Market Commentary

U.S. Stock Market Outlook Third Quarter, 2007

Arthur A. Micheletti, CFA
Chief Economist and
Investment Strategist

August 22, 2007

Executive Summary

Our long-term outlook for stocks remains positive. Stock valuations look relatively cheap, and we continue to have a constructive view about future economic growth and inflation. In the short-term, there has been a downward shift in market momentum and an increase in negative sentiment. However, we view this development as a correction in a bull market. From a historical perspective, negative investor sentiment and oversold conditions are typically consistent with market turning points. Currently the market is converting from a period of excess optimism to excess pessimism, which we believe creates opportunity. As long as the long-term trend is up, we will recommend buying the dips and riding through what we see as temporary turbulence.

TABLE OF CONTENTS:

Bailard
INVESTING. REDEFINED.®

U.S. Stock Market Valuation

The majority of valuation indicators we monitor suggest that the U.S. stock market is relatively cheap compared to other asset classes and represents good value. The S&P 500 index is currently trading at less than 14 times next year's earnings. This price/earnings (P/E) ratio is roughly in line with the long-term historical average. Given today's low inflation and interest rate environment, however, we believe a higher level forward P/E of 17 to 18 times earnings represents fair value.

Valuation measures help us identify the relative attractiveness of stocks compared to their own history, relative to inflation and relative to other competing asset classes. Absolute measures such as the price/earnings ratio tells us if the P/E multiple is high or low compared to its long-term history. While absolute multiples provide some information, they can be misleading. Multiples tend to shift over time as the economic environment changes. During periods of high inflation, multiples tend to compress as interest rates and the discount factor move higher. In addition, during these periods, bonds, cash and other asset classes typically provide greater competition for investor funds. This is why most of our valuation measures evaluate the stock market relative to underlying inflation and compared to other asset classes.

There are a number of problems with valuation measures as investment tools. Although value tends to win in the long run, valuation measures can be notoriously early in identifying market bottoms and tops. To avoid being early, we tend to remain close to our long-term norm allocation until an asset class becomes extremely over or under valued. We also use other non-valuation tools to help us determine buy and sell points.

Valuation measures can also be misleading at cyclical turning points. At the end of the economic cycle, revenue growth, profit margins and earnings tend to be at cyclical highs and P/E's tend to be lower. To help smooth out cyclical swings in earnings that can distort multiples, we normalize earnings by using the average earnings over a number of years.

U.S. STOCK VALUATION MONITOR

Indicator	Current Bias
Bailard P/E Model	Bullish
Operating P/E relative to:	
Inflation	Bullish
T-Bill yield	Bullish
10-Year Treasury Yield	Bullish
BAA Yields	Bullish
Fed Model Forward (Forward EPS/Treasury Yield)	Bullish
Ned Davis Research (NDR) Valuation Composite	Bullish
Real Bond Yield to DIvidend Yield	Bullish
Normalized Dividend Yield	Bullish
Normalized E/P realtive to Bond Yield	Bullish
Absolute Level of P/E:	
Median Reported EPS	Neutral
Operating EPS	Neutral

Sources: Bailard Research, Ned Davis Research, Yardeni Research, Bear Stearns

U.S. Stock Market Environment

We believe the fundamental environment for stocks is positive and conducive to value recognition. The economic outlook remains constructive, earnings continue to surprise to the upside, inflationary pressures are subsiding, investment grade bond yields are falling, and the Fed has shifted to an easing bias.

We use a number of indicators to help us evaluate the stock market environment: economic conditions, inflation pressures, Fed Policy, interest rates and other miscellaneous factors. In general, a positive outlook for the economy is good for earnings and positive for stocks. However, if economic conditions lead to high and accelerating inflation, the environment for stocks becomes less attractive. A deteriorating inflation outlook leads to higher interest rates and tighter Fed policy, which tend to restrain stock prices since higher interest rates work to slow an overheated economy, dampen earning expectations and kindle recession fears.

Conversely, as economic conditions weaken, inflation and interest rate pressures ease and set the stage for economic recovery. The best time to buy stocks is in the midst of recession as inflation pressures ease, the Fed becomes less restrictive and long-term interest rates are declining. The prospect for improving economic conditions helps boost earning expectations and stock prices. While stocks have their most powerful moves off the bottom, they also perform well during periods of moderation and stability.

U.S. STOCK MARKET ENVIRONMENT MONITOR

Indicator	Current Bias
Bailard Base Economic Scenario	Positive
Lagging Indicator	Positive
Output Gap	Positive
Bond Yields vs. NGPD	Positive
Real M2 Industrial Production (y-y)	Positive
Monetary Fiscal and Currency Policy	Positive
Earnings Growth (y-y)	Positive
Earnings Acceleration	Neutral
Earning Surprise	Positive
Profit Margins	Neutral
Crude Oil (26 wk)	Neutral
Inflation (y-y) vs. 6-month smoothing	Positive
Inflation vs. 5-year trend	Positive
Fed Funds Rate Momentum	Positive
Fed Policy Bias	Positive
T-Bill Yield (y-y)	Positive
3-Year Treasury Yield (y-y)	Positive
10-Year Treasury Yield (y-y)	Positive
Moody's Baa Yield (y-y)	Positive
Seasonal Tendancy	Negative
Presidential Cycle	Neutral

Sources: Bailard Research, Ned Davis Research, Yardeni Research, Bear Stearns.

U.S. Stock Market Trend, Momentum and Breadth Indicators

Market momentum has turned down, but the long-term trend remains up. Breadth has deteriorated to the point where it is now bullish. Stocks are being sold indiscriminately as investors scramble for liquidity. Investors are selling what they can, not necessarily what they'd like.

Trend indicators help to keep our strategy in harmony with the direction of the market. The problem with trend indicators is that acting on these signals in the short term can leave investors vunerable to whipsaws. However, trend sensitive indicators can help keep investors on the right side of big up moves and act as a stop loss to help minimize the downside of a major downtrend. Since we are long-term investors and not short-term traders, we are looking for major changes in long-term trends.

Momentum indicators help to evaluate the strength of the overall market. High and rising momentum tends to be positive for the market, while low and falling momentum tends to be negative. Monitoring reversals in momentum after extreme moves can help identify market turning points.

Breadth indicators include the number of new highs and lows, advancing versus declining issues, upside/downside volume and the percent of stocks above/below moving averages. When a lot of stocks are trading above their 10-week and 30-week moving averages, breadth is high. High and rising breadth readings tend to be positive for stocks. Extremely low and falling breadth reflects oversold conditions. Extremely low breadth occurs near market lows and indicates lower risk. Similarly, when there are a lot of new highs and few new lows, the market is moving in-sync. When there are few new highs and many new lows, a selling climax and a potential market bottom are indicated.

U.S. STOCK MARKET TREND, MOMENTUM AND BREADTH MONITOR

Indicator	Current Bias
Momentum	Bearish
Price Relative to 200-day MAV	Negative
Long-Term Trend	Bullish
Trend Momentum Relative to Bonds	Bullish
FFR and Momentum	Neutral
Breadth and Momentum	Neutral
Advance/Decline Line	Neutral
New High-to-Lows	Negative
% of Stocks Above 200-day MAV	Neutral
% Above 10-week and 30-week MAV	Bullish (both below)
% of Stocks on Bullish NDR Ratings	Neutral

Sources: Bailard Research, Ned Davis Researh, Yardeni Research, Bear Stearns

U.S. Stock Market Sentiment Indicators

Risk has rapidly been priced into the market. Sentiment has been converted from over-optimism to over-pessimism, which suggests a potential reversal.

Sentiment indicators attempt to measure investor psychology by looking for periods of over-optimism or over-pessimism. As good news is discounted, optimism drives stock prices higher. When optimism becomes excessive, the market becomes vulnerable to bad news. During periods of pessimism, the reverse is true. The general rule is, "Go opposite the crowd at extremes."

The one problem with sentiment is that it can stay overly optimistic or pessimistic for long periods of time. In order to lessen this problem, we use many different measures to evaluate the psychology of different types of investors. Individual investors are known for being wrong at turning points, buying at the top and selling at the bottom. Investment professionals, strategists, advisors and hedge fund managers also tend to be wrong at sentiment extremes.

U.S. STOCK MARKET SENTIMENT MONITOR

Indicator	Current Bias
Wall Street Strategists Poll	Pessimism/Bullish
Hedge Fund Sentiment	Net Short/Bullish
Large Speculators	Net Short/Bullish
Put/Call Ratio	Extreme Pessimism/Bullish
UBS Investor Optimism Survey	Neutral
Investment Advisory Sentiment	Pessimism/Bullish
Hulbert Newsletter Advisory	Extreme Pessimism/Bullish
American Association of Individual Investors	Neutral
Ned Davis Crowd Sentiment Index	Extreme Pessimism/Bullish
% of Stocks Above 10-Week MAV	Oversold
Deviation from Trend	Oversold
Volatility	High/Oversold

Sources: Bailard Research, Ned Davis Research, Investors Intelligence, Yardeni Research, Bear Stearns

DISCLAIMER

This piece has been distributed for informational purposes only and is not a recommendation of, or an offer to sell or a solicitation of an offer to buy, any particular security, strategy or investment product. This piece does not take into account the particular investment objectives, financial situations, or needs of individual clients. This piece contains the current opinions of the author and such opinions are subject to change without notice. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. Bailard will not offer investment advice in any jurisdiction where it is prohibited from doing so.

Bailard

INVESTING. **REDEFINED.**®

For more information, please call 800.BAILARD (800.224.5273) or visit www.bailard.com.

Bailard, Inc.
950 Tower Lane, Suite 1900
Foster City, California 94404