



INVESTMENT PROFESSIONALS

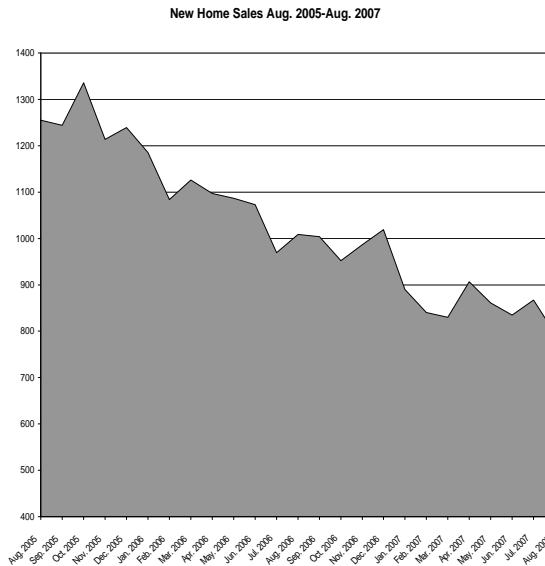
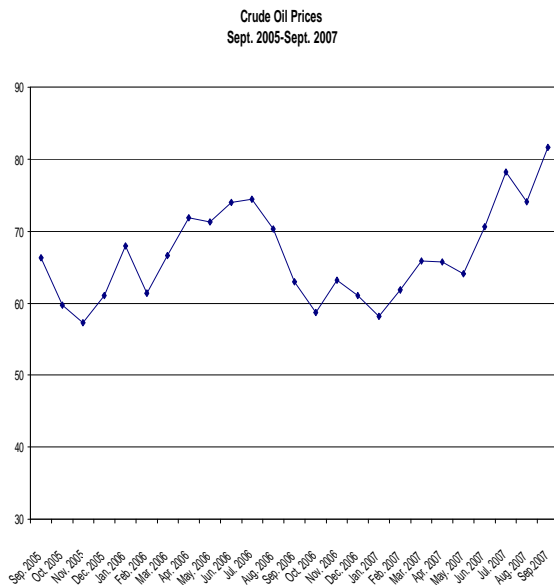
Quarterly Economic Report – 3rd Quarter 2007 (September)

“Where There’s Smoke.....”

Like firemen sitting in the firehouse “bored” from doing nothing except waiting and watching, once the FOMC smelled the smoke and heard the bells they jumped into action, trying to extinguish a fire that seemingly sprang up out of nowhere.

In our earlier commentaries we had noted the weakness in the housing industry and mortgage related financial instruments. It was apparently a rude awakening to some participants in this arena that there were actually loans that were non-performing investments and there was no “guarantee” of principal return, even in collateralized products. This market has grown exponentially around the globe and it is estimated to be in excess of \$2 trillion Dollars.

Almost overnight, this sudden concern triggered a tightening of credit standards and a reduction of the borrowing power of not only mortgage issuers but other commercial borrowers as well. Credit lines were withdrawn and companies which had been thriving based upon their ability to issue short term debt to offset long term assets found themselves unable to fund day to day operations. The general quality of assets being used as collateral came under much more rigid scrutiny and short term Libor rates rose by over 150 basis points (1.5%) as those lenders who had funds available to put out in the credit markets demanded a huge risk premium from even the most credit worthy borrowers.



It was this “conflagration” that the FOMC stepped into and began aggressively working to offset some of the fears of the credit markets. The initial step was a 50 basis point cut in the Discount Rate. The Discount Rate is the cost of money paid by a financial institution that needs to borrow from the Fed to fund its day to day operations. It is normally considered a “red flag” to regulators. The Fed also softened the collateral requirements, extended the term out to 30 days and also allowed “selected” non-banks to access the “window” to widen the spread of liquidity. They even encouraged the money center banks to avail themselves of this credit facility to reduce some of the “stigma” of borrowing there.

Next on the Fed’s list was a 50 basis point cut in the overnight Fed Funds Rate target. This was done at the Sept. 18 meeting and in the statement following the meeting the Committee acknowledged that there was

now a larger threat of slower growth in the economy than there was of inflationary pressures resuming. It is largely expected that there will be one or more further rate cuts before the end of 2007. With inflation contained in spite of oil trading above \$80 per barrel the Fed may have some way to go before they resume a neutral bias.

A traditional lagging indicator of a slowing economy is the Unemployment Rate and the pace of job creation as reported by the Non-Farm Payrolls calculation. Businesses are reluctant to trim staff at the first sign of slower activity as it is far more expensive to hire and train a replacement worker than to keep a qualified employee on the payroll. Weakness in this data is therefore usually one of the last and confirming signs of a transition underway in the economy. Job creation had been fairly stable as more service related jobs were steadily being created and this acted as somewhat of a counterbalance to the housing industry's problems and the pain being felt by U.S. automakers.

With the release of the August report on Sept. 7th we saw the first negative job creation report in 4 years. Concurrent with that news were revisions lower to both July and June's reports and what had appeared to be at least tepid growth for a three month period suddenly become perilously close to signaling an economy on the brink of a downturn.

It was this report, coupled with the widening inability of businesses to finance themselves, that forced the Fed to act. Unless we see signs of a significant change in the direction of both of these factors we will most likely see the Fed Funds Rate lowered at one or both of the remaining FOMC meetings this year.

In the months ahead there will be other challenges to growth. The current record weakness of the US dollar against other major currencies will create some ripples in the global economy. US exports will become "cheaper" but we are a nation with a huge trade deficit so many more dollars will go off shore and the reinvestment of those dollars will be a key element. Christmas sales, so often the only way retailers can make money on the year will be extra important this year as the question remains "Will a nervous consumer be a big spender for the holidays?" If not, 2008 could begin with even more pressure on the Fed to spur the economy in an election year.