CLARK CAPITAL
MANAGEMENT GROUP, INC.

Fourth Quarter 2007

THE navigator™ REPORT

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GRRRRRRRRR! WAKE UP, MR. BERNANKE

The noise you hear around Wall Street these days is the Bear growling. The Bear is growling in an attempt to wake up our sleepy university professor who just happens to be the Chairman of the Federal Reserve Board and head of the FOMC (Federal Open Market Committee), Mr. Bernanke. As you know, the Fed is charged with regulating the financial markets and that includes setting interest rates through the federal funds rate. For the remainder of this Report I will refer to Mr. Bernanke as the "Grinch" and, as you will see, I believe that is being kind. The Bear wants our professor to wake up in time to avoid an economic meltdown that we call a recession; the recession that I have, until now, felt we would avoid although I have expected two very weak quarters..

Boy, was I off base in my projections for '07. I called the market action of the third quarter the Cuckoo's Nest but my projections for the year were really done in by the fourth quarter! I based my projections for 2007 on the premise that the pre-election year pattern, which, traditionally shows the year to be the strongest of the entire four-year Presidential Election Cycle, would be repeated. The last four pre-election years averaged a return of 26% and the average return over the past 80 years has been 19%. The last time a pre-election year had a loss, Hitler was marching through Poland in 1939. Prior to that was in 1931 during the Great Depression. There was a 0% return year in 1947 during Roosevelt's last term and a 2.0% gain in 1987 following the '87 market crash. **The return of 3.5% on the S&P 500 in 2007 was the third weakest return in seventeen election cycles spanning 64 years.** What a disappointment! Sub-prime mortgages, structured investment vehicles, huge write-offs, a disastrous housing market, and the rest of the litany of woes, were just too much for the stock market. Hence, one of the most anemic pre-election years in recent memory.

To make sense of 2007, we have to go back to the origins of the two bubbles that burst this year: the housing market and credit market. These are tremendously deflationary forces that could spell years of trouble if not checked.

In the last Report, I pointed out that the seeds of today's housing and credit problems were sown in 2003 when the then Chairman of the Federal Reserve, Mr. Greenspan, moved the federal funds rate down to 1%. At the same time, he urged people who, heretofore, could not afford to buy a house, to do so with an adjustable rate mortgage (ARM).That began the housing boom, the biggest one ever as millions rushed to obtain low cost mortgages. As mortgage companies sought more and more mortgagees, they invented newer and newer ways to give people mortgages. People who could not finance a car were given mortgages. No document mortgages, no income verification mortgages, no down payment mortgages. If you can imagine it, they did it. Now we had a housing bubble inflating and the seeds for the credit crunch had been sown. Of course, the purveyors of these "sub-prime" mortgages could not take the chance of keeping them on their books and hence structured investment vehicles (SIVs) were born and the foundation for the greatest credit crunch since the '30s was complete. SIVs are created by financial institutions, banks and hedge funds, to take advantage of the spreads between short- and long-term rates. The first SIV was developed by Citigroup in 1988. SIVs began using sub-prime mortgages because the rates were nice and juicy and increased the spreads compared to their low cost short-term funding. That was fine until the FOMC raised rates 17 times in their feeble attempt to ward off inflation. All of a sudden, people who could barely afford to pay the mortgage in the first place couldn't! Sub-prime mortgages that had been sold around the world to banks, investment firms, hedge funds, and SIVs were defaulting in record numbers and the ones that were not in default could not be priced. The credit markets came to a screeching halt. Banks stopped lending to each other and to the public. The commercial paper market almost ceased to function overnight. Write-offs were rampant as financial institutions scrambled to rid themselves of stuff they could not price. Heads rolled at major banks and brokerage firms as the institutions searched the world for capital to stay afloat.

So if we are in a bear market, how long will we suffer? In the past 20 years, two of the three bear markets were very short, less than six months. I expect that if we really are in the teeth of a Bear, he won't bite very hard or for very long.

FED TO THE RESCUE....NOT !

The Federal Reserve came to the rescue on September 18th when the FOMC cut both the discount rate and the federal funds rate by .50%. The market celebration was a wonder – the Dow Jones rose 300 points. The rate was then 4.75% when the 90 day T-bill rate was 3.75% and dropping. Over the years, the FOMC typically has kept the federal funds rate very close to the 90 day T-bill rate. Too little too late?

Up to the time of the first cut in interest rates, the stock market had done nothing wrong; returns for the year were about as expected. The Dow Jones made a new all-time high at 14,150 on October 9th and the S&P set a record at 1565. The Dow Jones had gained 13.5% so far in '07 and the S&P 500 was ahead 10.4%. The year seemed to be living up to its reputation. The recovery in the equity markets from the bottom in late 2002 or early 2003 was getting long-in-the-tooth and was now the second longest bull market run in the past 80 years without a 10% correction. The Federal Reserve was assuring everyone that the sub-prime mortgage mess and the housing market decline would be contained. But they were wrong. Things have gone from bad to worse. Residential construction and new home sales plunged to their lowest levels in 16 and 12 years respectively as the housing slump continued. Residential construction has now declined for 21 straight months. I also expect another round of massive write-offs by financial institutions when fourth quarter earnings are reported.

THE TIMID FED

The economy had been strong and the recovery from the last recession is now the fourth longest on record. The housing market was and has refused to bottom and the sub-prime mess was and is spreading to other parts of the economy. **Clearly, measures were needed to contain the mess and hopefully lead to a "soft-landing" where the economy could become recharged for the rest of the decade.** The bond market was telling us, and the Fed, that lower rates were necessary to prevent recession, bear market, stagflation, or a combination of the three. The 90-day T-bill rate was below 3% and the Fed was clearly way behind the curve with fed funds at 4.75%. I and others were hoping that the FOMC would lower rates another .50% at the October 31st meeting. The market and economy needed that relief but more importantly the public needed assurance that the central bank was alert and working to stabilize a nasty situation.

What the economy and market got from the FOMC was a very timid .25% cut in rates. On the morning of the announcement, the Dow Jones was over 100 points ahead. When the FOMC announced a rate cut of only .25%, the market plummeted 400 points and continued lower for several more days. **The market finally got a 10% correction!!** As you will see, that is not a positive. Corrections are healthy and necessary for the market to keep greed and fear in balance. The longer a market runs without that 10% correction, the bigger the fall when it finally comes. In fact the other three longest bull market runs without a 10% correction resulted in a bear market each time. Can we avoid one this time?

Following that correction, investors, being the hopeful lot we are and with the holidays near, began to look forward to the next FOMC meeting on December 17th. **Again, a .50% rate cut was sorely needed. What did the FOMC do? They cut another .25%!** Again the equity markets sank over 2.5%. Since the end of the Great Depression, the equity market had only fallen by 2.5% following a rate cut on one other occasion – just after 9/11. **It declined over 2.5% on the day of (or the day after) a rate cut twice in the past two months, clearly showing the Fed that they are way behind the curve and would probably put us into a bear market and a recession.** Interestingly, there were five times during the Depression when the market tumbled over 2.5% on the day of or the day following a rate cut. A Bear Market preceded seven of the past 10 recessions and the other three were accompanied by severe market loses of 13 to 19%. We do not know if we are in a bear market yet but if we are, you can bet that a recession will follow. The chart below, from Jim Stack's Investech Research, shows the present bull market from its beginning in early 2003 to today. It also clearly shows the effect of the Grinch's stingy rate cuts at the end of 2007.

It is clear that the market was having a good old time until late summer when the problems began. The volatility since has been caused, in my opinion, by a wavering and ineffective Federal Reserve Board. I could go into a litany of Fed bashing here but suffice it to say that its members,

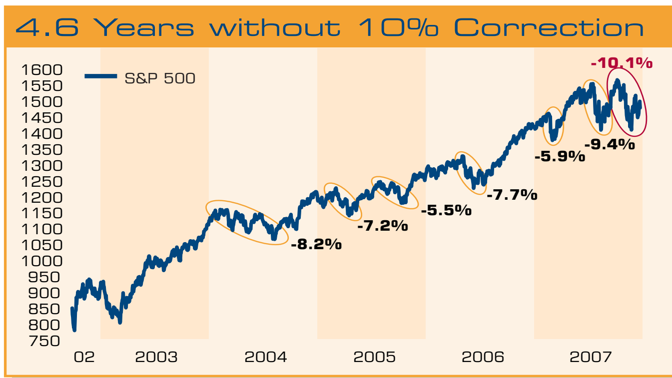
CCMG IN THE NEWS

Bloomberg TELEVISION

Bloomberg TV "Starting Bell" - January 2nd, 2008
Sean Clark, Chief Investment Officer of Clark Capital Management Group, appears on the "Starting Bell" on the first day of trading in 2008. Sean acknowledges investor uncertainty and that we might "flirt" with a recession but he does see some positives. .

FOX BUSINESS

Fox Business News - December 24th, 2007
Harry Clark, Founder and CEO of Clark Capital Management Group, discusses the Santa Claus Rally before the holiday. Harry sees the current rally as weaker than those of the past and offers historical evidence to prove it. Harry also warns Fox viewers not to "catch a falling knife" and to stay away from financial.for a bit longer.



apparently, know nothing about the markets and maybe not much else. Here are some comments from recent publications:

"By and large, this Fed is a room full of academics that have never run money. The Fed is in danger of appearing to lose what little control they have, and further in confusion as to what direction to take." "They're killing market confidence. And it's not like the Fed has engendered a lot of confidence in its forecasting skill over the past few years anyway." "The Fed just doesn't get it." "The Professor, can Bernanke handle the pressure?"

So I guess we can say the Grinch really did steal Christmas this year. There is a Santa Claus rally theory that says if the stock market falls over 4% from November 1st through January 31st we are in a true bear market. It has only happened three times since the Depression, in 1963, 1969, and 2001! So watch the market as of January 31st. **If we are down over 4%, it is likely that we are in a bear market.**

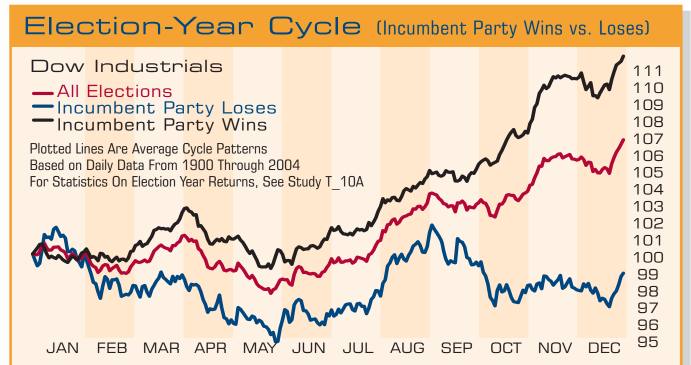
2008

With this background the politically charged election year of 2008 began. It had a very notable start: the largest first day of the year decline in 25 years, worst first three days of the year since 1932, and worst five days (-5.3% on the S&P 500 and -8.0% on the Russell 2000 index of small-cap stocks) at the start of the year EVER! And that follows the first down fourth quarter in 10 years. Kind of ominous?

All the talk over the past several weeks has been of the possibility of recession. Some very savvy market commentators are saying we are already in a recession. The decline in the leading economic indicators during three of the past four months may bear this out. In addition, the government report on employment released on January 4th showed that only 18,000 jobs were created in the prior month – mostly in the restaurant and health-care industries. Also, the report placed total U.S. unemployment at 5%, up from 4.7% the prior month and from 4.4% several months prior. **Since 1949, the unemployment rate has never risen by this magnitude without the economy either heading to, or already in, a recession.** Add to this the fact that the ISM manufacturing index was reported at 47.7, which indicates a contraction in the manufacturing sector, and we begin to see that we either are in recession or very close to one. Previous Reports have included a chart that shows over the past forty years private residential construction has never fallen this much without triggering a recession. An old adage says: if the public believes we are in a recession, then we already are! A recent poll said that 70% of those interviewed felt we were either in one, or would be shortly. The American economy is consumer driven and if the consumer says we are in a recession, **WE ARE!!**

Whether we are in recession or not and, if so, when it began will not be known with certainty for several months, not until the National Bureau of Economic Research tells us. So where does that leave the equity and bond markets…..what shall we expect during 2008?

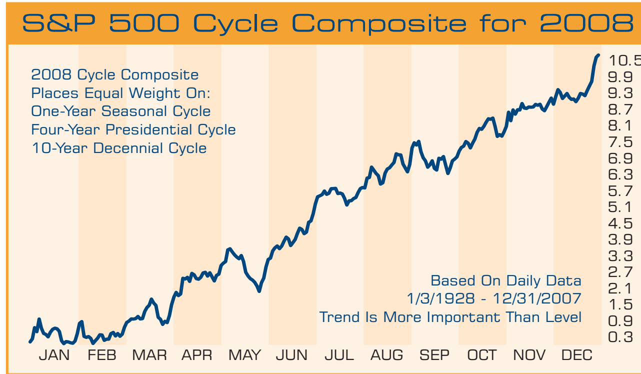
There are several cross currents to consider as we ponder the outlook for 2008. First, it is an election year, then it is a year ending in eight, then it is a year following a negative fourth quarter in a positive year (2007), next we are in the most severe credit crunch since the Depression, and finally we seem to have a very incompetent Federal Reserve which seems hesitant to take the steps required to secure a "soft landing." According to Jim Stack of Investech Research, the Fed has only been able to achieve a soft landing (avoid recession) on two occasions following an interest rate tightening cycle over the past 50 plus years, in 1966 and 1995. And in 1966 we still had a bear market.



CNBC "Power Lunch" - December 21, 2007
Harry Clark, President and CEO of Clark Capital Management Group, thinks there will be some spillover from financials and their problems but despite all the talk, he expects recession will be narrowly avoided. Harry predicts a sloppy first quarter but also expects the market will be flying by the second half of the year.

CNNMoney.com - December 19, 2007
Harry Clark, President and CEO of Clark Capital Management Group, says the Santa Claus rally appears to be non-existent and that we could be headed for a recession in the New Year.

First, this is an election year. A typical election year pattern would be a sloppy to down first quarter followed by a strong second and third quarter. The fourth quarter result depends on the outcome of the election as you can see in the chart above from Ned Davis Research.



Over the past 120 years, the S&P 500 has gained an average of 8.4% in an election year. In the 12 years when the incumbent party lost, the gain was only 1.6%. The incumbent party won 17 times and the S&P 500 gained an average 14%. **The best case is when an incumbent Republican Party prevails. The average gain there has been 17.5%.** Obviously, a win by an incumbent Republican would seem to be best for the market.

If indeed, October 9, 2007 was the start of a bear market, it would be only the second time in 87 years that a bear market started in a pre-election year. Four election years, 1948, 1956, 1968, and 1980, all began with bear markets but all ended the year on a positive note.

So if we are in a bear market, how long will we suffer? In the past 20 years, two of the three bear markets were very short, less than six months. I expect that if we really are in the teeth of a Bear, he won't bite very hard or for very long. If the market keeps behaving as it has recently, it could reach a bottom quickly. By quickly I mean sometime late in the first or early in the second quarter. I say this because this, as you know, is an election year. Election years are usually strong in the second and third quarters. Also, years ending in eight have a tendency to be very strong with an average return of 18.2%. Believe it or not, there have only been two declines in the eighth year of a decade since the 1880s. The market, as measured by the S&P 500, declined 6.6% in 1888 and 0.7% in 1948!! The eighth year of the decade is the second strongest after the fifth. Except for the two losing years, there have only been two years with single digit returns and even with those years (minus the two down years) the average return was 22.1%. The chart below from Ned Davis Research shows his expected path for this year. The results are a combination of the cycle composites listed on the chart.

CONCLUSION

It is obvious that the first quarter will be a little dicey. If the market did peak on October 9th, we could have a volatile ride for the quarter or at least until the credit crunch and housing mess get sorted out. I expect we will see billions more in write offs by the major players in the sub-prime arena and probably some very big takeovers before it calms down. There are, however, some saving graces if we look behind the curtain of fear and uncertainty that seem to be pervading investors' psyches at the moment.

First, the market is already extremely undervalued; by about 45%! The market is more undervalued today than it was at the bottom in 2002. That undervaluation could very well put a floor to the downside of this decline. And, as much as I am hesitant to hope for it, Mr. Bernanke just might wake up and take some drastic measures to stabilize the markets. No, the Fed is not charged with regulating the stock market but they know, as sure as you and I know, that public sentiment can have an enormous impact on the economy. A falling stock market, on the heels of the real estate decline, could do real damage to a fragile economy. And the Fed is charged with keeping the economy on an even keel.

Secondly, since 1897, the fourth quarter of a year has been negative (reference the Dow Jones) in a positive year 15 times including 2007. The Dow has rallied by the end of the next year 12 times with an average gain of 16.7%!!! The three declines were very large, average of 20.4%, but with the present market undervalued as it is I do not see this as a possibility.

And lastly, if we are in, or go into, a recession, the market bottoms, on average, five months after the beginning of the recession. If the recession began in November as some very bright people are claiming, the market should bottom by March or April. Market recoveries following a bottom are very strong as in 16% three months later, 24% six months later and 32% one year later. Could the stock market predict the outcome of the election? More on that topic in the next Navigator Report. Take care!

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