CLARK CAPITAL
MANAGEMENT GROUP, INC.

THE navigator™ REPORT

Third Quarter 2007

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TALK ABOUT A CUCKOO'S NEST

If an investor looked at the stock markets at the end of the third quarter on June 30th, and then went away for the next three months, he or she would think that little had transpired in their absence. The S&P 500 advanced 2%; the Dow Jones Industrials advanced about 4%, the Russell index of mid-cap stocks declined 1% while the Russell small-cap index declined 3%. Unlike in 2006, when growth stocks beat out value stocks as the Russell index of growth stocks advanced 4.2% while the Russell index of value stocks declined slightly. All in all, that overview would seem to portray a mixed and rather quiet quarter.

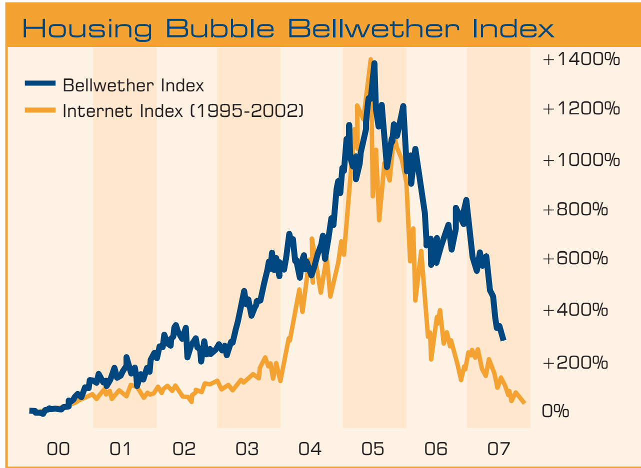
But to the investor that watched their holdings every day and kept pace with developments and current events, the quarter most likely caused many days of hand-ringing and quite possibly a little panic interspersed with days of euphoria and hope. If the investor had gone away for three months and could fly over the quarter's events and market turmoil, undoubtedly it would have appeared as though he had flown over the proverbial cuckoo's nest.

The Dow Jones set a new all time high on July 19th at just above 14,000 and the S&P 500 followed suit. The 14,000 mark was set only 57 days after the Dow had crossed 13,000. The NASDAQ recorded a new high for this bull market but, of course, is still 50% below its all time high of 5,048 reached on March 10, 2000. Then the sub-prime debacle surfaced and all the soothsayers on Wall Street and in Washington could not contain the damage. Realize that 25% of homeowners in this great country of ours have no mortgage at all on their principal residence. Of the remaining 75%, 15% have what are referred to as sub-prime mortgages. What is sub-prime you ask? I suppose that means any mortgage that is issued to less than a prime credit-rated holder. At the start of the debacle, 15% of sub-prime mortgages were in default and under foreclosure and I do not understand why that should have started such a ruckus. But it sure did! **After all, our famous (tongue in cheek) former Fed Chairman, Mr. Greenspan was adamant - telling home buyers to go out and obtain adjustable rate mortgages (ARM) in early 2003 just as he was dropping Fed Funds rates to 1%.** A whole host of people who could not have afforded a house before, realized that they could. Enter the recent housing boom! With Federal Funds at 1%, low mortgage rates meant that many could now afford the payments. That was all well and good until Mr. Greenspan realized that he had kept rates too low for too long and proceeded to increase the Fed Fund rate 17 times to 5¼% in his quest to kill inflation that was already dead. He must have forgotten about all the people he had told to go get ARMs. Mortgage rates are mostly tied to the 10-year Treasury Note which is controlled, for the most part, by the bond market, but Fed policy certainly does have an impact. When sub-prime mortgages issued at low rates were reset for incredibly higher rates, defaults ballooned as mortgage payments doubled in some cases. **As an example of how bad it has become: one in every four mortgage holders in Miami, Florida use over one-half of their monthly income to pay the mortgage.** No wonder defaults are increasing, and it has only just begun. During this month, $50 billion of ARMs are due to be reset. OUCH! And, already the number of mortgages in foreclosure is the highest in the 55 year history of the Mortgage Banker's Association (MBA).

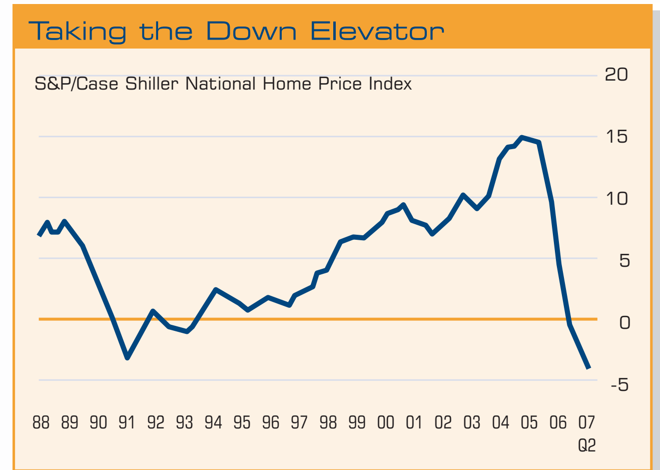
THE HOUSING DEBACLE

If you refer to the Navigator Report of the fourth quarter of 2006 (available on our website) you will see a chart which shows the housing recessions of the past 50 years and that the

last six times housing slumped, the country entered a recession shortly thereafter. Eight of the past ten recessions have been preceded by over-investment and then a slump in housing. **Economists place the chance of recession this time at between 35 and 45%.** But remember, economists have never predicted correctly! Are we near the bottom of the present housing decline? The chart below, from Investech by James Stack shows that we are nearing a potential bottom of this cycle.



I say 'potential bottom' because there are still several reasons to worry about this problem as Mr. Stack details. One is the Affordability Gap. Home prices have risen far above what most folks can afford. Over the past five years the price of homes has become detached from the average family income as tracked by the Consumer Price Index. Another concern is the inventory of unsold homes, both new and existing. New homes account for only 12% of sales while existing homes make up 88% of home sales. Both are at absolute record highs and, so far, show no signs of improvement. There is now a one year supply of existing homes for sale at about 4.6 million units. **All this as the price of homes is declining faster than during the last housing slump in 1991 according to an S&P index shown below.**



VOLATILITY RETURNS

Volatility works both ways and in mid-July just before the Dow Jones set the all time high, the market had a 283 point plus day. That's good volatility. Then the sub-prime mess surfaced with hedge funds closing, Bear Sterns' warning of pending doom, foreign banks closing redemption windows for hedge funds, Countrywide Financial (the largest mortgage originator) rumored to be in liquidation, etc. All this, because although sub-prime issuance was a fraction of the total mortgage pool, hedge funds had leveraged that pool by 10 to 20 times and developed many hybrid derivative investment products. Incredible as it sounds, there are 12,000 hedge funds of all sizes and types. All of a sudden there was no way to price these leveraged products and the major credit crunch ensued. Mortgage rates soared, prime creditors could not borrow, the commercial paper market literally stopped functioning. A real disaster was in the making. The 'R' word was being liberally discussed, and the market tumbled. From mid-July to mid-August the markets went straight down. An historic 1,132 stocks on the NYSE (1/3rd of

CCMG IN THE NEWS

CNBC 'Squawk Box' – September 21, 2007
Sean Clark, CIO of Clark Capital Management Group, is a task force member on CNBC's Squawk Box, discussing market activity and outlook after the interest rate cut.

CNBC 'Squawk Box' – September 12, 2007
Harry Clark, CEO of Clark Capital Management Group, expresses to CNBC's Erin Burnett that the Federal Reserve needs to cut interest rates.

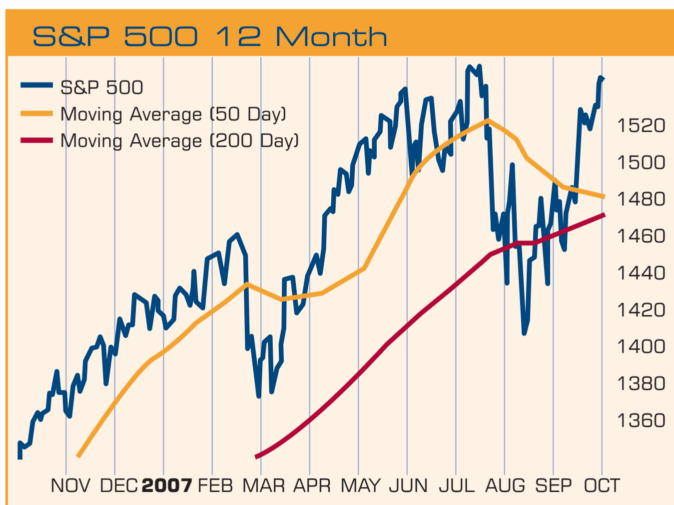
the entire market) made new lows for the year in several days. The 10% correction that we had been waiting for was here in spades (although not on a closing basis). If you refer to the Navigator Report of the First Quarter of 2006 you can see a chart of pre-election markets that showed this correction normally comes in September. It was early! The market suffered several 200 plus up and down days confusing everyone. The stock markets and credit markets were in shock and stability of our entire system was in question.

FED TO THE RESCUE

'Only a calamity would justify an interest rate cut now.' William Poole, President of the St. Louis Federal Reserve Bank, 8/14/2007, said one day before the first rate cut!!!!!!

'It is not the responsibility of the Federal Reserve- nor would it be appropriate- to protect lenders and investors from the consequences of their financial decisions.' Federal Reserve Chairman Ben Bernanke, 8/31/2007.

Obviously we should watch what the Fed does and ignore what they say. You will see why shortly.



The first signs of a true panic surfaced on Thursday, August 14th as the Dow closed down 210 points and was expected to open down several hundred points the next day. The Federal Reserve finally woke up and cut the Discount Rate by .50% before the market opened and calmed down the whole situation. Thank goodness for small, or large, favors from the Fed. Mr. Bernanke passed his first test. This, however, did nothing to help the housing and mortgage situation as the Discount Window is only used by banks to borrow when there is no other recourse open to them. In other words, banks in trouble go to the Discount Window which has not been used in several years. Mr. Bernanke was preparing, and rightly so, for the worst: a large bank or banks in trouble.

The real surprise came on September 18th when Mr. Bernanke stepped up to the plate and hit a home run. He dropped the Federal Funds and the Discount rate .50% (which I predicted two days earlier on CNBC) when only a .25% cut was expected by most analysts. This set off the largest celebration since 1982 when the bull market of the 80's blasted off. The Dow Jones rose over 300 points and upside volume trounced downside volume by better than **30 to 1**. Some say Mr. Bernanke panicked by cutting rates .50%. I don't care if he panicked; in my opinion he did the right thing.

IT'S THE ECONOMY!

Some say that the Fed has the power to prolong economic expansions but not to repeal the fact that every expansion is followed by a contraction. The current economic expansion is 5.8 years old which is well beyond the average of 3.7 years. This expansion is now the fifth longest since 1900 and is surely getting a little long in tooth. But this is a pre-election year and next year is an election year. Can the Fed prolong this expansion until after the 2008 election? Yes! I believe they can if they can control the housing mess. The Fed has tremendous power over the economy with many tools such as interest rates and they can literally make or break the economy with them. If this expansion were to continue past the 2008 election it would become the fourth longest since 1900. It's not an impossible feat. The longest expansion was from 1991 to 2001. We know what happened after that

Bloomberg
TELEVISION

Bloomberg Television - September 4, 2007
President and Chief Executive Officer Harry Clark, appears on Bloomberg Television explaining why the current volatility is healthy for the market.

Money Matters Today

CN8 Money Matters Today - August 14, 2007
Harry Clark, CEO of Clark Capital Management Group, appears live on CN8 to discuss market activity.

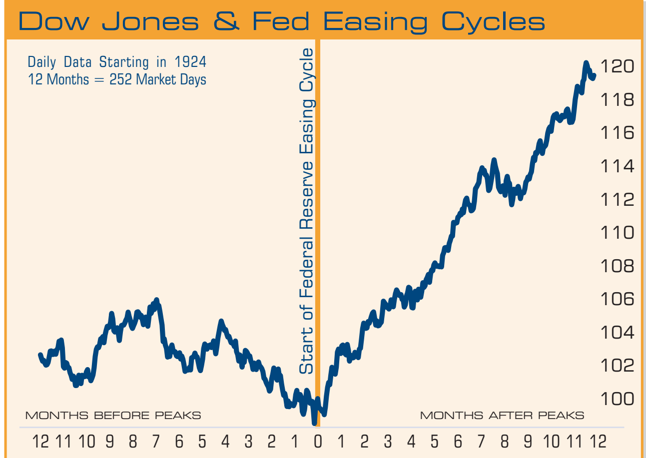
one! The shortest lasted 10 months beginning in 1919. There was another very short expansion in 1980 of one year which was followed by a one year recession. This preceded the 1982 expansion which was the third longest on record and ended shortly after the crash of 1987. **That being said; where do interest rates have to go to preserve the current expansion? The answer is down to 3.75% which is where the 90 day T-Bill is today.** I believe the Fed will lower rates twice more this year down to 4.25% and twice more next year to 3.75%. The Fed Funds rate has typically followed the 90 day rate which is set by the public bond market. The Fed is always behind the curve but they were way behind this time. They have a long way to go to catch up if they want to avoid a total meltdown in the housing and credit markets.

SURPRISE

Can you imagine the surprise of the person flying above the fray over the past quarter, who saw all the confusion and turmoil of the 'cuckoos nest,' when they realize that the market was only a stones throw from the all-time record high. That is the point! The market, so far, has been able to shrug off all the sub-prime, credit crunch, hedge fund bashing, bank problems, and turmoil to hold its head high.

So what next? What drives markets higher is, of course, the economy and the health thereof and anything that smacks of pushing the economy higher such as corporate earnings. Corporate earnings season is again upon us and if earnings are as good as I expect, it could be a very good fourth quarter. Most analysts are looking for third quarter earnings to come in at about a 4% to 5% gain. But recent quarters have all been greeted with 'Surprise, Surprise' as analysts have been way off. In each of the past six quarters, earnings were to have slipped significantly according to estimates. And 'Surprise' they came in higher! This quarter is no exception, as I am expecting analysts will again be low.

Interest rates and the Fed will hold the market hostage. If the Fed cuts rates again, as I expect, there will be another celebration. The chart below shows the result of Fed rate cuts over the years and it is pretty encouraging. A lot of investors are pessimistic at the moment because the last time the Fed cut rates in 2001, the market did not respond. We all know what happened then. But, based on the Fed discount model, the market was overvalued by over 90% at that time and by the same model is undervalued now by 34%.



So far, this market has done nothing wrong. It has not been the easiest market to follow and there have been some divergences which are troubling. But all in all the market has given a good accounting of itself. Could something go wrong and mess up the works? Of course! The housing mess could become more troublesome and spill over into the general economy to a greater degree. The sub-prime mess could resurface and cause problems etc. etc. etc. But there are always things that could go wrong in any environment. So far so good and we will deal with problems if and when they occur. They say 'A bull market climbs a wall of worry' and there are plenty of things to worry about. Maybe that is a good sign!

As to the short term the market is overbought and subject to a short-term correction. Investor sentiment is very bullish, which is usually a sign that a correction is due. After a correction and some more hand-ringing I expect the fourth quarter to be a good one. The fourth quarter is the strongest of the year and fourteen of the past fifteen years have witnessed a positive fourth quarter. This year will be no exception.

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