4TH QUARTER 2007

WaterStreet QUARTERLY

CAPITAL MARKETS REVIEW AND OUTLOOK

Credit Crunch, US Recession Concerns Drive Stocks Lower

Persistent volatility continues to hurt the global equity markets.

GLOBAL EQUITY MARKETS retreated across all styles and capitalizations as the extent of the global credit bust continued to unfold and the threat of a recession increased in the US. For the second consecutive quarter, significant volatility and total loss of liquidity in some credit markets caused a flight to high-quality fixed income instruments. As banks tightened lending standards and reduced exposures on their balance sheets, counterparties forced hedge fund managers to post additional collateral. These actions caused many managers to sell securities and contributed to the 1.7%

QUARTERLY OVERVIEW

■ US Equities

US stocks' string of five consecutive positive quarters came to an abrupt end as the severity of the global credit dislocation worsened and corporate earnings growth slowed substantially. Dominated by financials, value indices led the decline as banks, insurers, and brokerages continued to write down subprime mortgages, collateralized debt obligations (CDOs) and structured investment vehicles (SIVs). The S&P 500 lost 3.3% for the quarter to end the year up 5.5%. All capitalization segments suffered declines, while growth stocks significantly outperformed value in all segments. Volatility remained high, as the S&P 500 experienced 23 days where the index gained or lost over 1.0%. (page 2)

■ International (Non-US) Equities

Developed international issues lost 1.7% in dollar terms and 2.9% in local currency as GDP and corporate earnings growth among the mature economies slowed. Conversely, emerging markets continued above trend growth, propelling the MSCI Emerging Markets Index 3.7% higher in the fourth quarter to end the year up 39.8%. (page 3)

■ Fixed Income

International and US fixed income markets rallied strongly during the quarter, as a flight to quality continued due to extreme market volatility in the structured credit portion of the market. The Lehman Brothers Aggregate Index and the Citigroup Non-US World Government Index returned 3.0% and 3.9%. Continued downgrades by the major rating agencies of CDOs and SIVs bid up the price of Treasuries and high grade corporate debt. The US municipal market was rocked by solvency questions about several of the monoline insurers. The US Federal Reserve and the European Central Bank (ECB) continued to inject significant liquidity into the system through open market operations and rate cuts. (page 4)

■ Alternative Investments

Significant volatility throughout the capital markets created large return dispersion among hedge fund strategies. Global macro strategies posted the largest gains of the hedge fund sectors, returning 4.2% for the quarter, while the HFRI Hedge Fund of Funds Index returned 2.0%. The Dow AIG Commodity Index rallied 4.7%, as crude, precious metals, and grains all saw significant gains. Real estate, as measured by the NAREIT Index, lost 12.0% for the quarter and declined 17.8% for the year. The scrutiny of securitized commercial mortgages, fears of an economic recession, and the standstill in the credit markets contributed to losses in the REIT market. (page 5)

■ Global Outlook

World GDP growth remains robust in the 4.5% to 5.0% range, significantly higher than the long-term trend of 3.7%. Inflation concerns continue to take a back seat to fears of a liquidity crisis and concerns over a potential US recession in 2008. Inflation remains around 2.0% in developed economies and 5.0% in emerging. The US Fed seems poised to reduce rates further while the Bank of Japan and the European Central Bank are likely to resume tightening later in 2008. (page 7)

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decline in the MSCI All Country World Index during the quarter.

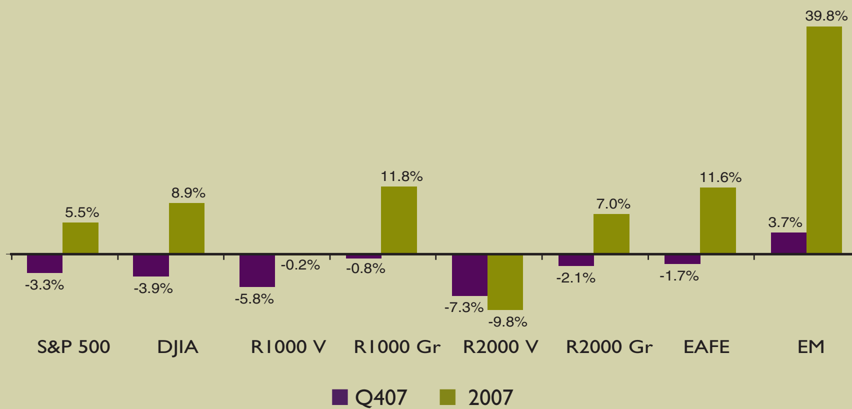
Emerging markets equity was again the best performing equity asset class. GDP growth in these markets remains strong as trade increases and the countries make advances in productivity. India led the way, posting a 23.3% return with the financial and energy sectors continuing to drive performance. China declined in the fourth quarter, but posted a 66.2% return for 2007.

US small capitalization value suffered the largest declines, falling 7.3% for the quarter, and 9.8% for 2007 as measured by the Russell 2000 Value Index. Concerns over mortgage defaults, write-downs of structured credit, and a slowdown in the US economy were the primary causes of decline in the index which is heavily weighted in financial companies.

The most significant story of the quarter continues to be the contagion of the global credit crunch as write-offs by international financial institutions grow towards $200 billion. Many believe that an additional $300 to $400 billion will be written down or off in the coming quarters as rating agencies continue to downgrade Collateralized Debt Obligations and (CDOs) Collateralized Loan Obligations (CLOs) which help power the senior bank loan and commercial paper markets. Additionally, the solvency of the major US monoline insurers such as MBIA, Inc. and Ambac Financial Group, Inc. has come into question creating tremendous turmoil in the US municipal bond market. The insurers of primarily municipal bonds got into trouble when they began insuring financially lucrative structured finance products such as CDOs. The insurers relied heavily on models based on historic defaults, recovery rates, and correlation risks. Unfortunately, the abandonment of prudent underwriting standards, especially in the mortgage market proved impossible to model. Additionally, the insurers made big bets on CDOs using credit default swaps which also proved to be an unreliable hedge. Credit default swaps are financial instruments that are based on loans and bonds that are based on an issuer's ability to repay their obligations. All the major insurers are seeking capital infusions.

EXHIBIT 1

MAJOR US STOCK MARKET INDICES

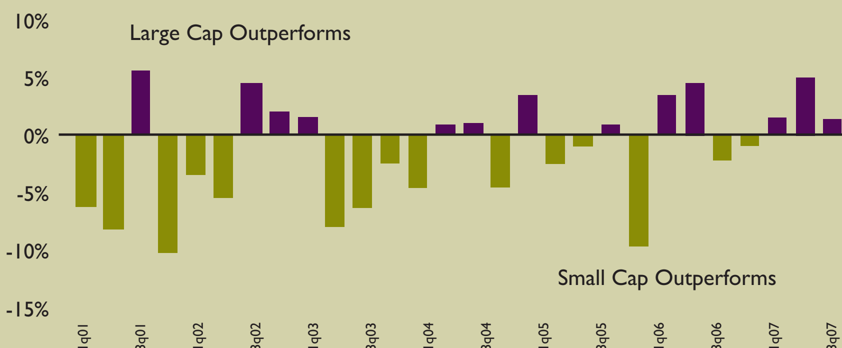


Source: MSCI, Russell, Dow Jones

EXHIBIT 2

LARGE CAP VS. SMALL CAP

Returns on Russell 1000 Minus Russell



Source: Russell

The Bank of England, Canada, and the US Federal Reserve cut rates during the quarter in response to the dramatic loss of liquidity in the financial markets. The European Central Bank (ECB) also continues to inject substantial liquidity into European money markets as European banks remain unwilling to lend to each other in a meaningful way. The ECB remains concerned about the lagging effects of the run-up in energy prices and continued dollar devaluation and may look to increase rates slightly later in 2008.

The US Federal Reserve cut rates by an additional 0.50% during the quarter to prevent further deterioration in the credit markets and to limit the possibility of a recession. The Fed remains concerned with higher than desired core inflation and a marked slowdown in consumer spending. The Bank of Japan had to suspend its monetary tightening program due to a sudden slowdown in the economy.

US EQUITIES

The US stock market suffered a decline of 3.3% during the fourth quarter as the severity of the global credit dislocation worsened and corporate earning growth slowed substantially. The fall pulled the 2007 S&P 500 Index return down to 5.5%, which is below historical levels *(Exhibit 1)*.

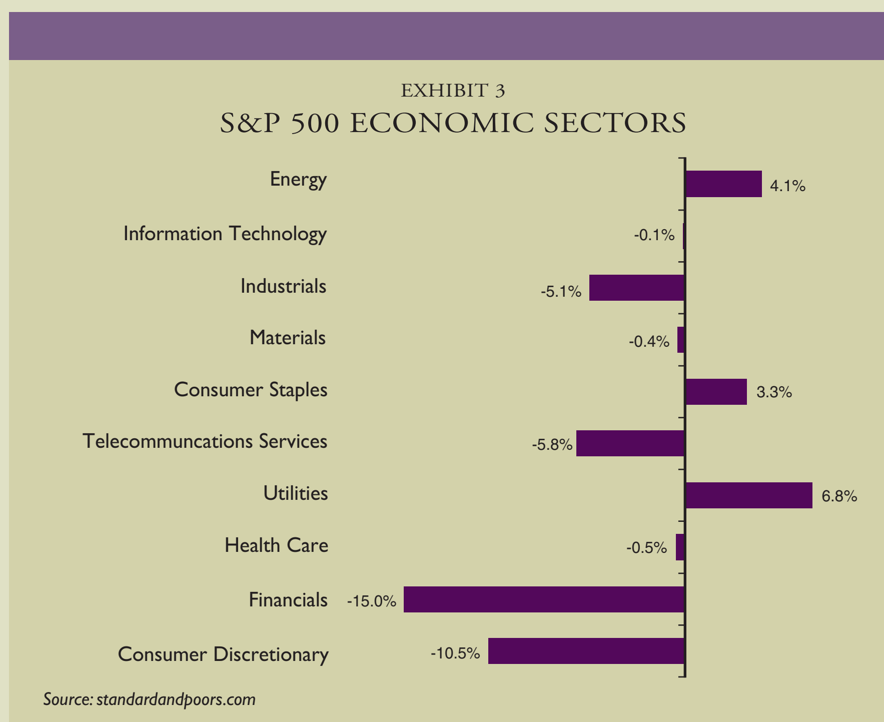
Volatility remained high as the S&P 500 experienced 23 days where the index gained or lost over 1.0%. Both the S&P 500 and

the Dow Jones Industrial Average reached record highs in October before credit concerns caused a plummet in November. Growth outperformed value across all market capitalization segments of the US equity market for the quarter and the year. Dominated by financials, value indices led the decline as banks, insurers, and brokerages continued to write down sub-prime mortgages, CDOs, and SIVs. Investors, expecting the economy to slow in the future, developed a preference for stocks with higher than average long-term growth prospects. Growth stocks seem poised to continue their relative run with energy, materials, and technology leading the way.

Large capitalizations slightly outperformed small capitalizations during the quarter with the Russell 1000 Index and Russell 2000 Index posting returns of -3.2% and -4.6%. Small capitalization companies are typically more vulnerable to cyclical downturns, thus economic concerns weighed more heavily on these securities *(Exhibit 2)*.

Only three of the ten economic sectors in the S&P 500 Index posted gains during the quarter. Investors attracted to steady dividends boosted the utility sector return to 6.8% in the fourth quarter. Utilities also benefited from expectations that regulators would approve higher rates to offset rising fuel costs. The energy sector rose with the price of oil, which reached record highs during the period. Economic concerns caused many investors to shift to the consumer staples sector, which gained 3.3% in the quarter. As investors sought stability in consumer staples, the consumer discretionary sector suffered, declining 10.5% during the quarter.

The financials sector suffered the largest decline of the quarter, dropping 15.0%, driven primarily by a rapid depreciation in the real estate market. Falling home prices and adjustable rate mortgages caused an increase in loan defaults and foreclosures *(Exhibit 3)*.



INTERNATIONAL EQUITIES

Developed Markets

Developed international issues lost 1.7% as GDP and corporate earnings growth among the mature economies slowed. The MSCI EAFE Index ended 2007 up 11.6%, which marks the sixth consecutive year for the EAFE to outperform the S&P 500 Index. As in the US, international growth outperformed value and large capitalization surpassed small capitalization during the quarter.

Developed European countries generally posted moderate returns in the fourth quarter. Additionally, a strong euro, compared to the US dollar, boosted returns to US investors. German markets benefited from strong export demand to emerging countries. The UK lost ground due to concerns over British real estate prices mimicking the US real estate slump. The Bank of England lowered rates in December for the first time in two years.

Hong Kong posted a strong fourth quarter return, to end the year up 41.2% *(Exhibit 4)*. Real estate and financial sector companies benefited from China's remarkable economic growth streak.

Political problems in Japan worsened during the quarter, leading to a 6.1% decline. The Bank of Japan suspended its monetary tightening program on expectations of weakened economic growth. Financial companies suffered the worst declines in Japan. Industrials and materials also saw a downturn, especially companies related to mining and metals.

Sector returns in the MSCI EAFE Index mirrored those in the US, with utilities and consumer staples posting strong returns, and the financials sector suffering a large decline. All developed countries saw steep declines in banks, insurers, and brokerages.

Emerging Markets

The MSCI Emerging Markets Index rose 3.7% in the fourth quarter to end the year with an impressive 39.8% gain. This marked the sixth consecutive positive quarter for emerging markets and the fifth consecutive year of positive returns. Emerging market countries continue to build their domestic economies and expand trade beyond their traditional trading partners, US and continental Europe.

China pulled back slightly in the fourth quarter, but still posted a 66.2% return for the year. The Chinese Central Bank tightened reserve requirements due to concerns over rising inflation and rapid investment growth. China's CPI rose 7% in November to its highest level since 1996.

The remaining three BRIC countries (Brazil, Russia, and India) performed well during the quarter. Brazil benefited from continued strong demand for the country's

agricultural and industrial commodity exports. Energy demand was also high in Brazil, leading to a 56.0% gain for oil producer, Petrol Brasileiros. Russia gained 17.4% in the quarter, bolstered by rising oil prices and strong capital inflows. India enjoyed a 23.3% gain in the period, with financial and energy companies providing the largest returns *(Exhibit 5)*.

Argentina was among the bottom performing emerging market countries during the quarter, losing 10.8% on inflation concerns. Taiwan and Korea also lost ground in the fourth quarter. Concerns over the possible impact of a global economic slowdown in Asian exports of manufactured goods contributed to the declines, which were most noticeable in the technology sector.

Sector returns in emerging markets were generally positive in the fourth quarter. Only three sectors declined in the period, with information technology suffering the largest loss of 7.4%. The energy sector enjoyed a 20.9% gain in the fourth quarter, reflecting the surge in oil prices.

FIXED INCOME

As previously mentioned, the US Federal Reserve cut the Fed funds rate by 0.50% during the fourth quarter. This brought the total rate reduction in 2007 to 1.0%. The rate cut came as yield curves were steepening in the US and Europe due to expectations of a loosening monetary policy.

Credit markets struggled again during late fourth quarter after a partial recovery from September's subprime-related downturn. Write-downs of subprime assets by many of the world's leading banks continued during the fourth quarter, doing little to relieve concerns regarding their balance sheets.

The Fed, alongside central banks in Canada, UK, EU, and Switzerland, injected more than $90 billion of liquidity into the financial system via money market auctions in an effort to get banks lending again. The fear by the central banks was that weakness in financial markets would spill over into the broader economy. Relatively low US unemployment, growing personal income, continued consumer spending, and an increase in exports eased some economic fears.

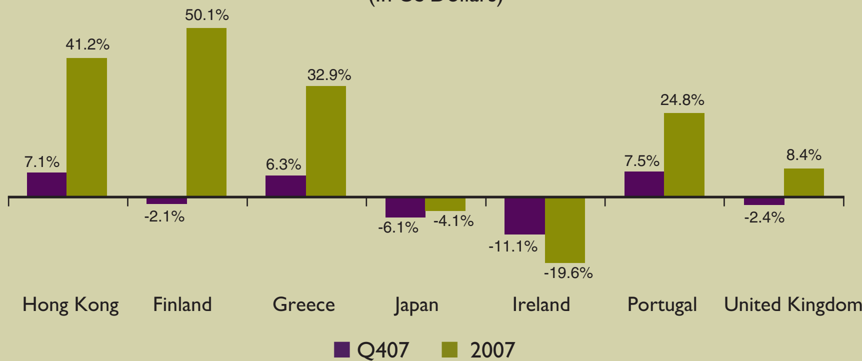
The Lehman Brothers Aggregate Bond Index gained 3.0% during the fourth quarter and 7.0% for 2007 *(Exhibit 6)*. Yields on government bonds around the world fell throughout the quarter as declining property values and the subprime market fallout threatened to push the US into a recession. Despite the turmoil in global credit markets, the JP Morgan Emerging Markets Bond Index, which is comprised primarily of sovereign debt, posted a solid 2.6% return for the quarter and a 6.3% gain for the year. Compared to the other areas of global credit, fundamentals in emerging markets remain strong, with growth exceeding that of the G7. Global risk aversion has risen significantly over the past six months.

The credit crisis continues to cause a massive flight-to-quality. Prices of Treasury securities have skyrocketed and yields have plummeted. The speculative end of the fixed income market continues to retreat due to concerns over leveraged companies in a deteriorating macro-economic environment. In a reversal of 2005 and 2006, the lowest quality subset of the leveraged credit market underperformed its higher quality counterparts. The Merrill Lynch High Yield Master Index ended the quarter down 1.2% and up only 2.2% for the year, barely holding on to gains made early in 2007. The Merrill Lynch CCC and Lower Index posted a 3.4% loss in the fourth quarter and a modest 0.4% gain for the year. Spreads on CCC-rated debt and lower widened by approximately 383 basis

EXHIBIT 4

DEVELOPED MARKETS

(In US Dollars)

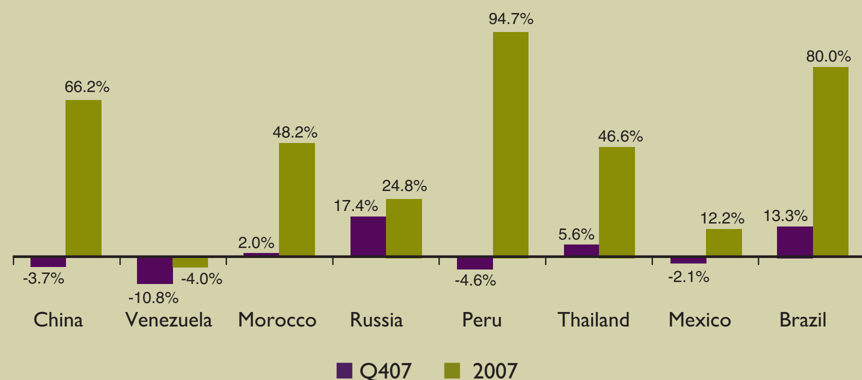


Source: mscibarra.com

EXHIBIT 5

EMERGING MARKETS RETURNS

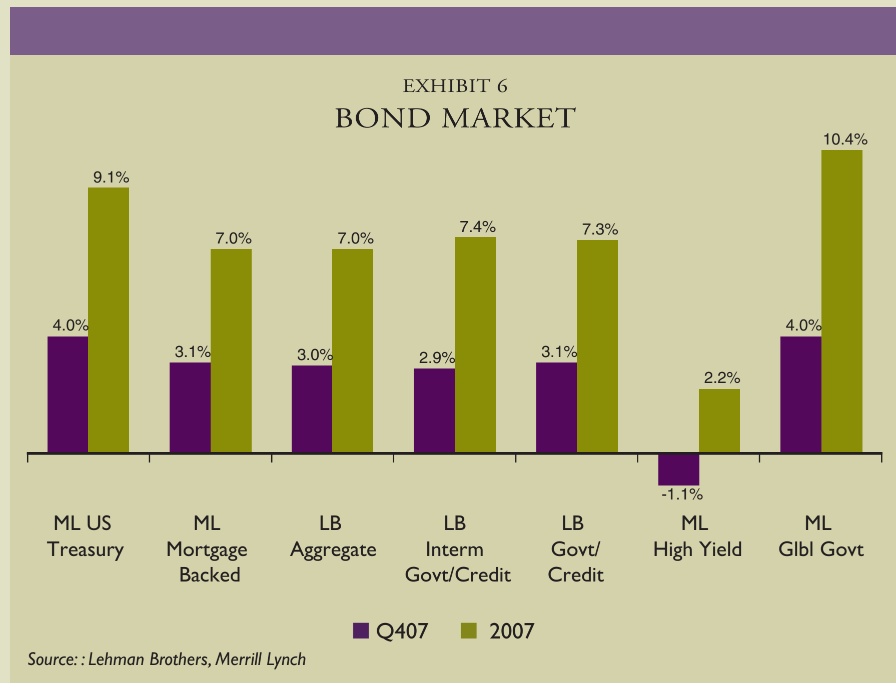
(In US Dollars)



Source: mscibarra.com

points during the year to 911 basis points. The spreads surged on weakness in the US economy and a loss of investor confidence in bond ratings. Spreads of Fannie Mae and Freddie Mac, seen as backed by the US government, have also widened significantly over the past 12 months.

The municipal bond market ended 2007 with yields very close to that of Treasuries. This was one of the worst municipal bond markets in years. Yields of municipals fell during the quarter as the municipal curve steepened. Returns on these bonds were weaker than almost every other sector of the fixed income market. Throughout the fourth quarter, the municipal market was threatened by liquidity challenges, particularly in intermediate and longer maturities. Rating agencies expressed concern over the amount of capital that had been set aside to handle defaults on securitized loans. The rating agencies then placed many of the major AAA-rated insurers on watch for a downgrade, thus resulting in a tumultuous market for municipal bonds.



ALTERNATIVE INVESTMENTS

Hedge Funds

Hedge funds outperformed the global equity market during the fourth quarter, with the HFRI Fund Weighted Composite Index posting a 1.1% gain in the quarter and a 10.0% increase for 2007. The hedge fund of funds benchmark slightly outperformed its single manager counterpart, returning 2.0% for the quarter and 10.3% for the year as represented by the HFRI Hedge Fund of Funds Index *(Exhibit 7)*. According to HFR, Inc., the industry attracted $195 billion of new capital during the year, which puts the industry close to the $2 trillion mark.

Within the hedge fund market, a few strategies stood out as a result of their ability to capitalize on market volatility. Equity long/short and global macro strategies took advantage of the market environment, generating 10.6% and 11.2% gains for the year. Strategies more reliant on credit or corporate event catalysts fell upon hard times during the second half of 2007. The HFRI Distressed Index lost 1.9% in the last six months of 2007, and the HFRI Event Driven Index fell 1.6% during that period *(Exhibit 8)*.

These results are primarily due to the credit crunch that has severely impacted the short-term commercial paper, auction rate debt, and junk bond markets. Managers in these strategies depend heavily on strength and reliability in these three markets.

Banks have written off upwards of $180 billion in bad debt related to mortgages in the US, which surpasses the write-offs following the S&L bailout of the late 1980s. Some hedge funds have not been able to escape the fall-out and have been forced to sell illiquid positions in fixed income assets. The absence of buyers in the market has often caused sale prices to be a fraction of the purchase cost. Losses from the credit crisis have not been limited to smaller hedge fund firms. Since July, a number of hedge funds with assets over $1 billion have collapsed as a result of the subprime and mortgage market contagion. As with every crisis, there remains a reason for hope in that many hedge fund managers are hoarding cash in order to take advantage of all the "broken-debt" strewn across the market. The biggest question in the minds of these hedge fund managers is when to begin deployment of their cash.

The credit market has not been the only area of volatility in 2007. Equity volatility, as measured by the VIX, has been on a steady increase over the last year. Hedge fund strategies targeting long volatility trades have been rewarded. Large gyrations in equity market prices provide ample opportunities for long/short managers to find entry and exit points for their portfolio positions. We believe this volatility trend will continue through 2008 and into 2009 *(Exhibits 9 and 10)*.

Directional equity long/short and global macro managers should benefit from continued high equity market volatility. The distressed credit and mortgage backed credit markets have experienced a dislocation of historical proportions which could lead to opportunities for hedge fund managers. Strong fundamental research will be an important factor in how well hedge fund managers perform in 2008. Determining the bottom of the credit market continues to be elusive. The bank loan market, which has taken a beating through the credit storm, may be the first segment of the fixed income market to recover due to its higher inherent transparency.

Commodities

The Dow AIG Commodity Index gained 4.7% in the fourth quarter to end the year up 16.2%. Crude, precious metals, and grains all saw large gains in the quarter and for the year. Natural gas, livestock, and industrial metals each ended the quarter and the year in negative territory *(Exhibit 11).*

Crude endured a volatile quarter to end 2007 at $95.78, a 40.1% gain for the year. In October, crude set record high prices, breaking the $90 barrier for the first time. Declining global inventories and weakness in the dollar supported the higher prices. In November, prices fell as refinery utilization levels recovered to normal levels. In December, strong global demand pushed prices higher once again. Geopolitical concerns, including the assassination of Pakistani opposition leader Benazir Bhutto, continued to push energy prices higher.

Grains rose 9.5% in the fourth quarter to end the year up 42.1%. Wheat prices dipped in October as investors realized profits from September's record highs. USDA export data showing softening of overseas demand also contributed to the temporary decline. However, wheat recovered in the second half of the quarter and ended 2007 up 52.1%. Corn rose sharply in December on reports that China may impose higher export tariffs as a means to boost domestic supply. Soybeans also rose during the quarter to end the year up 54.4%.

Natural gas enjoyed a brief rally early in the quarter due to rising crude prices. However, in November, prices fell once again as supply remained above the 5-year average. Natural gas ended the year down 22.9%. Livestock also suffered a double-digit loss for the year, falling 10.7%. Hog prices were hit especially hard due to ample US supply and sell-offs after investors failed to see evidence of potential Chinese imports.

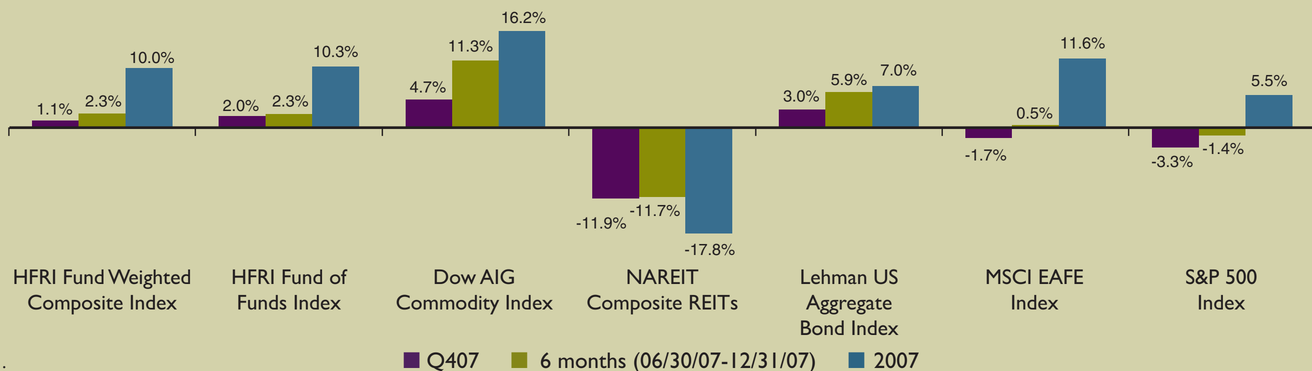
Dollar woes helped to boost gold prices in the fourth quarter. Precious metals rose 10.6% in the quarter and 26.0% for the year. Conversely, industrial metals dipped due to weak US housing data, worries over the US economy, and sizable inventory increases. Industrials fell 13.4% to end the year down 9.9%.

Real Estate Investment Trusts (REITs)

The fourth quarter was difficult for real estate stocks. The NAREIT Composite

EXHIBIT 7

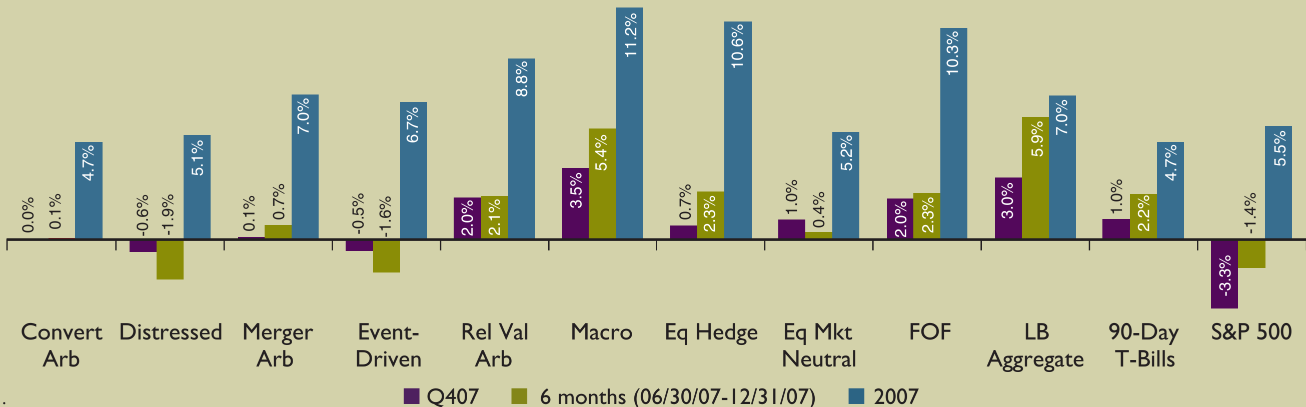
ALTERNATIVE VS. TRADITIONAL INDICES



Source: HFRI, Inc

EXHIBIT 8

HEDGE FUND STRATEGIES (HFRI INDICES) VS. TRADITIONAL INDICES

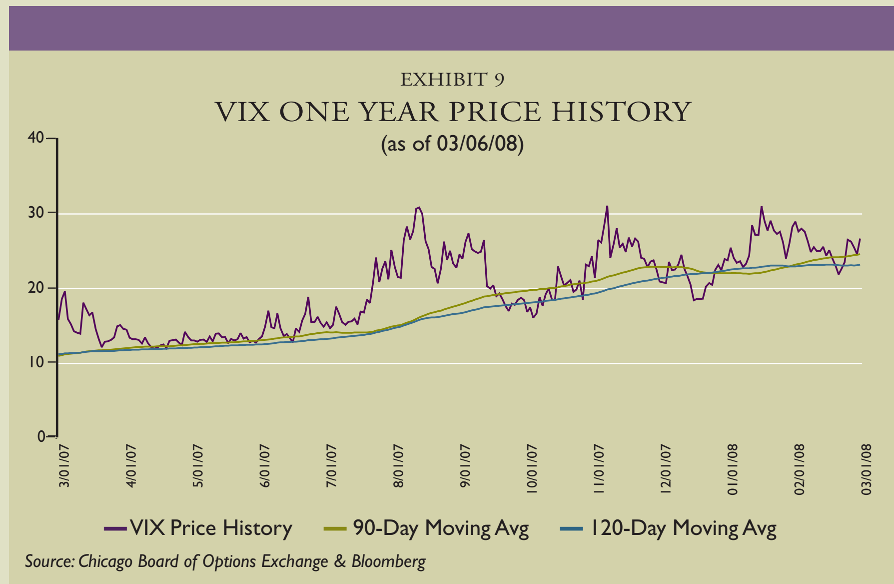


Source: HFRI, Inc

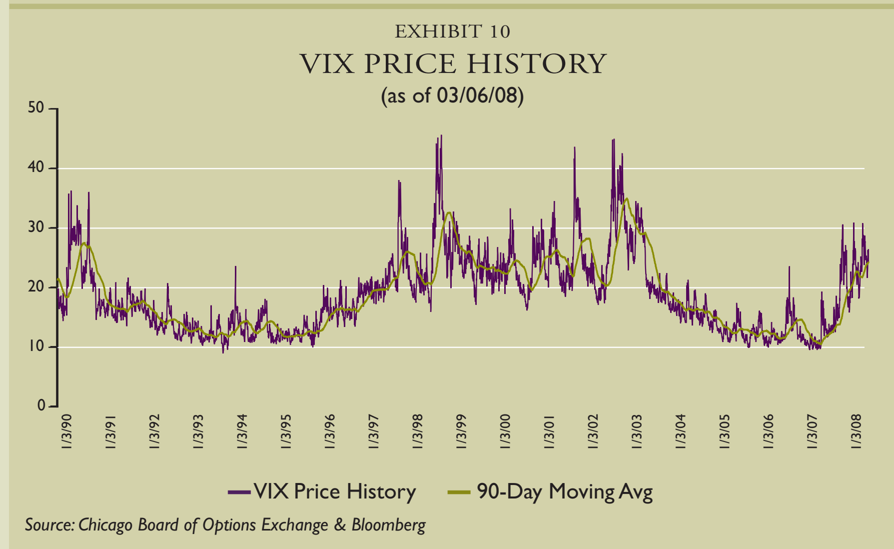
REITs Index declined 12.0% to post a decline of 17.8% for the year. The loss ended a seven-year streak of positive results for the REIT index. Fears over an economic recession fueled worries about the underlying fundamentals for real estate. Credit markets for real estate came to a standstill, removing a positive catalyst for the REIT market.

Most property sectors declined for the year. The best performers were those with longer leases, such as health care. The industrial sector was slightly profitable, benefiting from strong global trade and demand for warehouse space. Apartment REITs experienced sizable declines, reflecting their shorter leases and concerns over a rise in single-family homes available for rent. Offices also suffered amid fears that unemployment would rise, particularly among financial services tenants. Mortgage REITs were slightly positive for the quarter, but ended the year with a 42.4% loss.

International REITs posted mixed results for the quarter. The MSCI Europe REIT Index declined 12.8% for the quarter, and ended the year down 26.2%. Emerging markets, however, saw only a slight decline in the fourth quarter. The MSCI Emerging Markets REIT Index finished 2007 up 14.8%.



Source: Chicago Board of Options Exchange & Bloomberg



Source: Chicago Board of Options Exchange & Bloomberg

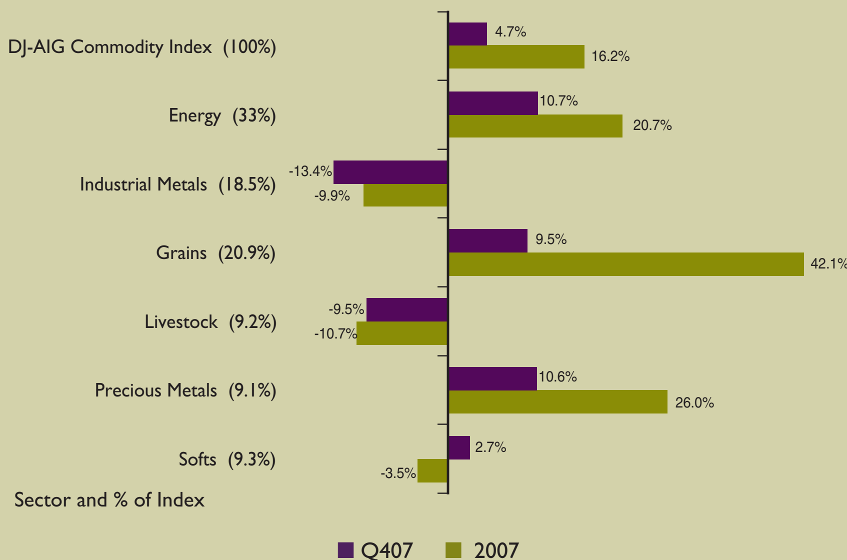
GLOBAL OUTLOOK

Despite a significant slowdown in the United States, global growth remains robust and should remain in the 4.3% to 4.7% range in 2008. Forecasted growth rates remain above the long-term trend line of 3.7%, and the current global expansion continues to be the fastest in over three decades. Double-digit GDP growth continues in the BRIC countries, while the US and continental European economies have slowed toward 2%. Central and Eastern Europe are growing in a 5.0% to 8.0% range, and Asian (except Japan) economies continue to grow at above trend rates.

The US economy slowed considerably in the fourth quarter and is forecasted to grow 1.5% to 2.0% in 2008. Several factors contributed to the slowdown, with the most significant being the fallout in residential housing and its effect on consumer spending and tighter lending standards. Residential housing still has not found a bottom and commercial real estate has now begun to see softness in several markets. It remains unlikely the US economy can realize any significant growth until the housing sector bottoms, consumer spending picks up again, and credit markets thaw. Additional factors limiting growth are the volatility in financial markets, a run up in oil prices, and a general erosion of consumer confidence.

The US dollar depreciated an additional 2.7% and 2.9% against the euro and yen during the fourth quarter. We believe the US dollar will continue to drift even lower as the Federal Reserve aggressively cuts rates in an effort to head off a recession and pump liquidity into "frozen" credit markets. Ever increasing fiscal deficits will also contribute to dollar devaluation along with China's long-term goal of slowly de-pegging its currency to the dollar. A major sell-off in the dollar seems unlikely as China, Japan, the UK, and Saudi Arabia continue to hold over 50% of total US debt. On a positive note, a slowdown in US consumer spending has helped contribute to a decline in the US current account deficit. The deficit dropped to 4.8% of GDP at year-end. The US labor market remains healthy with unemployment remaining under 5.0%.

European GDP growth advanced in each quarter during 2007 to end the year with a 2.9% gain. This represents the best year



since 2000, despite flat consumer spending. Looking to 2008, GDP growth is expected to slow to approximately 2.0%. The deceleration will likely be a result of higher interest rates relative to the US, a stronger euro, and rising energy prices. The European Central Bank has ended their cycle of tightening and is injecting large amounts of liquidity into the system to combat dislocated credit markets. Exports and capital investment should fuel growth as the expanding Central and Eastern European countries increase demand for goods and services produced in Western Europe.

In Japan, the recovery that began in 2003 seems to have stalled as housing continues to contract and business investment has flattened. This has caused the Bank of Japan to suspend rate hikes for the time being. Forecasted growth in 2008 is 1.3% to 1.5%.

Longer term, global inflation looks anything but benign. Continued high energy and commodity prices coupled with above trend wage increases will cause central bankers to increase rates as soon as the massive overhang of structured credit is absorbed and liquidity returns to the credit markets. Headline inflation in the US was 4.3% for 2007. Core inflation, which excludes food and energy, was 2.3%. Central bankers remain in a precarious position as they try to combat inflationary pressures while increasing liquidity through open market operations and rate cuts.

Equity valuation improved during the quarter, with Price/Earnings (P/E) ratios falling in most markets *(Exhibit 12)*. At year-end, the earnings yield on the S&P 500 Index was 5.9% compared to a 10-year US Treasury yield of 4.1%.

High quality fixed income has rallied as hundreds of securitized credit vehicles have been downgraded and investors have sought safer, more transparent vehicles. Leveraged investment vehicles financed by asset backed commercial paper (SIVs) have been dramatically re-priced. The contagion effect of this "credit bust" continues to spill over into the equity market, creating historically high volatility. This credit dislocation has gotten worse than even the most astute investors predicted, and is in fact a "credit bust," not crunch, with unprecedented actions being taken by the US Federal Reserve and the European Central Bank. How did this "bust" get so bad, and what were the drivers that helped facilitate the malaise? There is plenty of blame to throw around, but it would be helpful to go through the securitized debt implosion one step at a time.

Part One – Wizards of Wall Street packaged risks (mortgages, mezzanine debt, equity, etc.) into securities that could be sold to investors (we will call them CDOs for now, although there are all kinds of structured credit). The re-securitization of these is called CDO-squared – which of course can be exponentially more risky.

Part Two – Banks turned into loan originators in that they could deliver their mortgages to Wall Street firms that would securitize them and sell them to investors. The risk of loans and potential defaults where moved off the bank's books, therefore leaving reserve requirements virtually unchanged.

Part Three – The rating agencies determined that these pools of assets had sufficient diversification with minimal risk of default and awarded "gold standard" AAA ratings. High ratings were critical for the securitization and leveraging scheme to work. They did so willingly because of the generous fees they could collect for rating these securities. Delegating much of the responsibility and authority of assessing credit risk to credit rating organizations, that are compensated by the issuers, Wall Street, not the buyers, has inherent conflicts of interests. The Bush administration has told the US Treasury to consider splitting the agencies.

Part Four – Unknowing investors, such as pension funds and municipalities, sought higher yields to reach their return goals. However, the investors also faced restrictions on the quality of securities they could purchase. Investors snapped up these AAA-rated securities as the yields 100 to 300 basis points above US Treasuries, seemed very attractive. Thus, the real culprits of this debacle are Standard & Poor's, Moody's, and Fitch.

Securitization has transferred risk from loan originators to the holders of CDOs, CLOs, CMBS, CDO-squared, SIVs, etc. Of the $383 million in subprime loans packaged in 2006 by the 12 largest securitization firms, $77.3 million (20%) are now in default. (Data source: Inside Mortgage Finance and Bloomberg

Financial Markets.) Large financial institutions have taken a significant number of these structured finance products back to their own balance sheets. Not doing so would risk their reputations as well as their relationships with their best clients. The best estimate is that large banks and brokerages have written off more than $180 billion since June 2007. As much as $300 billion in write-offs could follow in 2008.

The ratings agencies claim they should not be accountable for their opinions because they are nothing more than journalists engaged in free speech. This stance is a travesty for the public and municipal funds that rely on ratings to formulate acceptable fixed income investment policy. Sean Egan, managing director of Egan-Jones, recently said, "The issuer-supported business rating model has led to a breakdown in faith among investors. Rating agencies are guilty of false advertising. They should provide a tobacco-style disclaimer with their ratings." Erick Mindich, chief executive of Eton Park Capital, said, "I do not think the market can discipline the rating agencies sufficiently."

We continue to believe the market may need another two to four quarters for the majority of the write-offs to occur. Continued downgrades will cause subsequent dumping of non-investment grade securities by a host of institutional investors to include municipalities, pension, and public fund entities. This will in turn create enormous opportunities for event-driven strategies, specifically distressed debt.

COURSE OF ACTION

We continue to favor stocks over bonds and international equities over US equities. Earnings growth in the US and continental Europe should be close to 5.0%, and we expect over 10.0% earnings growth in emerging markets. Bonds appear especially unattractive at this time. The recent bond rally is not sustainable, as it was a result of a flight to quality and central bank easing. Significant rate cuts have already occurred, and we believe further cuts are already priced into the market.

US equity valuations are in line with longer-term historical averages, but remain higher than international valuations. We believe the dollar will continue to weaken versus most global currencies as the Federal Reserve continues to cut rates and US fiscal deficits mount. The dollar may strengthen in 2009 when many tax cuts expire and the US moves towards balanced budgets. We recommend 70% of an equity allocation to developed and emerging markets.

Our equity style opinion remains unchanged from last quarter. We still recommend overweighting growth versus value. According to the US Russell Indices, in 2007 growth stocks outperformed value stocks by 12.0% in large capitalization, 12.9% in mid capitalization, and 16.8% in small capitalization. We expect value indices to remain under pressure due to a heavy weight to financial stocks. Financial stocks will face additional write-downs as a result of the securitized debt implosion for another two to four quarters. Conversely, growth stocks seem poised to continue their relative run with energy, materials, and technology leading the way.

EXHIBIT 12

12-MONTH FORWARD PRICE/EARNING RATIOS (P/E)

	Q407	Q307	% Change
S&P 500	14.36	14.84	-3.23%
Russell 1000	14.68	15.24	-3.67%
Russell 2000	19.53	20.43	-4.41%
Russell 3000	14.96	15.54	-3.73%
Russell 3000 Growth	17.42	18.16	-4.07%
Russell 3000 Value	12.93	13.49	-4.15%
MSCI EAFE	12.96	13.53	-4.21%
MSCI EAFE Small Cap	13.92	15.38	-9.49%
MSCI Emerging Markets	13.45	14.09	-4.54%

Source: Thomson Portfolio Analytics

We continue to be ambivalent as to market capitalization. Many market pundits have advocated large capitalization issues for the last three to four years. Their wish finally came true as large capitalizations outperformed small capitalizations in 2007 for the first time since 1999. We agree with the valuation argument for larger stocks, but are not sure they will retain leadership for long, especially in the US. The 65% plus devaluation of the dollar versus most major currencies over the past few years has artificially increased exports and earnings for US multi-nationals. Pent up inflation will also erode earnings going forward.

We are optimistic about many hedge fund strategies, especially relative to long equities. Continued volatility should create mis-pricing opportunities for many hedge fund managers. Strategies focusing on real assets and other commodities should do well as global GDP growth continues above trend and exerts additional pressures on prices. Opportunities for distressed debt strategies should become more abundant later in the year as banks, insurance companies, and brokerages continue to write off large exposures to mortgage-backed securities, SIVs, CDOs, and other structured products. Event-driven opportunities in equity could also begin to materialize later in the year as global consolidation continues, especially in the financial sector. In private equity, the leveraged buyout market has died with the disappearance of credit. However, growth capital private equity in Asia, Latin America, and East and Central Europe remains attractive. Global real estate, especially the residential sector has yet to find a bottom. Commercial real estate has recently come under pressure as a global economic slowdown and a scarcity of credit adversely affects the market. We remain underweight to this asset class for now, but continue to believe the asset class (at least residential) will bottom out in late 2008 or early 2009. We are anxious to see how the US market absorbs over $600 billion in mortgage resets over the next three quarters.

2008 looks to be a challenging year with continued dislocations in the credit market and significantly higher equity volatility. We do not expect much in returns from the equity market until later in the year, specifically until after the US presidential election.

EXHIBIT 13: Output, Prices and Jobs

% change from one year ago

	Gross Domestic Product				Industrial Production	Consumer Prices			Unemployment
	latest	qtr*	2008†	2009†	latest	latest	year ago	2008†	Rate‡, %
United States	+2.8 Q3	+4.9	-2	+2.6	+1.5 dec	+4.1 Dec	+2.5	+2.8	5.0 Dec
Japan	+1.9 Q3	+1.5	+1.4	+1.9	+2.9 Nov	+0.6 Nov	+0.3	+0.3	3.8 Nov
China	+11.5 Q3	na	+10.1	+9.6	+17.3 Nov	+6.9 Nov	+1.9	+3.5	9.5 2007
Britain	+3.3 Q3	+2.7	+1.9	+2.2	+0.4 Nov	+2.1 Dec§	+3.0	+2.1	5.3 Nov††
Canada	+2.9 Q3	+2.9	+1.9	+2.5	+0.8 Oct	+2.5 Nov	+1.4	+1.9	5.9 Dec
Euro Area	+2.7 Q3	+2.8	+1.8	+2.0	+2.7 Nov	+3.1 Dec	+1.9	+2.3	7.2 Nov
Austria	+3.3 Q3	+3.0	+2.6	+2.6	-0.8 Oct	+3.6 Dec	+1.5	+2.1	4.3 Nov
Belgium	+2.6 Q3	+2.2	+2.0	+2.0	+0.6 Oct	+3.1 Dec	+1.6	+2.0	10.7 Nov††
France	+2.2 Q3	+3.2	+1.8	+2.0	+2.5 Nov	+2.6 Dec	+1.5	+2.0	7.9 Q3§§
Germany	+2.5 Q3	+2.8	+1.9	+2.1	+3.5 Nov	+2.8 Dec	+1.4	+2.1	8.4 Dec
Greece	+3.8 Q3	+3.6	+2.9	+2.5	+3.6 Nov	+3.9 Dec	+2.9	+3.0	7.9 Oct
Italy	+1.9 Q3	+1.7	+1.3	+1.5	-2.4 Nov	+2.6 Dec	+1.9	+2.3	5.9 Q3
Netherlands	+4.2 Q3	+7.5	+2.1	+2.2	+1.8 Nov	+1.9 Dec	+1.3	+2.0	4.1 Dec††
Spain	+3.8 Q3	+2.9	+2.4	+2.3	-0.6 Nov	+4.2 Dec	+2.7	+3.1	8.2 Nov
Czech Republic	+6.0 Q3	+2.9	+4.8	+5.3	+6.7 Nov	+5.4 Dec	+1.7	+5.4	6.0 Dec
Denmark	+1.7 Q3	+5.8	+1.6	+1.7	-1.9 Nov	+2.3 Dec	+1.8	+2.0	2.8 Nov
Hungary	+1.0 Q3	+6.7	+3.0	+3.7	+5.5 Nov	+7.4 Dec	+6.5	+4.5	7.5 Nov††
Norway	+3.1 Q3	+1.2	+2.9	+2.6	+2.0 Nov	+2.8 Dec	+2.2	+2.2	2.5 Oct
Poland	+6.4 Q3	na	+5.2	+.4	+8.3 Nov	+4.0 Dec	+1.4	+3.3	11.2 Nov‡‡
Russia	+7.6 Q3	na	+6.7	+5.7	+4.7 Nov	+11.9 Dec	+9.0	+11.5	5.8 Oct‡‡
Sweden	+2.5 Q3	+2.4	+2.7	+2.6	+4.2 Nov	+3.5 Dec	+1.6	+2.6	5.2 Nov‡‡
Switzerland	+2.9 Q3	+1.3	+2.0	+2.0	+10.7 Q3	+2.0 Dec	+0.6	+1.4	2.6 Dec
Turkey	+1.5 Q3	na	+3.8	+5.2	+7.7 Nov	+8.4 Dec	+9.7	+8.1	9.2 Q3‡‡
Australia	+4.3 Q3	+4.1	+3.6	+3.4	+4.6 Q2	+1.9 Q3	+3.9	+3.2	4.3 Dec
Hong Kong	+6.2 Q3	+7.0	+4.8	+5.7	-2.1 Q3	+3.4 Nov	+2.2	+3.6	3.4 Dec††
India	+8.9 Q3	na	+7.7	+7.2	+5.3 Nov	+5.5 Nov	+6.3	+6.1	7.2 2007
Indonesia	+6.5 Q3	na	+6.1	+5.7	+8.3 Oct	+6.6 Dec	+6.6	+6.2	9.8 Feb
Malaysia	+6.7 Q3	na	+5.7	+5.8	+2.7 Nov	+2.3 Nov	+3.0	+2.5	3.1 Q3
Pakistan	+7.0 2007**	na	+5.4	+5.5	+9.8 Oct	+8.8 Dec	+8.9	+7.9	6.2 2006††
Singapore	+6.0 Q4	-3.2	+4.9	+4.7	-1.5 Nov	+4.2 Nov	+0.5	+3.0	1.7 Q3
South Korea	+5.2 Q3	+5.4	+4.9	+4.7	+10.8 Nov	+3.6 Dec	+2.1	+2.5	3.1 Dec
Taiwan	+6.9 Q3	na	+4.6	+3.9	+11.1 Nov	+3.3 Dec	+0.7	+2.0	3.9 Nov
Thailand	+4.9 Q3	+6.3	+4.8	+4.1	+10.8 Oct	+3.2 Dec	+3.5	+3.2	1.2 Sep
Argentina	+8.7 Q3	+11.7	+6.2	+4.7	+8.3 Nov	+8.5 Dec	+9.8	+11.4	8.1 Q3‡‡
Brazil	+5.7 Q3	+6.9	+4.5	+4.1	+6.7 Nov	+4.5 Dec	+3.1	+4.0	8.2 Nov‡‡
Chile	+4.1 Q3	-2.5	+4.5	+5.0	+4.2 Nov	+7.8 Dec	+2.6	+5.4	7.3 Nov††‡‡
Colombia	+6.6 Q3	+6.9	+5.5	+4.4	+8.3 Oct	+5.7 Dec	+4.5	+4.7	9.4 Nov‡‡
Mexico	+3.7 Q3	+5.9	+2.8	+3.5	+0.8 Nov	+3.8 Dec	+4.1	+3.8	3.5 Nov‡‡
Venezuela	+8.7 Q3	na	+5.1	+3.9	+2.7 Sep	+22.5 Dec	+17.0	+19.8	8.5 Nov‡‡
Egypt	+6.9 Q3	na	+7.3	+6.6	+7.5 2007**	+6.9 Dec	+12.4	+7.5	8.8 Q3‡‡
Israel	+4.8 Q3	+6.1	+4.3	+4.6	+6.9 Oct	+4.3 Dec	-0.1	+2.4	7.3 Q3
Saudi Arabia	+4.3 2006	na	+6.0	+5.6	na	+6.5 Dec	+2.9	+4.2	na
South Africa	+5.1 Q3	+4.7	+5.1	+5.4	+4.4 Nov	+8.4 Dec	+5.4	+6.6	25.5 Mar‡‡

*% change on previous quarter at an annual rate.
†The Economist poll or Economist Intelligence Unit estimate/forecast.definitions.
§RPI Infaltion rate 4.0% in Dec.
**Year ending in June.
††Latest 3 months.
‡‡Not seasonally adjusted.
§§New series.

EXHIBIT 14: Trade, Exchange Rates, Budget Balances and Interest Rates

	Trade Balance	Current account balance		Currency units, per $		Budget Balance	Interest Rates, %	
	latest 12 months, $bn	latest 12 months, $bn	% of GDP 2008†	Jan 16th	year ago	% of GDP 2008‡	3-month latest	10-year gov't bonds, latest
United States	-813.0 Nov	-752.4 Q3	-4.8	-	-	-1.7	3.74	3.71
Japan	+107.0 Nov	+212.9 Nov	+4.8	107	121	-2.5	0.74	1.39
China	+261.5 Dec	+249.9 2006	+10.9	7.23	7.77	0.1	4.48	4.62
Britain	-168.2 Nov	-129.4 Q3	-3.4	0.51	0.51	-3.0	5.58	4.37
Canada	+48.7 Nov	+16.3 Q3	+0.4	1.02	1.17	0.8	3.59	3.81
Euro Area	+51.7 Oct	+38.2 Oct	+0.2	0.68	0.77	-0.9	4.51	3.97
Austria	+1.0 Oct	+11.3 Q3	+2.7	0.68	0.77	-0.6	4.51	4.07
Belgium	+19.2 Oct	+13.3 sep	+2.3	0.68	0.77	-0.4	4.57	4.15
France	-51.7 Nov	-31.6 Nov	-1.3	0.68	0.77	-2.6	4.51	4.07
Germany	+268.1 Nov	+218.0 Nov	+5.6	0.68	0.77	0.8	4.51	3.96
Greece	-53.7 Oct	-43.2 Oct	-12.9	0.68	0.77	-2.5	4.51	4.33
Italy	-12.0 Oct	-42.3 Oct	-2.4	0.68	0.77	-2.7	4.51	4.33
Netherlands	+56.4 Nov	+57.2 Q3	+7.6	0.68	0.77	0.4	4.51	4.06
Spain	-128.7 Oct	-126.1 Aug	-8.9	0.68	0.77	0.1	4.51	4.15
Czech Republic	+4.1 Nov	-5.4 Oct	-3.6	17.8	21.5	-2.6	3.97	4.53
Denmark	+4.2 Nov	+4.0 Nov	+1.4	5.07	5.76	2.8	4.77	4.09
Hungary	-0.5 Nov	-6.8 Q3	-6.2	174	196	-4.4	7.50	6.90
Norway	+59.0 Dec	+59.9 Q3	+15.3	5.42	6.44	18.0	5.74	4.60
Poland	-11.7 Oct	-15.8 Nov	-4.2	2.45	3.01	-1.9	5.65	5.85
Russia	+128.2 Nov	+76.6 Q4	+4.0	24.5	26.5	1.0	10.00	6.19
Sweden	+18.7 Nov	+29.4 Q3	+6.4	6.42	7.02	2.3	4.02	4.02
Switzerland	+11.8 Nov	+69.6 Q3	+14.7	1.10	1.25	0.6	2.65	2.83
Turkey	-60.8 Nov	-35.7 Nov	-7.1	1.18	1.43	-2.9	16.67	6.12‡
Australia	-17.6 Nov	-49.9 Q3	-5.4	1.14	1.27	1.4	7.17	5.97
Hong Kong	-22.7 Nov	+26.9 Q3	+8.9	7.80	7.80	2.3	3.12	2.58
India	-67.9 Nov	-10.9 Q3	-2.0	39.3	44.2	-3.3	7.00	7.77
Indonesia	+40.3 Nov	+10.3 Q3	+1.9	9445	9108	-1.8	8.00	6.84‡
Malaysia	+29.9 Nov	+28.7 Q3	+11.3	3.27	3.50	-3.0	3.62	3.87‡
Pakistan	-15.2 Dec	-7.3 Q3	-6.4	62.5	60.9	-5.0	9.92	9.77†
Singapore	+36.1 Dec	+46.3 Q3	+22.4	1.43	1.54	0.1	1.75	2.19
South Korea	+15.3 Dec	+7.2 Nov	+0.6	940	937	0.3	5.86	5.39
Taiwan	+16.7 Dec	+28.4 Q3	+5.9	32.3	32.8	-2.0	2.60	2.63
Thailand	+11.0 Nov	+14.4 Nov	+2.4	33.1	35.8	-2.1	3.55	4.22
Argentina	+10.8 Nov	+6.8 Q3	+1.7	3.14	3.08	1.2	12.95	na
Brazil	+40.0 Dec	+4.7 Nov	+0.1	1.77	2.14	-2.5	11.18	6.16‡
Chile	+24.5 Dec	+6.7 Q3	+4.0	478	543	5.4	6.36	4.19‡
Colombia	-1.8 Sep	-5.2 Q3	-3.8	1965	2225	-1.3	9.05	5.89‡
Mexico	-11.2 Nov	-7.5 Q3	-1.8	11.0	10.9	nil	7.41	8.03
Venezuela	+23.4 Q3	+20.2Q3	+6.9	5.40	3980§	-2.6	12.88	6.55‡
Egypt	-15.8 Q2	+2.7 Q2	+0.7	5.46	5.70	-6.9	6.78	5.23‡
Israel	-10.3 Dec	+5.9 Q3	+3.1	3.73	4.23	-1.4	4.33	5.47
Saudi Arabia	146.6 2006	+98.9 2006	+23.9	3.75	3.75	22.4	4.03	na
South Africa	-10.0 Nov	-19.9 Q3	-7.5	6.95	7.17	0.6	11.30	8.31

*Merchandise trade only.
†The Economist poll or Economist Intelligence Unit forecast.
‡Dollar denominated bonds.
§Unofficial exchange rate

EXHIBITS 15 & 16: Index Tables (period ending December 31, 2007)

INTERNATIONAL DEVELOPED MARKET PERFORMANCE

	In Local Currency		In US Dollars	
	Q407	2007	Q407	2007
REGIONS				
EAFE	-2.91%	3.97%	-1.71%	11.63%
EURO	-0.17%	10.39%	2.64%	22.39%
EUROPE	-1.43%	6.53%	-0.43%	14.39%
THE WORLD INDEX	-2.94%	5.20%	-2.33%	9.57%
PACIFIC	-6.26%	-1.40%	-4.58%	5.61%
WORLD ex USA	-2.74%	4.46%	-1.57%	12.92%
NATIONAL INDICES				
AUSTRALIA	-3.19%	16.51%	-3.94%	29.79%
AUSTRIA	-2.23%	-7.42%	0.52%	2.65%
BELGIUM	-8.51%	-11.49%	-5.95%	-1.87%
CANADA	-0.71%	10.46%	-0.03%	30.24%
DENMARK	-2.53%	13.79%	0.17%	26.13%
FINLAND	-4.77%	35.37%	-2.10%	50.09%
FRANCE	-1.98%	2.84%	0.77%	14.03%
GERMANY	2.22%	22.60%	5.09%	35.93%
GREECE	3.41%	19.87%	6.31%	32.91%
HONG KONG	7.53%	41.57%	7.14%	41.20%
IRELAND	-13.52%	-27.52%	-11.09%	-19.64%
ITALY	-2.00%	-3.26%	0.75%	7.26%
JAPAN	-8.77%	-10.13%	-6.07%	-4.14%
NETHERLANDS	-4.42%	9.26%	-1.74%	21.14%
NEW ZEALAND	-5.29%	0.59%	-3.55%	9.78%
NORWAY	-0.38%	15.50%	-0.52%	32.44%
PORTUGAL	4.53%	12.51%	7.46%	24.75%
SINGAPORE	-6.30%	20.44%	-3.37%	28.38%
SINGAPORE FREE	-6.30%	20.44%	-3.37%	28.38%
SPAIN	5.44%	12.46%	8.40%	24.69%
SWEDEN	-12.83%	-4.15%	-12.75%	1.48%
SWITZERLAND	-4.95%	-1.63%	-1.93%	6.06%
UNITED KINGDOM	-0.09%	6.57%	-2.38%	8.39%

Source: Morgan Stanley Capital International

INTERNATIONAL EMERGING MARKET PERFORMANCE

	In Local Currency		In US Dollars	
	Q407	2007	Q407	2007
REGIONS				
EM (EMERGING MARKETS)	2.89%	33.55%	3.66%	39.78%
EM ASIA	0.51%	39.11%	0.20%	41.58%
EM EASTERN EUROPE	11.50%	20.14%	13.44%	25.98%
EM EUROPE	10.39%	22.34%	12.54%	30.36%
EM EUROPE & MIDDLE EAST	9.32%	23.34%	11.71%	31.62%
EM LATIN AMERICA	4.60%	35.58%	7.01%	50.67%
NATIONAL INDICES				
ARGENTINA	-10.79%	-1.40%	-10.83%	-4.02%
BRAZIL	9.60%	50.06%	13.30%	79.99%
CHINA	-3.29%	66.66%	-3.65%	66.24%
CHILE	-4.23%	15.71%	-1.67%	23.68%
COLOMBIA	3.74%	3.57%	4.06%	15.00%
CZECH REPUBLIC	8.11%	35.86%	14.89%	55.93%
EGYPT	22.81%	53.17%	24.33%	58.43%
HUNGARY	-8.16%	5.93%	-6.16%	16.80%
INDIA	21.98%	54.16%	23.31%	73.11%
INDONESIA	21.37%	61.90%	18.17%	55.03%
ISRAEL	1.85%	29.12%	5.88%	40.02%
JORDAN	24.22%	24.24%	24.17%	24.28%
KOREA	-2.39%	33.45%	-4.57%	32.58%
MALAYSIA	9.00%	36.92%	12.31%	46.07%
MEXICO	-2.24%	13.06%	-2.06%	12.15%
MOROCCO	-0.30%	36.17%	1.99%	48.15%
PAKISTAN	4.70%	40.09%	3.15%	38.39%
PERU	-5.50%	90.77%	-4.58%	94.74%
PHILIPPINES	-1.32%	19.32%	7.71%	41.68%
POLAND	-5.60%	7.89%	1.73%	27.39%
RUSSIA	17.09%	23.07%	17.42%	24.79%
SOUTH AFRICA	0.36%	14.52%	1.28%	18.14%
SRI LANKA	-0.22%	-12.47%	4.17%	-13.44%
TAIWAN	-8.22%	8.62%	-7.65%	9.13%
THAILAND	3.79%	36.63%	5.61%	46.63%
TURKEY	2.44%	44.67%	5.86%	74.81%

Source: Morgan Stanley Capital International

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