

March 19, 2007

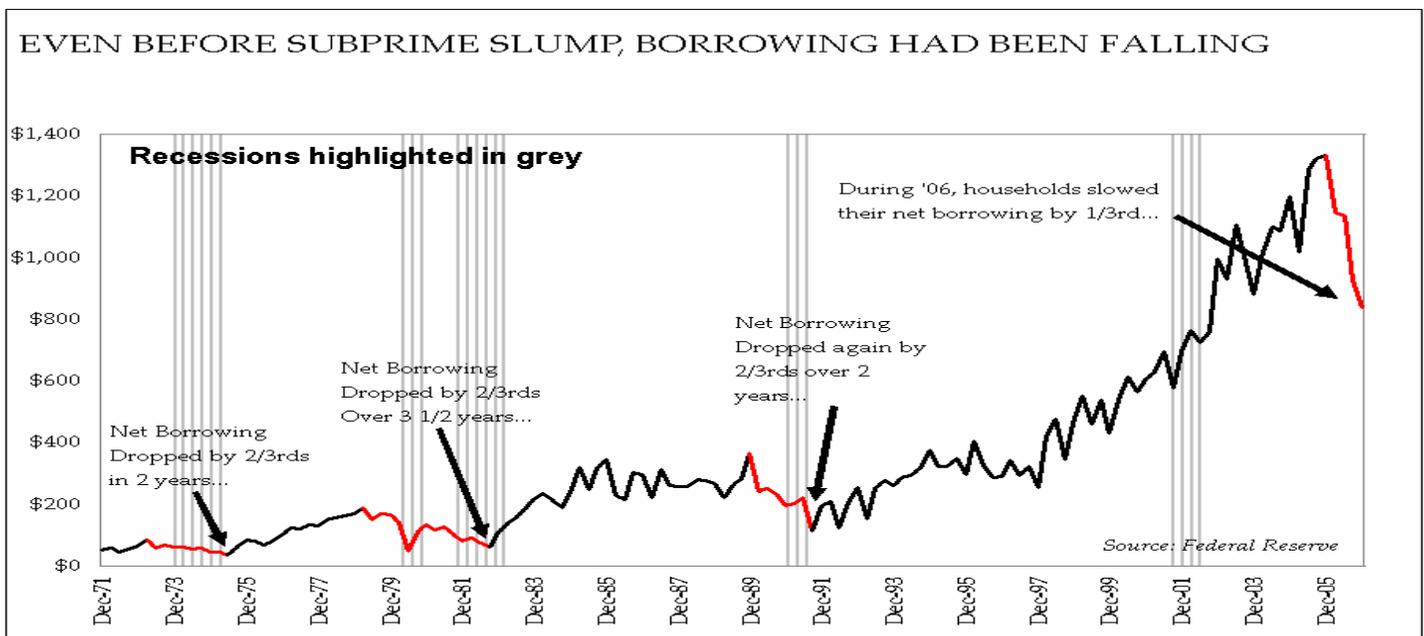
Joseph V. Battipaglia, (215) 504-1623
Chief Investment Officer
joseph.battipaglia@ryanbeck.com

Kevin Caron, (973) 549-4051
Market Strategist
kevin.caron@ryanbeck.com

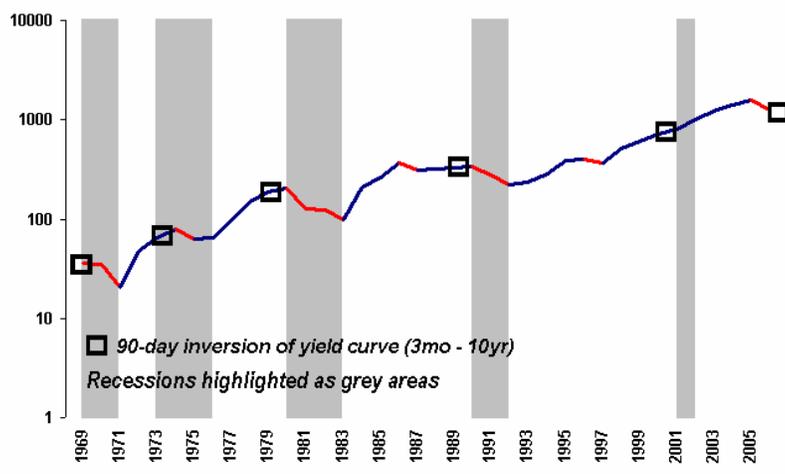
Cutting Earnings & Equity Target

Highlights

- Recent data from the Federal Reserve shows household borrowing off by one-third since 2005 (chart below). With sub-prime lending and housing in retreat, we must assume that credit conditions will continue to worsen throughout the year. Recession risk is rising and current consensus profit forecasts are at jeopardy of not being met.
- Reducing our expected earnings for 2007 to \$85 from \$91, maintaining assumption for a 17x market multiple. Cutting year-end S&P 500 target to 1,430 from 1,510.



US HOUSEHOLD NET NEW BORROWING (\$BIL)



Odds of a recession are increased when long-term interest rates fall below short-term interest rates. This condition in the bond market is commonly referred to as an "inverted" yield curve. In short, higher short-term interest rates tend to raise incentives to save and may discourage borrowing. It can also discourage some forms of lending by making certain types of loans less profitable. Whatever the cause, the net effect is that the economy is forced to do without some of the borrowing that had previously been contributing to growth.

This chart shows that recessions (highlighted grey) prior to 2001 were preceded by both an inverted yield curve (black squares) and a falloff in net new household borrowing (highlighted red). In the past, recessions preceded by this combination also tended to be longer than the 2001 recession that did not include slippage in net borrowing.

Recall that the inversion of the Treasury yield curve last year and other inputs led us to increase our estimated recession odds and prompted us to tilt recommended portfolios toward a more defensive mix of assets. To that list we must now add the sharp drop in net new borrowing by households in '06 as further evidence of slowdown.

Well before sub-prime loan problems made front page news in February, the economy had already begun to course-correct from a period of very robust growth in household borrowing. The latest borrowing surge began when interest rates hit bottom in '02-03 but the real start to the consumer credit cycle can be traced back into the early 1990s when the U.S. emerged from the last consumer-led recession. You might remember that the 2001 recession was created by the technology spending downturn and the events of September 11th and was not the result of a retrenchment in consumer spending. Thus, the elapsed time between the trough in the last consumer downturn and 2006 was approximately 15 years.

For some time now, we have discussed the fact that access and demand for credit are important ingredients for the economy and equity markets. We now believe that the economy's growth rate will remain under pressure through 2007 as borrowing recedes and credit becomes harder to come by – especially in some segments of the mortgage market. This restriction of credit, coming at a time of significant vacancies and housing inventory, will likely produce a more severe correction in prices than expected and may invoke a negative "wealth effect" as changes in real estate value has been found to have a more direct link to spending in the economy than changes in the value of other asset classes.

We also note that borrowing by corporations tends to follow consumer borrowing and that the recent spike in spreads for corporate debt over risk-free

Treasuries calls into question whether or not the liquidity-driven LBO and M&A boom will be able to sustain itself going into next year. Indeed, the recent rush by private equity firms to go public may signal the beginning of the end of the private equity cycle, in our view. As mentioned in the box above, there is mounting evidence that the increases in interest rates that the Fed initiated in 2004 and continued through the first half of 2006 are having a bite on the economy. In the last employment report, for example, the year-over-year growth rate in non-government jobs slowed to the lowest level in over 2 ½ years. Consumer demand also continues to show weakness as seen in the trend in final sales buried within the GDP report, falling imports, slack retail sales and slippage in borrowing for durables. In short, the composite mix of data has transitioned from a more expansionary and accelerating mix to one that is slipping toward 0%. As tactical asset allocators of portfolios, we must not overlook these trends — especially at a time of record high profit margins.

Cutting Earnings & Equity Target

Our earnings model for the S&P 500 starts with a forecast for the economy, profit margins for the economy as a whole and works down to an earnings forecast for S&P 500 companies (a complete discussion of this model, including the details of the model can be found in our December 6, 2006 “*Strategy Comment*”). Our last estimate resulted in a “good case” 2007 S&P 500 earnings estimate of \$90.58 and a “recession or bad case” estimate of \$79.50. At the time, we based our 33% recession odds on the trends we saw in the economy and based on the slope of the yield curve. Today, with the additional information on consumer borrowing trends, additional data on the economy and continued inversion of yield curve and emerging credit issues in the sub-prime lending markets we anticipate that recession odds are now at least 50%. As a result, our new earnings estimate is **just under \$85**. With a 17X multiple, the new target for year-end is 1,430 – a 4-5% total return from current levels. We have also reduced our equity exposure to 60% for growth investors, 37% for balanced investors, and 18% for conservative investors after eliminating exposure to emerging markets and increasing our exposure to bonds via an investment in Treasury inflation protected securities (aka. TIPS).

Conclusion

Much changed during the past 15 years since the last consumer led recession, but it remains clear that consumption is at least as much a key contributor to economic cycle behavior today as it was then. We also know that it is very, very difficult to break the long-term trend of rising income and spending that comes along with growth in the population of the United States — particularly when combined with rising productivity and wealth. It is folly, however, to assume that economic cycles are gone forever and it is at the investor’s peril that they be ignored. In fact, investors that use the broadest array of assets in their portfolios may find opportunities despite near-term challenges to the economy. Consider, for example, the fact that large capitalization, high-quality, defensive stocks have become relatively inexpensive compared to small caps or the fact that yields on high-quality, low-risk short term credits are well above the inflation rate. Treasury inflation protected securities, or TIPS, also appear to be attractively valued compared to yields offered on straight Treasury bonds. These are a few of the categories we believe will offer some of the better risk / reward choices for portfolios given our outlook for the economy over the next few months.

FOR ADDITIONAL INFORMATION ON OUR RECOMMENDED ASSET ALLOCATIONS PLEASE REFER
TO:

OUTLOOK 2007: TACTICAL ASSET ALLOCATION ISSUES

Please contact your Ryan Beck & Co. Financial Consultant Or Call The Investment Strategy Group At 973-549-4052 For A Free Report Copy