Economic & Capital Market Summary

Third Quarter, 2008

The Economy

A major shock is hitting our economy and the result will inevitably be a recession.

Economic growth slowed during the third quarter as the financial crisis accelerated and spread around the globe. A growing lack of investor confidence combined with the expectation of additional writedowns continued to plague the financial system. The Fed and US Treasury have taken unprecedented and bold actions over the past several weeks to prop up the financial system in an effort to contain the damage that the financial crisis is having on the overall economy.

During the third quarter, we estimate GDP growth was flat at 0.2%, following a 2.8% growth in the second quarter. Similar to the second quarter, the continued deterioration in the value of the U.S. dollar has provided strength in exports. Also, we've continued to see strength in the government sector. Otherwise, we expect to see that every other major sector of the economy, lead by residential fixed investment, is contracting.

We have maintained that economic growth can persist if employment remains strong and the U.S. financial system is allowed to de-lever in a methodical manner. However, given the turmoil in the broader financial markets and the gridlock in the credit markets, we do not believe that scenario is now realistic. A jump in the unemployment rate to 6.1% in August, the highest in almost five years, underscored the troubling trend in job creation. A major factor for the economy is employment. Over the past eight months, the US economy has lost over 600,000 jobs as layoffs in banking, housing, investments, and the auto sectors materialize. However, as the employment picture remained weak, labor costs fell and productivity increased. Productivity, which is defined as output per unit of labor, has held up well in the face of weak domestic demand. During the second quarter, productivity increased by 4.3%, significantly above expectations.

Additional job losses will have the effect of compounding the trouble in the housing sector. As unemployment increases, so does the rate of foreclosures. To put the housing crisis in perspective, it is generally considered that the foreclosure rate today is the worst since the period during the Great Depression. Among mortgages on single family homes, over 9.15% were at least 30 days overdue or in the foreclosure process by the second quarter. This is the highest level since the Mortgage Bankers Association began measuring data 39 years ago.

Signs that the consumer is retrenching are pervasive. Retail sales plunged in September by 1.2% as mounting job losses and plunging home prices have impacted buying behavior. The two biggest outlays for the consumer sector are housing and automobiles. Housing starts, not surprisingly are at a 17 year low. Automobile sales are plunging and fell to an annualized level of 12.5 million units in September, the lowest level since 1993. Consumer confidence has weakened to its lowest level since the measure began 28 years ago. Given the sharp decline in the consumer sector, which represents over two-thirds of the total economy, we expect holiday sales to be abysmal.

The business sector, which has been the lone bright spot in an otherwise dimming picture, is a growing concern. The credit crunch has made it difficult for businesses to borrow and maintain operations. In spite of these difficulties, the demand side appears to be fading quickly. Capacity utilization is expected to fall below 78% as business inventories decline.

The decline in energy and other commodity prices has helped to reduce the upward pressure on inflation. Core CPI rose 0.1% in September and is projected to slow to an annualized rate of 5.0%.

Fiscal Policy and the Budget Deficit

As a result of the government's initiatives to provide liquidity and confidence in the U.S. financial system, the federal budget deficit is ballooning. With the passage of the $700 billion financial rescue bill, the budget deficit is expected to grow to $455 billion dollars. The budget deficits of the 1980s compounded problems in the economy and were in part responsible for the higher level of interest rates during that period of time. Any progress toward narrowing the budget deficit will be difficult in the current environment. Any tax increases on consumers will be difficult and unpopular. Tax receipts from the corporate sector, in an environment where business development is suffering, will be like pushing a boulder up a hill.

Separate from the $700 billion financial rescue bill, The Internal Revenue Service, the U.S. Treasury Department and Congress have been rolling back various provisions of the tax code to help out companies and investors in the current market turmoil. One example, and the major reason that Wells Fargo was able to purchase troubled Wachovia without government assistance, is the repeal of an obscure tax rule that now gives banks the ability to use the tax losses of banks they acquire. It is estimated that Wells Fargo may have almost $19 billion in tax savings as a result of the purchase of Wachovia, which is more than the $14.3 billion they are paying for the bank.

The Impact of the Credit Crunch on Economic Growth

We are living history in our capital markets. While there have been periods in history where asset bubbles burst resulting in deleveraging and economic contraction, this period is unique. One of the seminal books on capital market behavior was first published in 1841 entitled Extraordinary Popular Delusions and the Madness of Crowds, by Charles MacKay. It describes the Dutch tulip bulb frenzy of the seventeenth century which has similarities to the housing craze in the United States from 2001 to 2006. The U.S. government has aggressively taken steps to mitigate the impact of the financial market crisis on the economy. The government stepping in to rescue the financial system has happened several times in our history. The U.S. banking system was bailed out in 1907 and 1929. With the creation of the Resolution Trust Corporation (known as the RTC) in 1989, the government orchestrated the bailout of the savings and loan industry.

As a result of the freezing of the credit markets, the economy is inevitably headed into a recession. Perhaps the most similar period in recent economic history was the credit controls that President Carter implemented in 1980. As a result of surging inflation, President Carter implemented credit controls on the banking system. The result was a decline in lending, a spike in the rate of unemployment and a contraction in GDP of 8%. While the circumstances were different in 1980 and inflation is not the current problem it was back then, we expect the results of seizing in credit will be the same: a decline in lending, a spike in the rate of unemployment and a contraction in the growth of GDP.

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