The Economy and the Markets

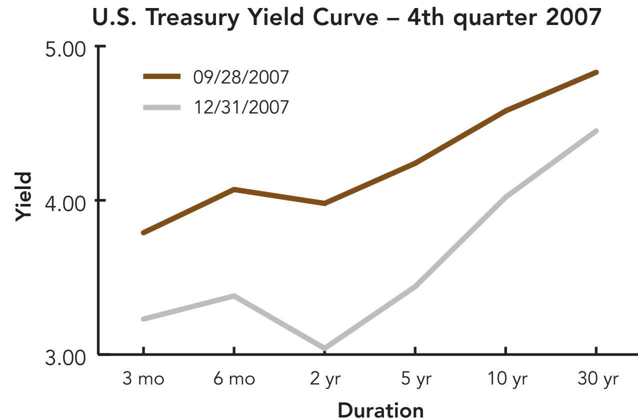
The markets finished 2007 on an uncertain note, concerned about the economy's ability to stave off a recession. A stall in the credit markets, continued subprime mortgage losses and residential housing woes combined to worry investors and threaten economic growth.

The Fed's moves, from rate cuts to new attempts to lure lenders back in the game, brought brief moments of euphoria that were soon followed by long periods of doubt. While the Fed defended its actions as sufficient to sustain moderate economic growth, the markets did not routinely share that view. Investors will be watching the Fed very closely in the months ahead.

Credit market problems persisted during the quarter. Subprime mortgage losses earlier in the year prompted lenders to take a top to bottom reassessment of lending risks. Banks, fearful of both current and future losses, are not eager to lend now, a major change in attitude from the past 15 years.

The residential housing market also entered dark new territory, with home values falling across the country. There has not been a time since the Great Depression when the economy has experienced a nationwide decrease in home values. Lower home values could reduce consumer confidence and slow consumer spending, further damaging the economy.

All, however, is not doom and gloom. Employment remains good, providing a very strong positive economic force. The drop in the value of the dollar has increased demand for U.S. goods and spurred domestic growth, although further weakness could drive up the cost of imports, adding to inflation.



The yield curve between short and long-term Treasuries steepened over the quarter as the Federal Reserve begin cutting rates. Yields fell as the credit markets avoided risks in and pursued Treasuries in a flight to quality.

Equities

The equity markets performed positively in 2007. The Standard & Poor's 500 Index finished up 5.49 percent for the year, even after a down fourth quarter. The international markets were particularly strong, with the MSCI EAFE Index up 11.63 percent for the year.

While large-cap stocks benefitted from their exposure to international markets, the lack of international exposure hurt small-cap stocks. They were -1.57 percent for 2007, as reflected by the Russell 2000 Index.

While stocks did not suffer the difficulties that fixed income investments experienced in 2007, they at some point will probably go through similar troubles. We believe the equity markets have more downside risk than upside potential in the first half of 2008. Stocks, however, don't appear to be significantly overvalued when measured against long-term averages. If they do fall, it may not be that far.

Continued

Fixed Income

A rough fourth quarter finished off one of the toughest six-month periods in history for fixed income securities. Treasuries were the quarter's best performers, benefitting from a continuing flight to quality. Most sectors of the market were down, and housing and financial issues in particular dropped in value.

Although the economy has been strong enough to avoid wide scale corporate defaults, the fixed income markets have become less liquid as buyers stand back, waiting for clarity.

Real Estate

The residential real estate market is definitely hurting, with negative housing-related statistics dominating the news. The inventory of homes on the market will continue to grow as a result of widespread foreclosures, which means housing is not likely to turnaround anytime soon. Potential home buyers are content to wait sellers out, anticipating that prices will continue to drop.

In the commercial real estate market, the story is different. There are solid fundamentals in occupancy and rental rates, but the easy money that was being thrown at the sector earlier in the year has gone away. Investors have subsequently overreacted and pushed values unreasonably low, particularly in light of the 5 percent average REIT dividend yield rate. For those who know how to look, value can be found in commercial real estate.

Outlook

Uncertainty will continue into 2008, and investors should expect volatility. We believe that near term there is more downside than upside in stocks. In the fixed income markets, a bottom up approach that goes beyond ratings and thoroughly evaluates each potential investment is more important than ever.

The momentum that drove the market earlier in the year is being wrung out, and times like these tend to reward the smartest investors. We think it is a time when paying attention to fundamentals and investing into market declines will be a sound approach.

The S&P 500 dividend-adjusted Index is market-value weighted based on 500 common stocks, which are traded on the NYSE, AMEX and Nasdaq. The weightings make eachcompany's influence on the performance of this index directly proportional to that company's market value.

The Morgan Stanley Capital International Europe, Australia and Far East Index (MSCI EAFE) is an unmanaged index composed of the stocks of approximately 1,000 companies traded on 20 stock exchanges from around the world, excluding the USA, Canada, and Latin America. It assumes the reinvestment of dividends and capital gains and excludes management fees and expenses.

The Russell 2000 Index is designed to measure the performance of the 2,000 smallest companies in the Russell 3000 Index, and represents approximately eight percent of the total market capitalization of the Russell 3000 Index.

Risks associated with real estate investing in addition to other risks include rental income fluctuation, depreciation, tax value changes, and differences in real estate markets.

Investment risks associated with international investing, in addition to other risks, may include currency fluctuations, political and economic instability and differences in accounting standards when investing in foreign markets.

Investing in smaller and micro-cap companies involves greater risks not associated with investing in more established companies, such as business risk, stock price fluctuations and illiquidity.You cannot invest directly in an index.

Past performance is not indicative of future results.

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400 Robert Street North, St. Paul, MN 55101-2098
www.advantuscapital.com | 1.800.665.6005

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