STANDARD & POOR'S

INDUSTRY SURVEYS

Trends & Projections

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April 2008

Volatility and Market Bottoms

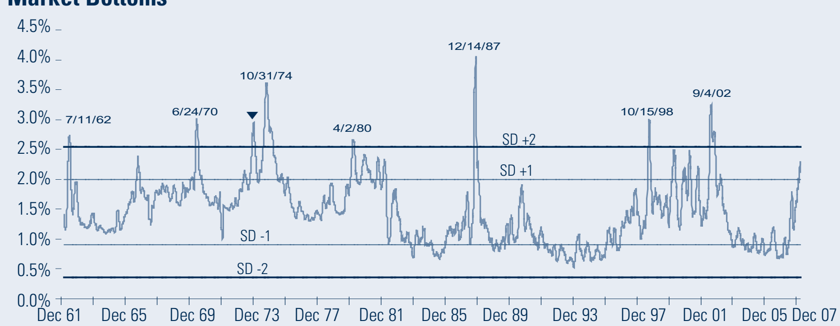
As March comes to a close, we now see that it indeed came in like a lion and went out like a lamb. Month to date through March 10, the S&P 500 declined 4.3% to 1273.37, bringing the total decline from the market's peak (1565.15 on October 9, 2007) to 18.64%. From March 10 through March 28, the "500" advanced 3.3% to 1315.20.

Investors may be wondering whether the equity market is bottoming along with consumer confidence

Reasons for this reversal of fortune, in our opinion, include the prospects that the first-half weakness in S&P 500 earnings per share (EPS) will likely mark the bottom of this earnings contraction, and the realization that the Fed will do whatever it can to stabilize the credit and financial markets. In addition, investors may be wondering whether the equity market is bottoming along with consumer confidence. These words of future comfort don't mask the beating that investors took during the first quarter of 2008, however, as the Nasdaq fell 14.7%, while the S&P 500, MidCap 400, and SmallCap 600 declined 10.4%, 10.0%, and 8.4%, respectively.

Within the S&P Composite 1500 Index (our US Total Market Index), all 10 sectors posted year-to-date declines in price, ranging from tumbles of 4.2% or less for the Consumer Staples and Materials sectors, to slumps of 16.0% or more for the Information Technology and Telecom Services groups. Finally, despite double-digit advances for the Trucking (+14.6%), Homebuilding (+12.3%), and Oil & Gas Exploration & Production (+11.6%) sub-industries, 117 (85%) of the 137 sub-industry indexes in the S&P 1500 fell during the quarter, led by declines in excess of 30% for Oil & Gas Refining & Marketing (–30.6%), Commodity

Spikes in Trailing 3-Month Volatility Have Traditionally Signalled the Approach of Market Bottoms



Sources: Standard & Poor's Equity Research.

Chemicals (–33.2%), Education Services (–35.2%), Wireless Telecom Services (–37.6%), Managed Health Care (–38.7%) and Consumer Electronics (–38.9%).

With results such as these, it's no wonder that price volatility has been on everyone's mind. Adding to this concern, the S&P 500 has registered 16 one-day declines of 2.0% or more in the past 12 months, which is four time the annual average since 1950. Then, on March 18, the "500" surged 4.24% to record the 17th largest one-day increase in nearly 60 years.

Investors are now wondering if this wide variation in volatility is a harbinger of even worse things to come. If history is any guide (it's never gospel), it does not appear to us that volatility has become severe enough to signal that the worst is behind us. Whenever the three-month average of the S&P 500's daily high-low volatility has peaked above 2.55% (two standard deviations above the daily average of 1.45%), the S&P 500 has been about a month away from the bottom of a bear market or sharp and swift corrective action.

Since 1962, the bottoms of the bear markets of 1962, 1970, 1973–74, 1987 and 2000–02, as well as the corrective actions of 1980 and 1998, were identified as being close at hand by a spike in trailing three-month daily intraday price swings for the S&P 500. And while this volatility measure did issue a false signal one year into the 1973–74 bear market, it successfully identified that the end was near for the five worst market declines since 1945, which declined an average of 39%.

As of March 31, the trailing three-month volatility index was below the threshold that would signal a bottom is near. There are two ways to read this. First, we are in a sideways trading period that will be followed by further downside action to be accompanied by a pick-up in volatility. Only after the volatility index has peaked above the 2.55% level would we feel more confident that a bottom was close at hand. The other possibility is that, like the deep bear markets of 1966 (which fell 22%), 1982 (–27%) and 1990 (–20%) that developed more slowly and were less volatile, this corrective action may end up being as subdued as these three, which, as a whole, declined an average of 23%.

Is the worst behind us?

Standard & Poor's Investment Policy Committee believes that from economic, fundamental, technical, and historical perspectives, the second scenario is more likely and that worst is behind us. We see real GDP declining during the first half of 2008, but then advancing in the second half as a result of the economic sugar rush offered to American consumers in the form of a tax rebate, as well as the effects from a year's worth of Fed rate cuts. The yet-to-be-resolved worry is whether US GDP growth will again slip into negative territory once the tax stimulus has worn off.

Fundamentally, we don't expect to see 2008 go down in the S&P 500 earnings annals as a repeat of 2007. As of March 31, Standard & Poor's equity analysts were projecting the market-cap weighted S&P 500 to post a 16.5% increase in EPS for the year, led by double-digit EPS recoveries by companies in the Telecommunications Services, Financials, and Information Technology sectors. Eight of the 10 sectors in the S&P 500 are expected to see double-digit earnings growth in 2008, with only the Industrials and Materials sectors likely to see single-digit advances. Bear in mind, however, that projected earnings increases may tell an overly optimistic story, particularly with financial companies, as mark-to-market writedowns are typically not included in forecasts.

While we believe we haven't performed enough penance to atone for the sins of subprime, we don't tell the market how far it has to fall; it, after the fact, tells us how far it has fallen. Technically speaking, therefore, we believe the onus is now on the bears to prove that the 1270 level of the S&P 500 — which was reached on an intraday basis on January 23 and successfully retested on March 10, in our opinion — will not hold and that we will eventually break below 1250 and thereby enter into a new bear market. What's more, sentiment is extremely negative, which we find to be a typically reliable indicator of major market bottoms.

Trends & Projections

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Historically, the correction of 2007–08 is shaping up similarly to the mini-bear market of 1990. Not only did the S&P 500 and US economy peak within two months of each other this time as they did then, but the 19.9% decline in 1990 is also close to the 18.6% correction experienced from October 9, 2007 through March 10, 2008. Also, while the S&P 500 declined 13.7% six months after the Fed started cutting rates in 1990 — one of only five times since 1945 that the S&P 500 was not higher six months after the Fed began an easing cycle — the S&P 500 was off 13.2% six months after the Fed started cutting rates in back in September 2007. While we have been comfortable advising investors to fight the Fed in the near term, we are not so confident it will be the correct advice longer term. ■

Sam Stovall
Chief Investment Strategist

What I Tell You Three Times Is True

The third consecutive drop in payrolls implies that the economy has clearly moved into recession. We are raising the odds of recession to 80% from 70%. The data still suggest that the recession will be mild; we expect first-quarter real GDP to be only slightly negative. Even now, we expect the economy to improve in the third quarter, as rebate checks are spent. After the stimulus package ends, however, the economy will decelerate; the risk of falling back into recession remains high.

The Federal Reserve is responding to the evidence by not only cutting interest rates more aggressively, but also by being creative in trying to unfreeze financial markets. The problem is that every time markets seem to be calming down, more bad news surfaces and they slide back into recession territory. Various term-lending facilities are being used (for example, $38 billion in loans outstanding to primary dealers in early April), but spreads remain wide. Mortgage markets, in particular, remain tight; even the conforming mortgages are trading relatively high compared with Treasury yields. We now expect another 50-basis-point rate cut April 30, bringing the funds rate down to 1.75%.

Construction remains the major area of weakness. January and February housing sales were stronger than expected, but prices dropped more. This suggests that sellers are capitulating, realizing that price cuts are necessary to sell their homes. At the same time, lower prices and mortgage rates are attracting bargain-hunters, new entrants into the market.

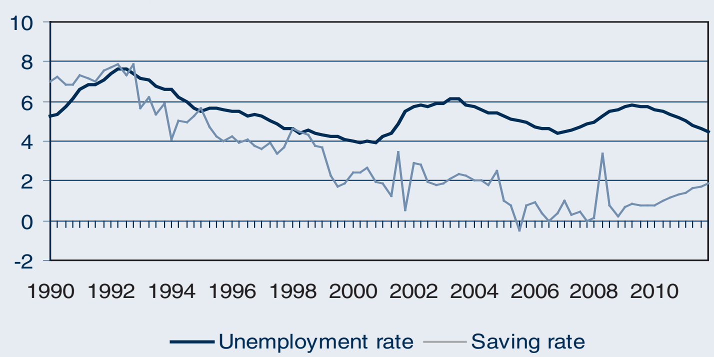
Weak Employment Leads to Weaker Spending

The payroll decline is a problem in itself, but is likely to lead to even bigger problems in the future. When consumers are worried about their jobs, they cut back their spending. Because higher fuel prices are already hitting incomes and falling home prices are cutting wealth, spending has to slow. We don't expect consumers to stop buying, and we still expect that most of the rebate checks will be spent, but the increase in real consumer spending is likely to be reduced to a meager 1.2% in 2008 from 2.9% in 2007.

Auto sales are particularly hard-hit. Tighter credit conditions have made it more difficult for many Americans to buy a car, while higher gasoline prices make it more expensive to drive one. We expect light-vehicle sales to drop to 14.8 million units in 2008 from 16.1 million in 2007. This would make 2008 the worst year for car sales since 1993.

The soft housing picture also hurts consumer spending. Wealth is declining because of low housing prices. Stock prices are still below their 2000 peak. Although net worth remains high compared with the 463% average of disposable income between 1960 and 1995, it is well below its 618%

Exhibit 1
The Saving Rate Rises with Unemployment
(Four-quarter percentage change in real consumption and saving, as % of disposable income)



Source: Bureau of Economic Analysis.

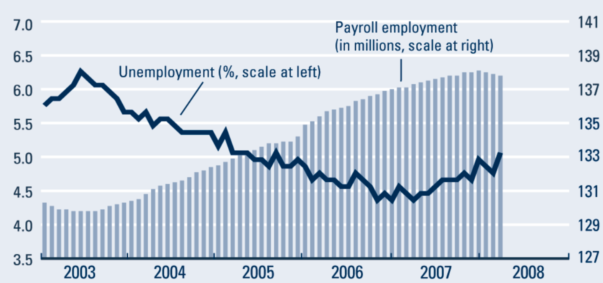
peak in 1999, and we expect it to drop to a low of 508% in mid-2008. However, less wealth will mean greater saving. We have argued for the last few years that a major propellant of the low US saving rate was the high level of wealth. The stock and housing markets were doing households' saving for them. Now, those markets have gone into reverse.

Sagging housing sales also cut retail sales directly, because many household purchases are tied to buying a house. Furniture and appliances are the obvious examples, but even sales of gardening supplies, lawn mowers, and tools increase when homes are bought.

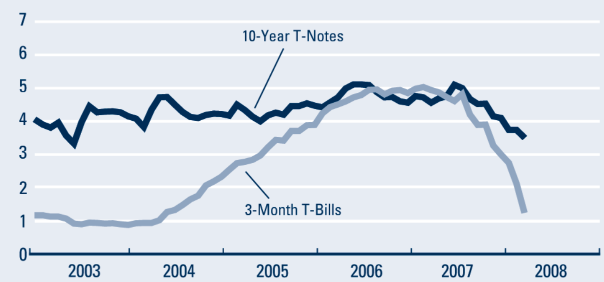
We still expect the tax rebate checks to be spent quickly. Americans may say that they are going to save the money or use it to pay down debt, but even those who do pay down their credit card balances are likely to build them back up rapidly. Analysis of the 2001 tax rebate suggests households spent about 60% of the rebate within 90 days. With this rebate concentrated in lower income brackets, it's reasonable to predict that more will spent this round, but we think that only 50% will spent. The approaching retirement of baby boomers adds urgency to the wealth picture. Most baby boomers do not have enough wealth to retire on comfortably. Reliance on Social Security and Medicare will cause the federal deficit to balloon in coming years. With the leading edge of baby boomers hitting 62 this year, there is too little time to save. Will that result in a flurry of late saving or in delayed retirements?

Retirement shifts may distort the unemployment data. With so many approaching retirement age, the drop

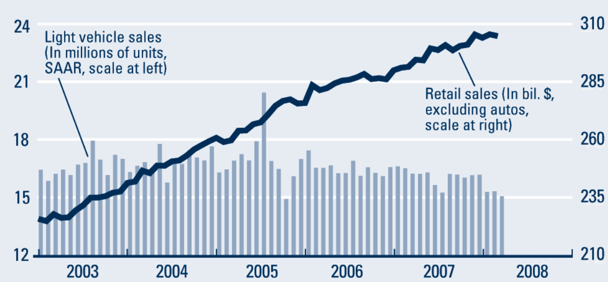
Employment



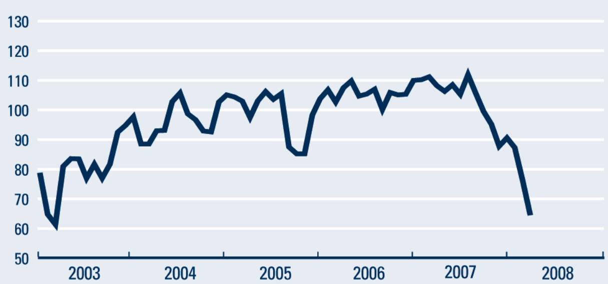
Interest Rates (In percent)



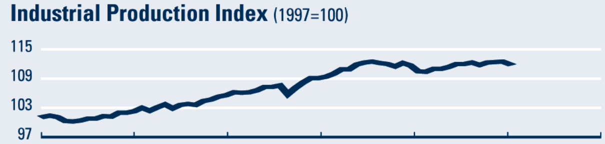
Retail Activity



Consumer Confidence (1985 =100)

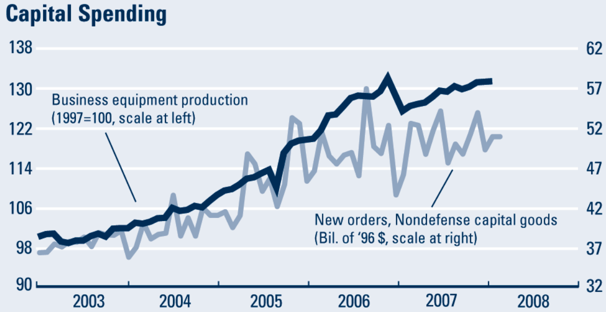


Industrial Production Index (1997=100)



Capacity Utilization (%)

Capital Spending



in employment may result in declining participation rates as older workers decide to call it "early retirement" and take Social Security rather than unemployment benefits. The result may be more volatility in the participation rate, which would stabilize the unemployment rate, but also make it less useful as a measure of labor market pressure.

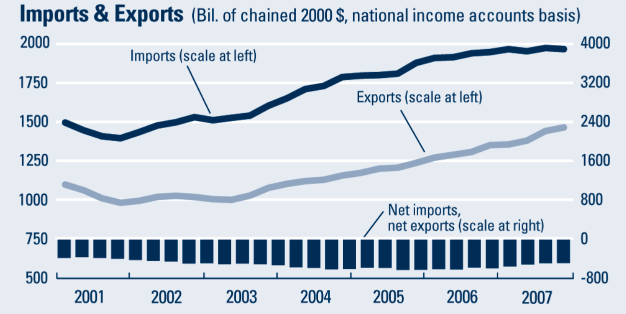
Housing Continues to Slide

Home prices continued to drop in recent months, with the S&P/Case-Shiller home price index for 20 major metropolitan areas down 10.7% in January from a year earlier. On the bright side, sales and starts were slightly stronger than expected. The combination could imply that sellers are finally capitulating and accepting lower prices, while buyers are bargain hunting. On the other hand, the winter data are often misleading, and we shouldn't get too excited until we see the March and April data.

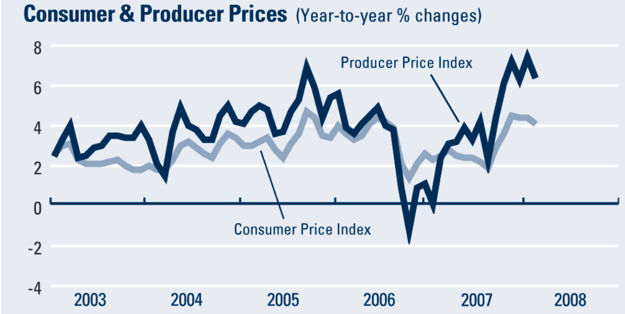
We do not know whether any of the rescue bills in Congress will make it out. The House bill proposes to allow the Federal Housing Authority (FHA) to insure more subprime mortgages. That, of course, won't make the underlying mortgages any safer. It just means that the taxpayer rather than the investor will eat the cost. Homeowners are increasingly treating their mortgages as a put option on their houses. If the house price drops below the mortgage amount, they're mailing the keys back to the bank.

Many of these houses were bought as investments, not as places to live. When the value of the investment drops, people are living free in the house as long as they can, but are

Imports & Exports (Bil. of chained 2000 $, national income accounts basis)

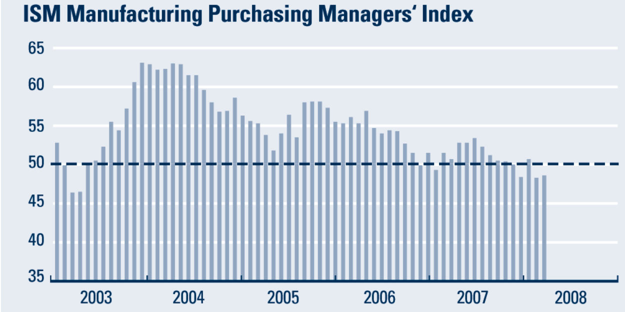


Consumer & Producer Prices (Year-to-year % changes)

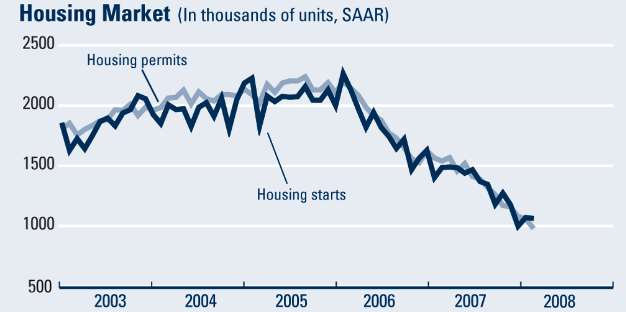


S&P 500 Stock Price Index (Monthly average, 1941-43=10)

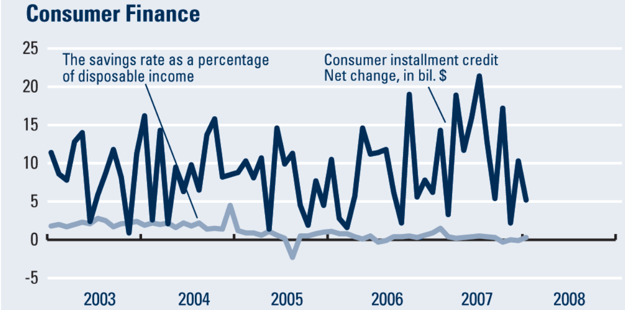
ISM Manufacturing Purchasing Managers' Index

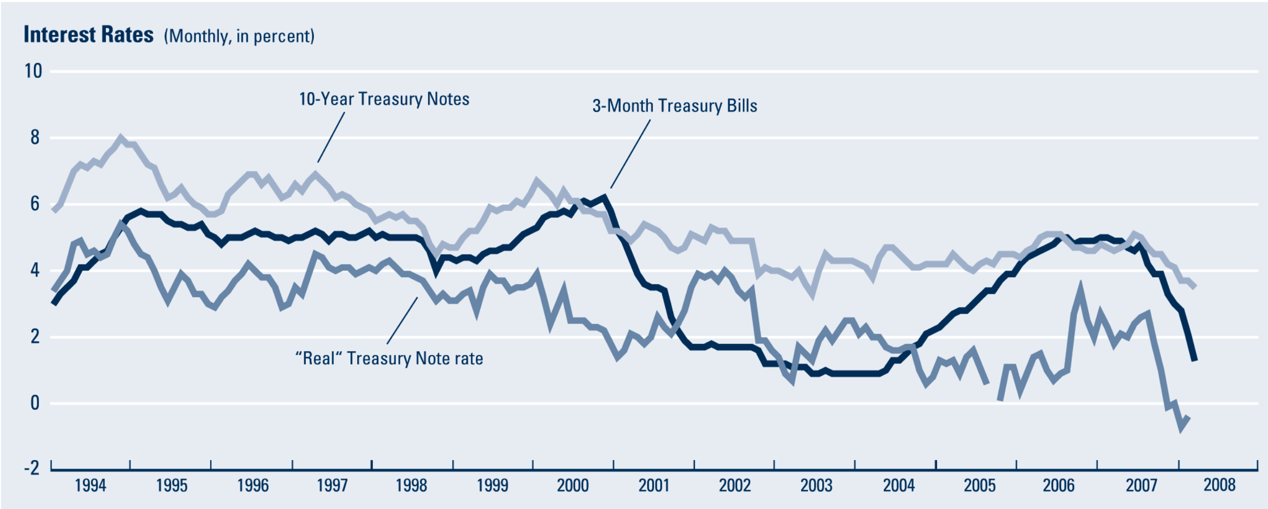


Housing Market (In thousands of units, SAAR)



Consumer Finance





going back to renting (or living in another home that they own) rather than trying to keep the mortgage current. Web sites ask, "What if you could live payment free for up to 8 months or more and walk away without owing a penny?" and state, "Your lender WILL NOT be able to collect any deficiency or loss they may receive by you walking away!" (from yourwalkawayplan.com). The penalties resulting from defaulting on a mortgage seem nonexistent.

We still expect housing starts and sales to continue to decline through midyear, and make a sluggish recovery thereafter. We expect housing starts to fall to 890,000 in 2008 from 1.34 million last year and a record 2.07 million in 2005. This year will have the lowest number of housing starts since World War II. Housing prices are not expected to hit bottom until early 2009, dropping another 10% from current levels.

Capital Spending

Strong investment in nonresidential construction helped offset the weak housing market last year, but nonresidential construction is softening this year. Most of the reason is the weaker employment picture — fewer workers need fewer offices. An additional explanation reflects funding problems, as commercial mortgages and construction loans become harder and more expensive to get. The problems in the residential markets have hurt commercial-mortgage-backed securities (CMBS), although CMBS defaults remain very low. We expect nonresidential construction activity to drop 7.7% (fourth-quarter to fourth-quarter, 2000 chain-weighted dollars) in 2008, after rising 15.1% in 2006.

Equipment spending will also slow, as a weaker economy makes capacity additions less necessary and financing problems make them more expensive. Most large US corporations are in very good shape going into this recession, having paid down debt to the lowest level relative to net worth (at historical cost) since the early 1980s. They also have near-record levels of cash on hand. However, smaller companies — the ones who are doing the borrowing — are less well positioned. The cost of debt is relatively high, and these expanding companies must invest to grow. The outcome may be that cash-

Exhibit 2
Nonresidential Construction Drops in 2008
(Four-quarter change; real chain-weighted dollars)

Sources: US Census Bureau; S&P/Case-Shiller.

rich larger companies will find these smaller ones ripe for takeovers. We expect capital equipment spending to fall 1.4% in 2008 (fourth quarter over fourth quarter), after rising 1.5% last year.

The Fed's Next Move

The Fed seems to have accepted that the economy is in, or at least close to, a recession. In his testimony before Congress, Chairman Ben Bernanke talked about a potential contraction in early 2008. The minutes of the March 18 Federal Open Market Committee meeting show that the Fed's staff revised its growth forecast downward (negative in early 2008) and its inflation forecast higher.

The Fed will fight recession first, and worry about inflation later. We now expect a 50-basis-point rate cut on April 30. After the April meeting, the Fed will wait to see the results of the rebate program before moving again (barring another major financial crisis). Because we expect the rebate checks to be spent quickly, the Fed should be done.

Inflation is likely to remain low during the recession. If history tells us anything, it's that recessions are good at bringing inflation down (former Fed chairman Paul Volcker proved that with the recessions of the early 1980s). This recession will be less effective than most, however, because it is expected to be relatively mild; moreover, the falling dollar will tend to increase inflation by raising import prices and providing a price umbrella for domestic competitors.

After the recession, the Fed will be forced to revert more quickly than usual to inflation-fighting mode, raising rates sharply. The Fed believes it erred after the 2001 recession in keeping rates too low for too long. After 2001, the Fed was still lowering rates 18 months into the recovery, and didn't start to tighten until after three years. We expect a rate hike beginning in mid-2009, bringing the funds rate back to a neutral 4.75% by mid-2010.

The Fed's other concern remains the financial markets' lending freeze. Lenders have gone from being totally oblivious to risk a year ago to paranoia, without stopping at rationality on the way. Our forecast implies a return to rationality, which means that spreads will narrow, but will not become nearly as tight as they were a year ago. In fact, spreads in the corporate markets are similar to the last recession and are probably appropriate for the current state of the business cycle.

Short-term risk premiums remain abnormally high. Although the various term-lending facilities have helped reduce the spreads in term loans (especially LIBOR), they remain very wide by historical standards. ■

David Wyss
Managing Director &
Chief Economist

Economic Policy

	2007	E2008	E2009
Monetary Indicators			
Discount Rate	7.3	4.8	6.0
Fed Funds Rate	4.3	1.8	3.0
M-2 Growth (%)	5.9	5.6	5.0
Fiscal Policy: Budget Surplus/(Deficit)			
Unified*	(162.7)	(412.8)	(394.6)
NIPA**	(220.6)	(484.1)	(377.4)
Surplus: GDP Ratio (%)	(1.6)	(3.4)	(2.5)

E-Estimated. *Fiscal year. **Based on accrual (not cash) accounting; excludes the S&L bailout funds and uses a calendar year.

Economic Indicators

Seasonally Adjusted Annual Rates — Dollar Figures in Billions

2007	E2008	E2009	Annual % Change P2007	Annual % Change E2008	Annual % Change E2009		2007 3Q	2007 R4Q	E2008 1Q	E2008 2Q	E2008 3Q	E2008 4Q	E2009 1Q	E2009 2Q
						Gross Domestic Product								
$13,841.0	$14,261.0	$14,815.0	4.9	3.0	3.9	GDP (current dollars)	$13,971.0	$14,074.0	$14,155.0	$14,128.0	$14,318.0	$14,441.0	$14,537.0	$14,700.0
4.9	3.0	3.9	-	-	-	Annual rate of increase (%)	6.0	3.0	2.3	(0.8)	5.5	3.5	2.7	4.6
2.2	1.1	1.9	-	-	-	Annual rate of increase–real GDP (%)	4.9	0.6	(0.5)	(0.9)	2.5	1.3	0.5	3.3
2.7	2.0	2.0	-	-	-	Annual rate of increase–GDP deflator (%)	1.0	2.4	2.7	0.2	2.9	2.1	2.2	1.2
						***Components of Real GDP**								
$8,278.0	$8,381.0	$8,496.0	2.9	1.3	1.4	Personal consumption expenditures	$8,302.0	$8,349.0	$8,357.0	$8,345.0	$8,399.0	$8,423.0	$8,425.0	$8,466.0
2.9	1.3	1.4	-	-	-	% change	2.8	2.3	0.4	(0.6)	2.6	1.2	0.1	2.0
1,235.4	1,201.9	1,222.2	4.7	(2.7)	1.7	Durable goods	1,241.9	1,248.1	1,220.5	1,185.0	1,196.3	1,205.7	1,197.0	1,212.5
2,392.8	2,401.0	2,431.6	2.4	0.3	1.3	Nondurable goods	2,396.8	2,404.2	2,393.4	2,392.7	2,404.7	2,413.1	2,413.3	2,424.9
4,674.8	4,787.2	4,853.2	2.8	2.4	1.4	Services	4,689.5	4,722.4	4,759.3	4,772.5	4,804.0	4,813.1	4,820.3	4,837.6
1,368.4	1,365.0	1,351.1	4.7	(0.2)	(1.0)	Nonresidental fixed investment	1,387.3	1,407.8	1,384.7	1,362.4	1,354.0	1,358.8	1,337.2	1,343.0
4.7	(0.2)	(1.0)	-	-	-	% change	9.4	6.0	(6.4)	(6.3)	(2.4)	1.4	(6.2)	1.8
1,064.5	1,057.2	1,087.8	1.3	(0.7)	2.9	Producers durable equipment	1,073.5	1,081.7	1,061.1	1,052.3	1,049.1	1,066.3	1,059.3	1,080.7
463.7	351.4	342.9	(17.2)	(24.2)	(2.4)	Residental fixed investment	454.3	422.1	389.7	356.5	334.9	324.6	324.6	336.4
(17.2)	(24.2)	(2.4)	-	-	-	% change	(20.8)	(25.5)	(27.3)	(30.0)	(22.1)	(11.7)	0.0	15.4
4.5	(23.1)	8.4	-	-	-	Net change in business inventories	30.6	(18.3)	(21.0)	(32.6)	(25.1)	(13.7)	(12.4)	(1.5)
2,021.6	2,057.0	2,060.2	2.0	1.8	0.2	Gov't purchases of goods & services	2,033.6	2,043.4	2,048.8	2,055.7	2,060.8	2,062.6	2,062.4	2,060.8
755.1	782.9	794.5	1.7	3.7	1.5	Federal	764.0	765.0	771.1	779.4	787.9	793.1	795.8	795.2
1,266.4	1,274.7	1,266.9	2.2	0.7	(0.6)	State & local	1,269.6	1,278.3	1,277.9	1,276.7	1,273.7	1,270.6	1,267.7	1,266.8
(555.6)	(416.9)	(320.6)	-	-	-	Net exports	(533.1)	(503.2)	(470.8)	(425.8)	(389.9)	(381.2)	(350.6)	(321.7)
1,409.9	1,525.1	1,666.3	8.1	8.2	9.3	Exports	1,441.2	1,464.1	1,481.5	1,507.5	1,538.9	1,572.3	1,607.0	1,647.1
1,965.5	1,942.0	1,986.9	1.9	(1.2)	2.3	Imports	1,974.3	1,967.3	1,952.3	1,933.4	1,928.8	1,953.5	1,957.6	1,968.8
						****Income & Profits**								
$11,660.0	$12,138.0	$12,586.0	6.2	4.1	3.7	Personal income	$11,735.0	$11,857.0	$11,971.0	$12,156.0	$12,167.0	$12,259.0	$12,385.0	$12,504.0
10,177.0	10,694.0	11,009.0	5.7	5.1	2.9	Disposable personal income	10,245.0	10,349.0	10,465.0	10,862.0	10,715.0	10,732.0	10,847.0	10,941.0
0.4	1.1	0.8	-	-	-	Savings rate (%)	0.4	0.0	0.1	3.4	0.7	0.2	0.7	0.8
1,876.7	1,588.2	1,882.1	3.9	(15.4)	18.5	Corporate profits before taxes	1,879.7	1,879.9	1,671.8	1,525.3	1,588.8	1,566.8	1,851.3	1,861.9
1,410.1	1,219.9	1,425.9	4.3	(13.5)	16.9	Corporate profits after taxes	1,410.2	1,425.5	1,276.1	1,172.5	1,223.4	1,207.6	1,409.4	1,413.7
66.20	63.60	72.60	(18.8)	(3.9)	14.2	‡Earnings per share (S&P 500)	78.60	66.20	60.20	54.30	56.30	63.60	65.20	67.50
						†Prices & Interest Rates								
2.9	3.5	1.7	-	-	-	Consumer price index	2.8	5.0	4.3	1.9	3.0	1.2	2.1	0.0
4.4	1.7	2.1	-	-	-	Treasury bills	4.4	3.4	2.2	1.4	1.5	1.6	1.6	1.8
4.6	3.7	4.4	-	-	-	10-yr notes	4.7	4.3	3.7	3.5	3.8	3.9	3.9	4.2
4.8	4.4	4.9	-	-	-	30-yr bonds	4.9	4.6	4.4	4.3	4.4	4.4	4.5	4.7
5.6	5.7	6.1	-	-	-	New issue rate–corporate bonds	5.8	5.5	5.5	5.6	5.8	5.8	5.8	5.9
						Other Key Indicators								
1,340.0	890.0	1,080.0	(25.8)	(33.5)	21.3	Housing starts (1,000 units SAAR)	1,300.0	1,150.0	1,030.0	860.0	830.0	850.0	930.0	1,030.0
16.1	14.8	15.1	(2.4)	(8.1)	2.1	Auto & truck sales (1,000,000 units)	15.9	16.1	15.2	14.5	14.7	14.9	14.5	15.0
4.6	5.3	5.8	-	-	-	Unemployment rate (%)	4.7	4.8	4.9	5.2	5.5	5.6	5.8	5.8
(5.6)	(10.6)	(3.9)	-	-	-	§U.S. dollar	(11.4)	(17.9)	(6.9)	(14.4)	(2.0)	(2.6)	(5.2)	(6.7)

Note: Annual changes are from prior year and quarterly changes are from prior quarter. Figures may not add to totals because of rounding. A–Advance data. P–Preliminary. E–Estimated. R–Revised. *1996 Chain-weighted dollars. **Current dollars. ‡Trailing 4 quarters. †Average for period. §Quarterly % changes at quarterly rates. This forecast prepared by Standard & Poor's.