Capital Markets Outlook

The Economy ♦ Fixed Income ♦ Equities

The Economy:

With the strong 3rd quarter decidedly in our rear view mirror, the time has come to openly acknowledge what has been transpiring in the 4th quarter. While economists have flip-flopped back and forth with the changing data, the fact is that we are in a slowing phase. Retailers have sent out mixed messages, but many stores, such as Target, are predicting a weak holiday season. That should come as no great surprise as consumers don't have as much free cash to spend with housing values falling (reducing available equity to tap), and with many prices increasing, particularly within the energy sector, as evidenced in the most recent inflation reports. Consumers do tend to be resilient, however, and we are therefore estimating growth to be slightly positive for the 4th quarter in the 1% range. As far as interest rates are concerned, we expect the Fed to continue to be entirely predictable and likely somewhat behind the curve. This Fed tends to be reactive, not only to data but also to market expectations. With inflation statistics moving in the upward direction of late, it is unlikely the Fed will step in and make any sudden policy changes relating to easing of monetary policy. The Fed worries about inflation and the falling dollar, and therefore does not want to risk creating a problem by cutting rates too much too quickly. While we agree this is a concern, we feel the liquidity problems the markets are facing are a greater threat to the health of the economy. In a perfect world, the Fed will be able to continue to cut rates at a measured pace while inflation remains at least in Fed's targeted range, even if it is at the highest part of that range. Under that scenario, we should experience slower, non-recessionary growth for a few quarters while the credit mess is cleaned up, and then move into more healthy 2.5-3.0% GDP growth for the economy. Continued modest rate cuts are likely for the next few Fed meetings, but the timing of those cuts remains the question.

Fixed Income:

The bond market ended 2007 in much the same way it began the year—searching for stability. As the upheaval over the sub-prime mortgage and Structured Investment Vehicle (SIV) meltdown began to surface in the spring, the direction of fixed income securities and the Treasury yield curve itself became virtually impossible to handicap. The "flight-to-quality" mentality took over and repeated itself on numerous occasions throughout the 12-month period. This unfortunately kept bond managers more reactive than proactive. The undulations of the yield curve and the opposing margins in "spread" products made it a challenge indeed to determine if one should be short, long or neutral to their respective benchmarks. Against the backdrop of a tepid economy, that will struggle to counter the headwinds of the worst housing market since the Great depression, the bond market should selectively post greater than a coupon return in the year ahead. The average Treasury security returned approximately 8% in 2007, but the return on alternative spread products fell short of the mark. Although inflationary pressures will continue to frustrate the Federal Reserve's initiatives, there is more monetary-policy work to be done. We believe the Fed will eventually lower rates several more times in 2008, by as much as another 75 basis points (.75%), opting to stimulate the economy initially and grapple with inflation problems later. This approach will have the effect of steepening the Treasury yield curve and widening inter-segment spread relationships creating value for those with patience (in between occasional flights-to-quality). The most prudent course of action will be to acquire Treasuries on weakness and simultaneously overweight durations to the benchmarks. Investors will need to be cautious, however, against taking on too much marginal credit in the face of such a tenuous economic environment as we expect.

EQUITIES:

Equities -- The Elixir – Lower Rates – A Macro View Continued

As this is written, prospects for the equity markets are on the mend and beginning to brighten: 1) the European Central Bank's action of a few weeks ago to inject a mammoth $500 billion into the system in an effort to bring down short term interest rates is bearing fruit, 2) the last few days has brought the beginnings of a "Santa Claus rally," 3) the bank stock index is 3% above its November low, 4) consumer spending has not collapsed and is growing slowly, 5) and some Wall Street strategists are bullish for 2008, like Cohen of Goldman, Don Hays, Argus Research, and the Bank Credit Analyst. Still, it is clear that the future path for the economy and the stock market is paved with some significant speed bumps: 1) eurodollar 3 month borrowing rates are still about 40 basis points higher than normal versus fed funds, 2) the banking sector's monetary base is shrinking and in need of some repair (through reserve building by direct investment or dividend cuts) even though liquidity is super high, 3) the housing market is poised to experience 1 million defaults in 2008 up from 300,000 in 2007 according to Lehman analysts, 4) Moody's estimates that US corporate default rates will rise to 4.7% in 2008, up from 1% in 2007, 5) profit margins will be under further pressure, and 6) the consumer will continue to be squeezed if real wage gains reverse or slow.

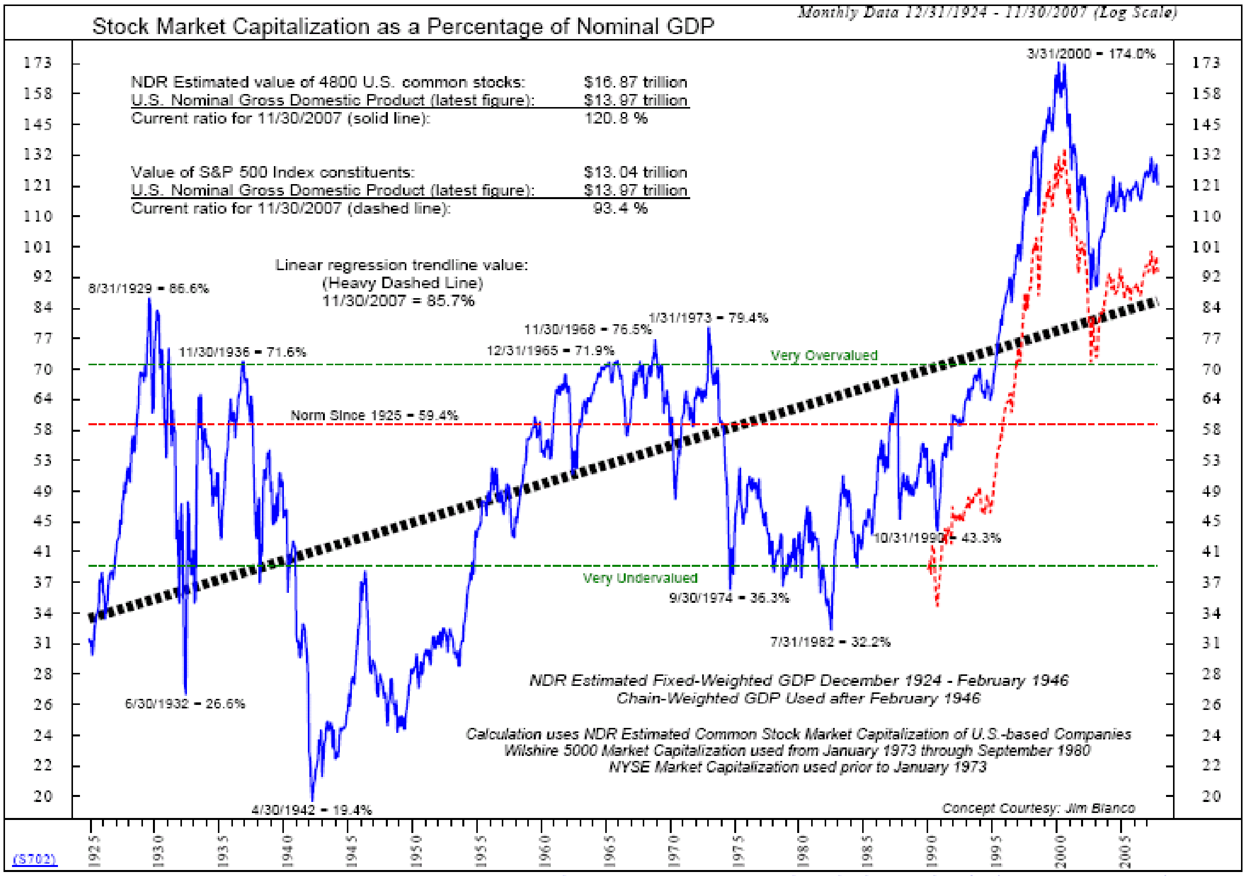
The Bank Credit Analyst recently published a 48-page document titled "Waiting for Reflation" that summed up the current conundrum this way:

> "The essence of the Debt Super cycle is that because the long-term rise in debt burdens increases the vulnerability of the economy and financial system, the authorities are under growing pressure to shore up the system every time there is a downturn. And, because we never get a cleansing of balance sheets during economic downturns, each new upturn begins from a higher level of debt and financial imbalances than the one before. So the stakes get higher over time, creating ever-increasing pressure to prevent a debt deflation…. There is no way to have a cleansing of balance sheet excesses without running enormous risks with the economy. So, policymakers feel little option other than to keep easing, regardless of future consequences….The authorities ultimately will be successful in pumping up the system again, and new financial excesses will occur down the road."

The elixir of lower rates needs ready borrowers to assume debt as discussed in our October newsletter. Lower rates also affect valuations as P/E ratios typically expand. As profit margins begin to normalize from all time highs the appreciation effects on stocks will slow, but how much? If one assumes that profit margins are constant, then the valuation variable that becomes important is how much you pay for sales. And at the macro level that variable is the total value of all stocks relative to GDP.

For long-term investors, Ned Davis recently performed a study for us that examined the 10-year future return of the S&P 500 based on the value of the stock market capitalization to GDP. The results of this study in depicted on the graph on page 3. Because of the historically elevated reading, the results suggest that the total return of the S&P 500 will be 9% or less for 2008 and going forward over the long-term. The message is that double-digit rates for the S&P 500 are unrealistically high using this historical measure. This valuation ceiling may also help explain the anemic response of the market to the FED's recent easing efforts.

Fulton Financial Advisors



The year ahead promises to be a challenge for policymakers and the financial system and therein lays the added risk for investors. The degree to which we are successful in avoiding a recession will be the dominant indicator for the outcome for stocks. The last time the economy suffered a minor recession was in 2001 when interest rates were plunging and the stock market bottomed out after a decline of approximately 50%. This was the first time since the Great Depression that the stock market failed to respond to lower rates on a timely basis. The FED, in an effort to buoy the economy, was forced to keep rates too low for far too long and spawned what we know was a bubble in credit, especially for real estate. Avoiding a recession will insure that investors continue to reap positive total returns in the range of 4 to 10% and it will allow the financial system to gather its legs for an assault at higher levels.

In this challenging environment we continue to believe that emphasis on large-capitalization stocks versus small-cap and favoring growth over value will provide added returns. At the sector level, consumer discretionary, financials, and energy are being monitored for additional emphasis and entry points.

Have a Happy and Prosperous New Year!