of these financial guarantors' credit ratings have been put on either a negative watch or negative outlook. This is the rating company's (S&P) attempt to "warn" the entire sector that action needs to be taken by the guarantors to increase their capital cushion and/or decrease their exposure to the guarantees on subprime related mortgages or securities. If action is not taken, they run the risk of losing their ability to guarantee the AAA ratings on insured municipal bonds; those already issued and those that would be issued in the future. Many are already taking the appropriate steps to remedy the situation. We are fairly confident that these companies will raise the necessary capital to retain their AAA rating.

What do these developments mean to our clients? In the short-term many of the insured municipal bonds that you currently own are also on negative watch or negative outlook. The potential downgrade is from AAA to AA (the second highest rating). However, we want to assure you that this does not affect the obligation that the respective municipalities or local governments have in making timely payments of principal and interest. The insurance on many of the bonds we buy is intended as an added measure of safety that is rarely needed since we buy only investment grade bonds. States and local governments with investment-grade ratings default on less than 1% of their debt because they can raise taxes and fees, according to a March report by Moody's Investors Service. Furthermore, there is no reason to currently believe that these municipal guarantors would not honor the claims against an insured bond in the event of a default. It's not as though they are going out of business. That business is still insuring and reinsuring bonds. There is time for them to strengthen their financial position.

However, in the near term we and the entire municipal market question whether the value of having insurance is worth the cost. We will monitor the situation as it develops and if the cost is negligible then having it is better than not. Above all we will continue to look to the underlying credit quality of the municipal issue as our primary gauge of risk and return.