



Quarterly Economic Report – 3rd Quarter 2005

Hang in there - hurricane seasons do end.

During the past quarter consumers were buffeted by storms of immense proportions from Mother Nature as well as the markets. With cross-currents of killer hurricanes, soaring gasoline prices and rising short-term interest rates even a strong economy has significant challenges. But, the American consumer and the American economy are resilient creatures and hurricane seasons do in fact end. The massive dollars focused on rebuilding will probably have a larger and longer positive impact than the storms negative ones.

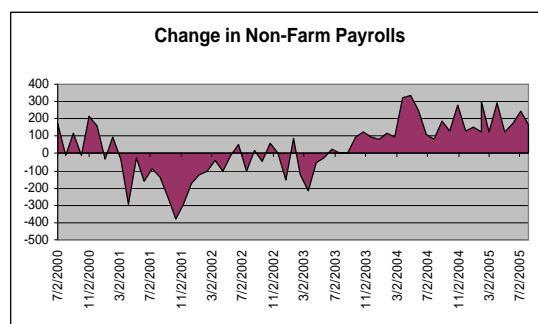
The hurricanes hit our prime energy transport and refining areas adding to already surging oil prices (up to \$70) and natural gas prices (to \$14 from \$8 in June). But most refinery outages were the result of electricity outages not long-term damage. These and many oil platforms will be back in operation within the month. Despite the human suffering, the hurricanes were not a big impact for the US economy but the inflow of \$200 billion is a *really big deal*.

The hurricanes tended to create a political competition as to who contribute the most. Mississippi has changed their gambling laws to allow casinos inland and the gaming industry is salivating at the vision of a Las Vegas-Atlantic City-Gulf Coast slot-machine triangle. New Orleans wants to rebuild levees and raise its terrain. All this will pump the federal billions back into tradesmen, business owners and suppliers which profits business, employs people, and fuels the economy.

The FOMC resolve to maintain its "measured pace" of hikes, taking us to 3.75% in September, reflects this long-term view of the storms' impact. An additional 65 bps have been added to the futures prediction in the last month and currently there is a 98% chance of a hike 11/1, 75% chance of a second on 12/13, and 36% on 1/31/06 taking us to 4.5% on fed funds. The dollars directed, in less than a planned fashion, to the rebuilding will stimulate the overall economy because the suppliers and manufacturers across the US. The Federal Reserve must also be considering the long-range effect of the liquidity generated. To counter-act too much liquidity they must signal the continuation of higher rates. Against a backdrop of an economy on solid footing and potentially high inflation they had no choice than to continue this overarching inflation focus and the market agrees.

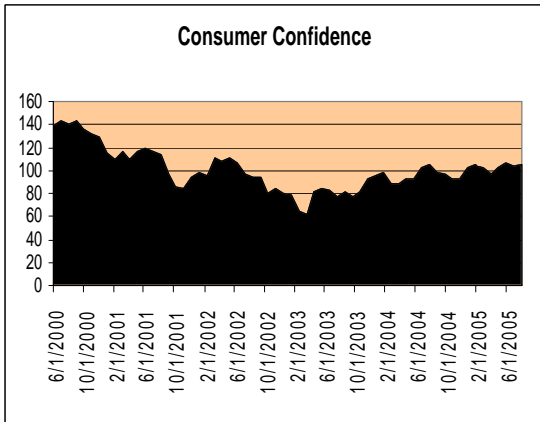
Once the immediate emotional and political attention is diverted from the Gulf the economic focus will return to major issues. Before the storms arrived the economy was on the solid footing the change is only temporary. Manufacturing is still strong with a broad-based rate up 3.6% on the core and durables are soaring. Manufacturing was and is still sporadically affected by supply streams which should continue for the next quarter. The non-manufacturing sector took most of the storm's blast with mining, construction and retail falling dramatically to 53.3 from 65 in August. Restrictions in supply and energy costs boosted the ISM prices paid index a record high 81.4 from 67.1 in August with energy spikes. This weakness will diminish as delivery through the ports and refineries open again. For another quarter we will undoubtedly hear everything blamed on energy and hurricanes.

A bigger impact of the storms for the economy is the risk to pro-growth tax cuts which would ultimately slow growth and create a smaller tax base to finance the spending and debt. US rates are still attractive to overseas buyers and since the US supplies half the worlds bonds, sales should continue even with higher longer rates keeping the curve relatively flat. This appetite has kept the dollar strong but cost of servicing US debt (which has been in the short-end) is increasing which will lower the dollar and raise the trade deficit.



would be on net-importers of energy especially in Asia. Rates will have to move up in those countries to absorb the impact. With that comes competition to our bonds.

We are likely to see a rise in unemployment to 5.1% in October but again the rise will probably be temporary. The increase is not in large part from Louisiana where unemployment was at 16% in New Orleans! A relocation of people may actually increase their chances for employment longer term. Many of these people will not return to the state. There is no property draw for them because 53% in New Orleans were renters and a move could likely push people to where jobs exist.

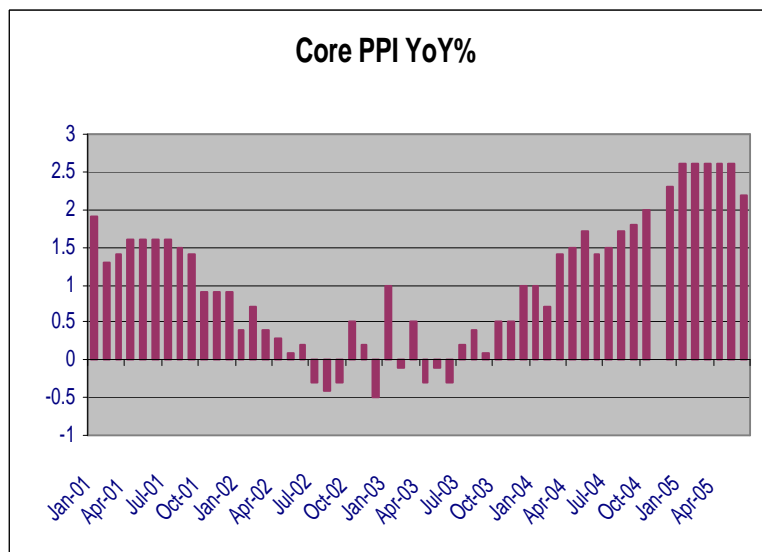


The hike in natural gas prices will probably require some conservation this winter which may affect confidence. A lot hinges on consumer expectations and reaction. The University of Michigan survey has confidence at a 13 year low in August which should force consumers to pull tight on the purse strings, but, there has been only limited correlation between spending and confidence in the past. The magnitude of the UM drop from 105.5 to 86.6 should be reflected in spending however which is critical coming into the holidays. The homeowner has been feeling particularly rich from home equity appreciation! The consumer's visceral energy pinch may dampen housing actions which could blunt the housing demand and cycle back to the consumer's own

wealth image. National homebuilders have seen three consecutive months of decline and the slightly higher long rates are undercutting the affordability of ARMS and IO mortgages so popular in CA. In addition supply tempers prices. The condo/coop supply climbed 4.4% with 287 million units now available!

The housing bubble (or "froth" per Mr. Greenspan) created by low rates and creating higher home prices and 'equity-wealth' is a problem. Although housing does not factor directly into the inflation outlook it contributes to Greenspan's current concern for long term risk. He has been reminding us that *"history cautions that extended periods of low concern about credit risk have invariably been followed by reversals"* i.e. ongoing expectations of this level of growth are unrealistic. When the realism hits the reverse wealth effect will be felt with hurricane force. The consumer will not spend as much but prices may continue to rise. Household incomes would be flat but energy prices will pinch. Unless the air is released slowly the reaction could be recessionary. But, the strength of the general economy should prevent it.

Inflation risks are not overwhelming as long as the Fed can force us to maintain realistic expectations. Cable TV bills rising 5% may be noticeable to us all but the 15% cost reduction in TVs is less visible but more prevalent. Soaring gas prices raise eyebrows but automobile prices continue to fall. If the Fed can get the markets to focus on inflation and longer rates to rise slowly the housing bubble may begin to fizzle - and not burst - averting chances of a sharp reversal. The impact with the re-introduction of the 30-year bond in October will also be interesting. Size-wise it will not affect supply but a larger future supply may slow the longer end bulls holding rates down which will in turn slow housing.



As a continuing strategy in this bear market stepping up and out the yield curve in small steps, matching investments to known liabilities as market yields rise, is the best defensive move. The income earned from such a strategy exceeds the income available from liquid investments and uses the curve for incremental earnings. Short securities allow portfolios to maintain adequate liquidity while moving with the