

INVESTMENT BACKGROUND

January 2008

Positives

Negatives

ECONOMIC

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| <ul style="list-style-type: none"> • U.S. exports benefiting from weak U.S. dollar and rising middle-class abroad • Inflation still subdued • Interest rates remain at low levels • Non-financial companies are cash rich – can be used for dividend increases, share repurchases, M&A, capital spending • Liquidity – huge pools of investable funds outside U.S. • Foreign interest in buying U.S. assets • Demographic – older, richer population | <ul style="list-style-type: none"> • Global and U.S. economic growth slowdown - chance for U.S. recession/stagflation • U.S. consumer under pressure. Retail sales slowing and more credit/solvency issues • Housing prices still declining • Unemployment rising • Debt bubble—government/consumer debt over \$30 trillion • Negative U.S. savings rate vs. high savings rate abroad • Legacy costs—pensions, social security, healthcare • Dollar instability—central banks are diversifying away from U.S. dollar • Commodity prices, including food, remain high |
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GOVERNMENT FISCAL POLICY

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| <ul style="list-style-type: none"> • Political gridlock • Low tax on capital gains and dividends for now • Possible economic stimulus package | <ul style="list-style-type: none"> • Ongoing federal and state budget deficits • Protectionist/populist economic policy moves by Congress • Post-election probability of tax increases |
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MONETARY POLICY

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| <ul style="list-style-type: none"> • Adequate liquidity available in banking system • Further Federal Reserve action to reduce short-term interest rates | <ul style="list-style-type: none"> • Lending standards are being tightened |
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VALUATION

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| <ul style="list-style-type: none"> • Earnings yield of stocks vs. 10-yr bonds • Avg. level of P/E's reasonable | <ul style="list-style-type: none"> • Low yields—investors income starved • Profit margins historically high |
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(over)

Positives

Negatives

TECHNICAL

- Presidential cycles—4th year usually good for stocks
- Sentiment – many investors are dispirited
- Low cash in mutual funds
- Poor breadth and weak momentum
- Significant weakness in the financial sector

GENERAL

- Stocks reasonably valued versus investment alternatives
- U.S. consumer addiction to debt
- Banking/subprime crisis not resolved
- Proliferation of quick twitch investors—hedge funds, program trading, and derivatives
- Terrorism
- Markets are cyclical—“seven fat years, seven lean”—long bull market period 1982-2000 vs. slowdown 2000-?

CATALYSTS FOR CHANGE

What could make us more bullish:

- Business friendly legislation from Washington
- Pull out from Iraq and Afghanistan
- Lower stock prices
- Financial sector stability
- Corporations boost pace of hiring, capital spending, stock buybacks, and merger activity
- Inflation remains subdued
- Oil prices decline

Key downside risks:

- Recession/stagflation
- Housing prices continue to fall
- Higher inflation and long interest rates
- Financial accident/crisis—hedge funds, Yen carry trade, derivatives, subprime lending/higher consumer default rates
- Oil prices increase significantly
- Dollar collapse—foreign liquidation of U.S. debt, foreign investors stop lending to U.S.
- International crisis—North Korea, Iran, a major terrorism event

SUMMARY

History teaches that the greatest buying opportunities often arrive in periods of extreme stress. At some point, stock prices and valuations become so attractive that investors should be aggressive buyers. We are looking for that point, but do not believe it has yet arrived.

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