



Third Quarter 2007 Market Commentary

Beautiful credit! The foundation of modern society. Who shall say that this is not the golden age of mutual trust, of unlimited reliance upon human promises? This is a peculiar condition of society which...puts into the mouth of a distinguished speculator in lands and mines this remark: "I wasn't worth a cent two years ago, and now I owe two millions of dollar."

The Gilded Age, *Mark Twain*

It has been said that "history repeats itself, only differently." In analyzing the current credit market squeeze and the circumstances under which it developed, it indeed seems that history has repeated itself. While the facts unique to the sub-prime meltdown have not been seen before, the cycle of greed, fear and absence of common sense seems all too familiar. The players in this saga- homebuyers, mortgage brokers/lenders, Wall Street investment banks, credit rating agencies and sub-prime debt investors- all exhibited one of the behavioral patterns mentioned above.

And the primary losers in the recent meltdown: pension fund managers, domestic and foreign banking institutions and hedge funds, were all seeking outsized investment portfolio returns (often combined with excessive leverage) not available in a historically low interest rate environment. The resulting "crisis of confidence" in global credit markets was marked by massive illiquidity, frozen redemptions by multiple institutional managers and several large hedge funds reporting sizeable losses.

Central banks around the world injected hundreds of billions of dollars into their respective banking systems during July and August in attempts to restore liquidity that was unavailable amidst the turmoil in the credit markets. The U.S. Federal Open Market Committee (F.O.M.C.) took historically unprecedented action, between scheduled meetings, in lowering the discount rate (rate charged to banks for overnight borrowing from the Federal Reserve Bank of New York) by 50 basis points (.50%) on August 16th, a short ten days after leaving interest rates unchanged at their regular August meeting. The Fed's September 2007 meeting unanimous decision to lower by 50 basis points both the discount rate (again) and the fed funds target rate (first reduction in four years) were further evidence of the magnitude and potential for economic turmoil from the disruption in the capital markets. In response to the lower interest rate environment, the U.S. dollar continued to weaken against most major currencies.

Fallout from the turmoil in the global credit markets pushed volatility in the equity markets to levels not seen during the current 5-year bull market cycle. From the all time highs of July 19th, major equity indexes corrected downward 10% during the following weeks with multiple daily trading session swings of 2-3%. At quarters end, most equity indexes showed only modest gains or losses for the quarter. Larger company domestic stocks retained their leadership position over smaller company issues and continued to benefit from business activities outside the U.S. For the first time since 2000, growth stocks outperformed their value counterparts. Stocks of companies headquartered in developing nations (emerging markets) continued to outperform all others as ongoing beneficiaries of the global commodities demand cycle.

Looking forward, uncertainty has risen. With the sub-prime mortgage turmoil being concentrated in the capital markets, analyzing its effect on the overall economy is difficult. We would point to multiple positive economic factors. The sub-prime melt-down is largely a domestic problem, while global economic growth fundamentals remain healthy; U.S. exports of goods and services continue to grow at double-digit rates, likely offsetting any slowdown in consumer spending; and a strong likelihood of a continued low-interest rate low-inflation environment. We thank each of you for your confidence and trust.

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