# Economic & Capital Market Summary

First Quarter, 2008

## The Economy

*The question isn't "are we in a recession?"….the real question is "when does it end?"*

The U.S. economy experienced a dramatic slowdown during the first quarter of 2008. One of the pillars of growth over the past two decades has been the consumer sector which represents 70% of U.S. economic activity. Through a combination of rising stock prices, increasing wages, and rising home values the U.S. consumer has experienced an increase in their general level of wealth that is virtually unprecedented in history. While there have been periods of slow economic growth during this time frame, the consumer has continued to purchase houses, cars, computers and flat panel televisions at an increasing rate. Until now. February retail sales declined 0.6% as Americans grapple with high gasoline and food costs.

In some regard, the corporate sector has filled the gap left by the decline in the consumer sector. With improved balance sheet and solid earnings growth, the corporate sector has shown strength in manufacturing, investment in capital expenditures, and growth in jobs. However, the problems in the bank and finance industry will likely result in layoffs, further write downs in problem loans and the need to shore up fragile capital levels.

Over the past several years, as the U.S. dollar has weakened against other major currencies, we believed the currency played a secondary role in U.S. economic growth. Until now. With the significant decline in the value of the U.S. dollar relative to other currencies, it has become major factor for the prospects of economic recovery. If the dollar weakens further from current levels, we run the risk of foreign capital leaving our markets in search of stronger investment opportunities. However, the weaker dollar makes U.S. exports more affordable overseas which helps to strengthen economic growth.

## Monetary Policy & The Role of the Federal Reserve

*Is the Federal Reserve executing a bail out of our financial system - again?*

The short answer is yes. The Fed orchestrated a bail out of the U.S. financial system in 1990-1991 at time when banks were saddled with Latin American loans, commercial real estate, and an increasing level of default in corporate debt. The Fed helped to prop up our financial system again in 1998 when in helped to bail out the overly leveraged hedge fund Long Term Capital Management. The coordinated bail out of Long Term Capital Management created a new template for Wall Street and Government to work together to minimize the impact of financial firm failing. This model would be implemented again in 2007 with the orchestrated sale of the hedge fund Ameranth.

The merger of Bear Stearns into JP Morgan Chase last month is the most recent example of the Fed helping to provide the resources to avoid the failure of a key player in our financial system. The U.S. financial system is facing a severe liquidity challenge not a solvency crisis. In essence this means that banks and broker-dealers don't want to lend money. As a result, the Federal Reserve is playing its role as "the lender of last resort".

Today, the Fed has three major initiatives. First, by lowering short term interest rates 300 basis points, it is hoping to stimulate economic growth by lowering borrowing costs. Unfortunately, given the severity of the credit crunch, the machine is not functioning well. This leads to the second initiative by the Fed, the creation of the Term Auction Facility (TAF) and the Term Securities Lending Facility (TSLF). These facilities are designed to allow banks and broker-dealers the ability to lend their illiquid mortgage-backed securities in exchange for U.S. Treasury securities.

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ll these illiquid securities and hopefully a more orderly, functioning
e in the U.S. financial system through back-stop lending. These three
bility and have helped to boost the confidence in monetary policy. The major concern with the Fed's initiatives is that stimulating the economy will result in the potential for an increase in the rate of inflation. The Fed has clearly sacrificed price stability for economic and financial market stability.

## The Capital Markets

The painful deleveraging of the capital markets has been characterized by a heightened level of volatility, illiquidity and a significant repricing of risk during the first quarter. The equity market finished the quarter with a return of -10.4% measured by the S&P500 while the investment grade bond market posted a total return of 1.65% measured by the Lehman Brothers Aggregate Index. The problems in subprime mortgage debt have resulted in write downs in the financial sector. We expect the credit crunch to contribute to the general deterioration of credit quality and negatively impact earnings. The gridlock in the $300 billion Auction Rate Preferred market and the resulting higher borrowing costs for the issuers is an example of the pain inflicted by this credit crunch- not to mention that investors are unable to liquidate their ARP security holdings.

There are two major themes that we are tracking: First, the bank& finance sector is undercapitalized and needs to raise additional capital given the magnitude of the write-offs in subprime. Fannie Mae and Freddie Mac, two examples, are estimated to be raising $20 billion to shore up their capital. While this is good for bond holders, it is dilutive to stock holders. The second theme, a difficult business formation environment will impact commercial real estate.

## Investment Strategy for the Second Quarter, 2008

Our investment strategy in today's market is best characterized as defensive. The cornerstone of our investment process is fundamental research and measuring the relative value that exists between a company's debt, equity and preferred stock. The prospect of punitive government regulation combined with a tough lending environment has created challenging investment opportunity in the bank and finance sector. For some larger banks, structured securities accounted for over 50% of their earnings last year. We expect that to decline significantly making earnings projections difficult. We remain underweight the bank/finance sector in our equity portfolios and believe the best relative value is in the preferred stock of certain issuers.

Given current valuations in the credit markets, there are now sectors where the investor is finally compensated for taking the risk. The high yield market, which returned -6.52% for the first quarter, offers a yield spread of 1200 basis points measured by the Lehman Brothers High Yield Bond Index. This is the largest spread in the past eight years. Where appropriate, we are looking for opportunities to add high yield exposure in our portfolios.

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