Godsey & Gibb Associates
Investment Watch
September 28, 2007

Housing Weakens, Credit Corrects and Equity Market Fundamentals Favor Large Caps, However Downside Risks to the Economy and Corporate Profits Increased in the Third Quarter

After a booming real estate environment and a record number of private equity and leveraged buyout announcements over the last several years, growing concerns entered the marketplace in the third quarter related to the fallout in the sub-prime mortgage market and fears related to mergers and acquisitions financed through leveraged buyouts (LBOs) by private equity firms. In an LBO, the buyer typically borrows money to finance the majority of the cost, using the purchased company's assets to back the loan.

In July, nervousness by investors caused a repricing of risk in the fixed-income credit markets to what we believe are more reasonable levels. A credit correction occurred in the riskiest portions of the bond market – high-yield, or junk, bonds, that are susceptible to a greater risk 0f loss of principle repayment and interest payment. The increased levels of financial risk led to a rise in the interest rate premium, or spread, investors demand for the riskiest bonds in the market, over those of safer U.S. Treasury securities. We believe risk premiums between corporate and government bonds, which had been small for several years, are returning to more normal levels. However, the recent increase in credit spreads caused an increase in market volatility and a decline in stock prices.

Despite what we view as a credit correction, it is important to keep the recent market events in perspective. The third-quarter credit correction caused the worst one-week decline for stock prices in several years in July and the stock market recently traded as low as 10 percent below its July 19th all-time high on an intra-day basis.

Chicago Board Options Exchange Volatility Index

Source: Bloomberg

While the recent stock market declines were significant, the overall direction of the market has been decidedly up for the last year. In fact, over the trailing 12-months ending September 28, 2007, the stock market, as measured by the S&P 500 Index, increased by over 16 percent including dividends. In addition, we believe the fundamentals for large cap growth equities remain attractive. These positives include: an increase in market volatility, reasonable valuations with attractive earnings growth, strong global economic growth, and low inflation with low interest rates.

Volatility increase favors large caps

The recent credit correction has coincided with both bigger up days and bigger down days. Volatility increased above levels seen in the February – March 2007 correction, reaching a multi-year high in the third quarter. The rise in volatility reminds us of legendary investor and author Peter L. Bernstein, who wrote, "Volatility forces investors to focus on asset prices rather than fundamentals and on the short-term rather than the long-term. Those shortcomings can lead investors into decisions they may regret."

In the short-term, continued negative news related to the sub-prime mortgage market and a decrease in corporate LBOs could keep volatility at higher levels. However, it appears the greatest risks in the market lie with hedge funds (many of which use leverage thereby magnifying their exposures and risks) and other institutions exposed to sub-prime mortgages or credit sensitive collateralized debt obligations. As a relative safe haven, high-quality, large cap, consistent earnings growers have historically outperformed in periods of heightened market volatility.

U.S. Trade Weighted Real Dollar

Source: Federal Reserve and Bloomberg

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Reasonable valuations and attractive growth

Relative to small capitalization companies, we believe large caps are more reasonably valued. The Russell 2000 Index, a proxy for small caps, recently traded at a price-to-earnings multiple (P/E) of 37.2 times its expected forward earnings growth rate of 16%, for a forward PEG ratio (price-earnings multiple/growth) of 2.3. Large cap companies, as measured by the Standard & Poor's 500 Index, with a P/E of 17.5 times expected forward earnings of 8%, are more reasonably valued relative to their underlying growth rate with a PEG ratio of 2.1. A lower PEG ratio identifies a more relatively attractive valuation.

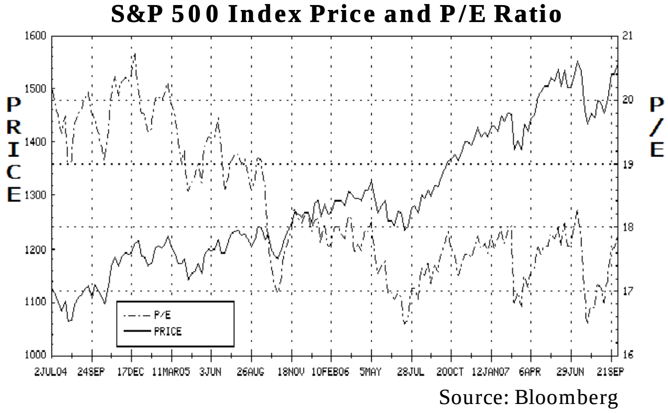
Moreover, many large cap companies are highly profitable and most maintain low debt levels. High-quality large caps have enjoyed double-digit profit growth. Second quarter earnings grew an average of 11.1% for the S&P 500 Index members, and 66% of firms beat analyst estimates. Earnings rose in nine of the ten S&P 500 industry sectors in the second quarter. The only exception was the Consumer Discretionary sector, which contains the homebuilders. However, the pace of earnings growth is expected to slow for the remainder of 2007.

In addition, leverage remains low on a historical basis. Companies are paying down debt and buying back their own shares at a record pace. More than $320 billion of share buybacks have been announced so far this year, which is on track to beat last year's record of $365 million. Buying back stock is one of several ways companies can return cash to shareholders. Buybacks take shares off the market so shareholders own a larger percent of the future earnings.

Strong global economic growth

U.S. Gross Domestic Product (GDP) measured 3.8% annualized in the second quarter of 2007, the fastest pace in more than a year, but U.S. GDP is expected to moderate for the remainder of 2007, dragged down by weakness in housing. Global growth however remains stronger than in the U.S. Economists estimate that China's economy grew at 11.3% in the second quarter, the fastest pace in a decade. India's GDP growth is forecasted to be 9.2% in 2007 after its 9.0% gain last year. Moreover, the percentage share of world GDP from developing economies is increasing, leading to more export growth for U.S. based multi-national companies.

S&P 500 Index Price and P/E Ratio



Source: Bloomberg

Large cap growth companies with multi-national exposure are benefiting from the strong global economic growth, combined with a falling U.S. dollar, which makes American goods cheaper for foreign buyers. On average, the companies that comprise the S&P 500 Index derive about half of their sales from overseas markets. Global oriented companies should be able to capitalize on this trend with higher revenue growth, margins and earnings growth.

Low inflation and low interest rates

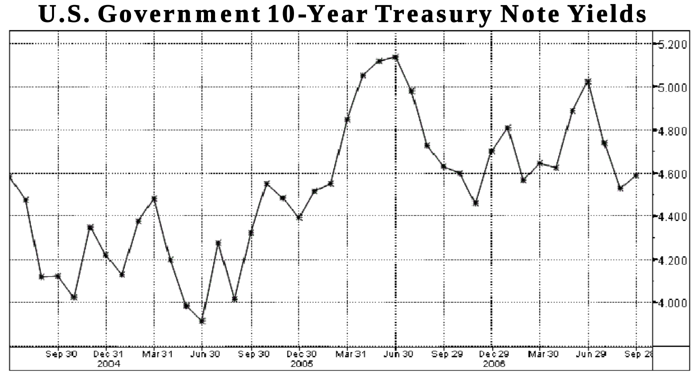
The core-Consumer Price Index (CPI) measured 0.2% in August, keeping the year-over-year trend at 3.8%. With the exception of food and energy, the CPI measured a 2.8% yearly gain according to the U.S. Department of Labor. Moreover, an additional inflation gauge, and one the Federal Reserve has indicated it monitors closely, the core-Personal-Consumption-Expenditure Price Index, measured a 1.8% year-over-year gain in August, the lowest in three years and within the Fed's comfort range of 1% to 2%.

After maintaining interest rate levels for eight consecutive meetings since last summer, the Fed lowered two key short-term rates in the third quarter. The Fed cut the Discount Rate 50 basis points on August 17th and both the Federal Funds Rate and the Discount Rate by an additional 50 basis points each on September 18th (a basis point is 1/100th of one percent). Longer-term rates like those for the U.S. Treasury 10-year note are also down from over 5.00% before the credit correction to near 4.60%, near an 18-month low point. Large cap companies, which generally have more favorable access to the capital markets than small caps, should find these rate levels accommodative.

Downside Risks Remain From Housing

The continued slide in home prices and a multi-billion wave of sub-prime mortgages scheduled to reset at higher rates are expected to keep economic growth and profit growth below trend for the remainder of 2007. Moreover, the rising inventory of unsold homes and tighter lending standards point to further housing related weakness. Profit growth is not immune, and as such, earnings for the S&P 500 could slow to 3.2% in the third quarter, ending a 20-quarter streak of gains above 10%. Fed easing cycles historically work with a lag of 9 months to two years, therefore we view the recent rate cuts as a start of the solution but not an end to the problems.

U.S. Government 10-Year Treasury Note Yields



Source: Bloomberg