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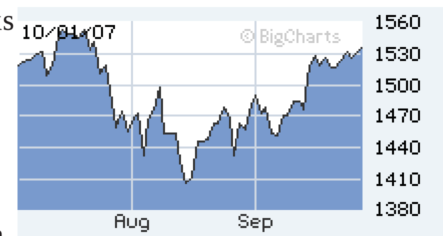
Investment Outlook Fourth Quarter 2007

Fourth Quarter Review

All seemed well in the financial world through mid-July. GDP growth was poised to rebound to the highest level in five quarters, corporate profits were forecast to grow by double digit rates for the 16th consecutive quarter, and the Dow Jones Industrial Average and S&P 500 had just set all-time highs. Merely one month later, with world credit markets in turmoil, and the major U.S. stock indices suffering their first ten percent correction in almost five years; central banks around the world were aggressively injecting liquidity into their monetary systems and the Fed was forced to cut the discount rate in an attempt to restore calm to an increasingly perilous financial situation. These actions, coupled with the Fed's bold half-point cut in the fed funds rate in mid-September appeared to produce the intended effect. Stock prices world-wide quickly rebounded to new all-time highs in less than two months from their mid-August lows and credit markets appeared to stabilize. Yet, with the housing downturn worsening, major retailers missing sales targets, oil prices skyrocketing and the unemployment rate rising, investors became increasingly worried about the possibility of recession.

S&P 500



The U.S. Economy

In order to fully comprehend the current state of affairs, it is important to understand how we arrived at this point. The first sign of trouble occurred in February when the Bank of Japan raised short term interest rates and investors began to worry that the yen carry trade (where funds are borrowed in low yielding Japanese debt instruments and reinvested in higher yielding or riskier assets throughout the globe) was ending. This repurchase of yen and sale of U.S. dollars forced the liquidation of many sub-prime assets that had specious valuations placed on them, and subsequently pulled the covers back on a whole security vehicle that had been mispriced. In fact, in retrospect, this was the first domino to fall, followed by sub-prime mortgages being re-priced downward which was the primary cause of the collapse of several high profile hedge funds from the likes of Bear Stearns, Goldman Sachs and others. Excessive sub-prime mortgage lending was also behind the failure of over 150 U.S. mortgage companies.

With this backdrop, U.S. economy activity is now threatened by three related forces: a credit market crisis, an unrelenting downturn in housing and a slowdown in consumer spending. As stated above, the current credit market crisis began with widespread defaults on sub-prime mortgages. Borrowers with poor credit histories and uncertain incomes had bought homes with adjustable-rate mortgages characterized by high loan-to-value ratios and very low initial "teaser" interest rates. The mortgage brokers who originated those risky loans sold them quickly to sophisticated buyers who packaged them into large pools and then sold participation in those pools to other investors, typically by slicing them into smaller segments with different estimated degrees of risk. Many of the buyers then used these to enhance yields in structured bonds or even money markey funds through asset backed commercial

10 Year Treasury Note

paper. Unfortunately, many sub-prime borrowers eventually had difficulty paying their monthly mortgage payments as the teaser rates rose to market levels. The resulting defaults exceeded what investors in the mortgage pools had expected and ultimately triggered a widespread flight from risky assets, with a substantial widening of all credit spreads, and a general freezing of credit markets. Official credit ratings lost credibility and investors and lenders became concerned that they had mis-priced many of the complex mortgage backed securities, collateralized debt obligations (CDOs) and structured investment vehicles (SIVs) that were created when global liquidity was so plentiful.

In some recent weeks credit became unavailable. Loans to support private equity deals could not be syndicated, forcing the banks to hold those loans on their own books. Banks are also being forced to honor credit guarantees to previously off-balance-sheet conduits and other back-up credit lines, further reducing the banks' capital available to support credit of all types. Estimates of the value of sub-prime and other risky debt that has to be written down run as high as $300 billion. Collectively, major US banksand brokerage firms have already announced third quarter asset revaluations measured in the tens of billions of dollars. Unraveling all the leveraged mortgage debts in the hands of SIV's and other conduits will take some time and will likely result in additional failures. But while this sorting out process will continue to garner its share of media attention and create additional headline risk, sub-prime borrowers are already shut out from obtaining any more credit. And though the housing market has yet to hit bottom, new construction activity has declined somewhat more quickly. That would be a positive event, even if it retards GDP growth somewhat more quickly.

With the continued drag from housing and credit market uncertainties, U.S. economic activity is projected to slow in the fourth quarter and into the first half of 2008. While the odds still favor a slowdown, weaker consumer spending trends along with housing and credit woes have increased the risk of recession. Fed easing and strong exports should provide an offset to help the U.S. avoid recession.

Oil Prices and the Dollar

Continued strong global demand for energy resources, tight supplies, tensions within oil-producing nations and a weak U.S. dollar have all combined to drive oil prices to an all-time high. India, China and other developing economies have sustained incredibly rapid growth rates, swelling their energy needs. Oil supply has struggled to keep pace with this strong demand. In addition, since much of the world's oil is produced in unstable countries, the risk premium placed upon oil prices remains high. And because oil and many other commodities are denominated in U.S. dollars, dollar weakness has also played a part in oil's record setting run.

Crude Oil

The dollar has been relatively weak all year due primarily to faster growth within the economies of our major trading partners. The recent precipitous decline however was triggered by the sub-prime credit fiasco. With the chances of recession rising and U.S. interest rates tumbling, investors fled the dollar in pursuit of higher yields in faster growing economies. With the Fed likely to cut interest rates further, a quick rebound in the value of the dollar is unlikely.

Capital Markets Analysis

After five years of advancing stock prices and increased corporate earnings, both are showing signs of weariness. Third quarter earnings are on track to barely break-even from a year ago. Not surprisingly, some of the worst results have been reported from banks, mortgage lenders and home builders. Investors had hoped banks' admissions of poor performance and write-downs would suggest that the bad news was behind them and the credit environment was beginning to improve. But at the same time as reporting big credit related losses, pretty tepid outlooks were offered in conjunction with lower 2008 earnings forecasts. While overall earnings are projected to bounce back in the next few quarters, weak corporate guidance is likely to temper those expectations leading to reductions in estimates. High oil prices, a tumbling dollar and soft consumer spending are also likely to pressure stock prices in the months ahead. Offsetting these negatives are low interest rates, a strong global economy and reasonable stock price valuation levels. International equity markets should sustain their relative outperformance versus the U.S. as global GDP growth trends are stronger than domestic growth at the present time. High-grade bonds should perform well as a safe haven while riskier fixed income instruments and REITs are likeley remain volatile with lingering weakness through at least year-end.

Investment Strategy

Calling for a fourth quarter rally in stocks has become an easy call for investment strategists as the S&P 500 has risen in 15 of the last 17 years. Also, over the last ten years fourth quarter performance has been greater than the first three quarters combined in eight of those years. Even with this in mind, a bit of caution is advised as we head into the final few months of the year. While we do not anticipate any catastrophic declines in stock prices from current levels, the headwinds of fragile credit markets and weak earnings should be enough to prevent a typical year-end rally from progressing to its fullest extent, especially since major stock indices entered the quarter near all-time highs. We will continue to focus on sectors where trends remain favorable such as technology, healthcare, consumer staples and energy and will stay underweighted in retail and financial services. Increasing our commitment to foreign markets remains an objective during any corrections as many markets around the world seem to be extended currently. We will also be slow in committing new capital to stocks, allowing proceeds of sales to sit in short-term instruments from time to time until opportunities present themselves. Fixed income investments will focus on high grade government instruments, including municipal securities when appropriate and in high-yield corporate funds when yield spreads warrant taking the additional risk.

Advisory Comment

Current dividend and long-term capital gains tax rates of 15% are set to expire on December 31, 2010. As we look ahead to Presidential and Congressional elections next year, there appears to be an increasing possibility that 2008 may be the last year capital gains taxes remain at 15%. While anything can happen over the next year to change the odds of a democratically controlled Congress coupled with a democratic administration, that potential seems most likely as we look forward. And we believe that if the democrats sweep, they will seek to change the tax rate on capital before the 2010 expiration through a comprehensive “tax reform” package. Though we don’t know the magniture of any rate increase, we wish to advise you of these prospects for planning purposes. If you are sitting on large capital gains and considering sale of assets or require additional liquidity at some time in the next few years, 2007 and 2008 may be more desirable to realize those gains than in years beyond these. We look forward to discussing this issue and any others unique to your circumstances in our next meeting or teleconference.