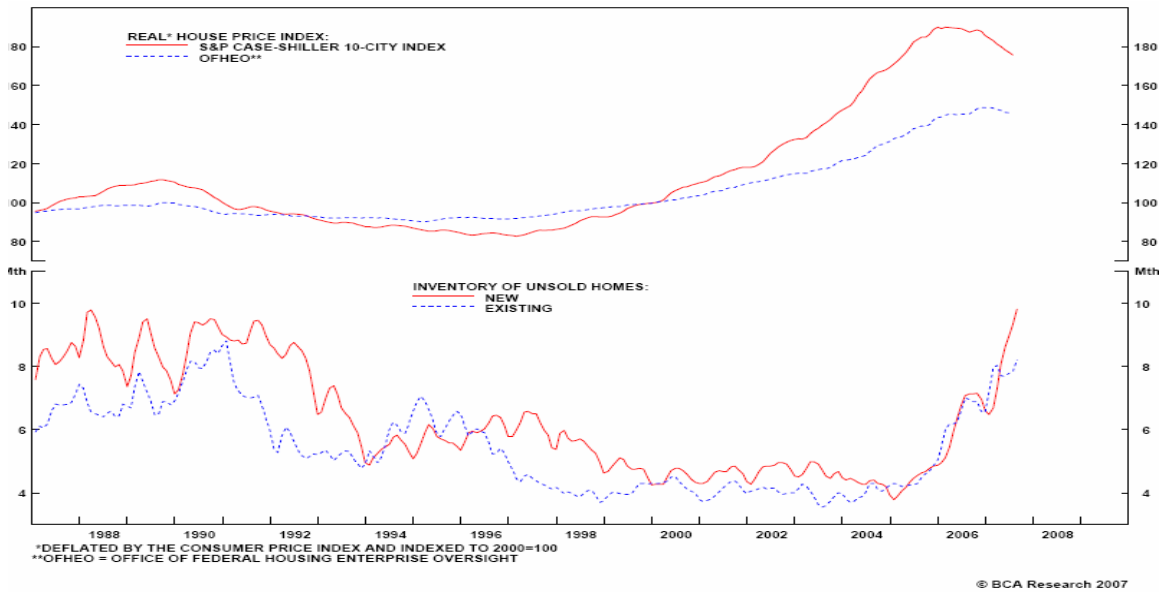




**ECONOMIC & MARKET COMMENTARY**

The Federal Reserve, the U.S. economy and investors find themselves between the proverbial rock and a hard place. The Fed must avoid turning the dollar into a falling rock while, at the same time, containing the damage from the faltering housing market, the hard place. The Fed finds itself in one of its most difficult conundrums. Housing prices as shown below have started to rollover after the big increases experienced since 1996. The inventory of both new and existing homes available for sale has spiked to ten months and eight months respectively, from four months as recently as early 2005, as shown in the graph below.

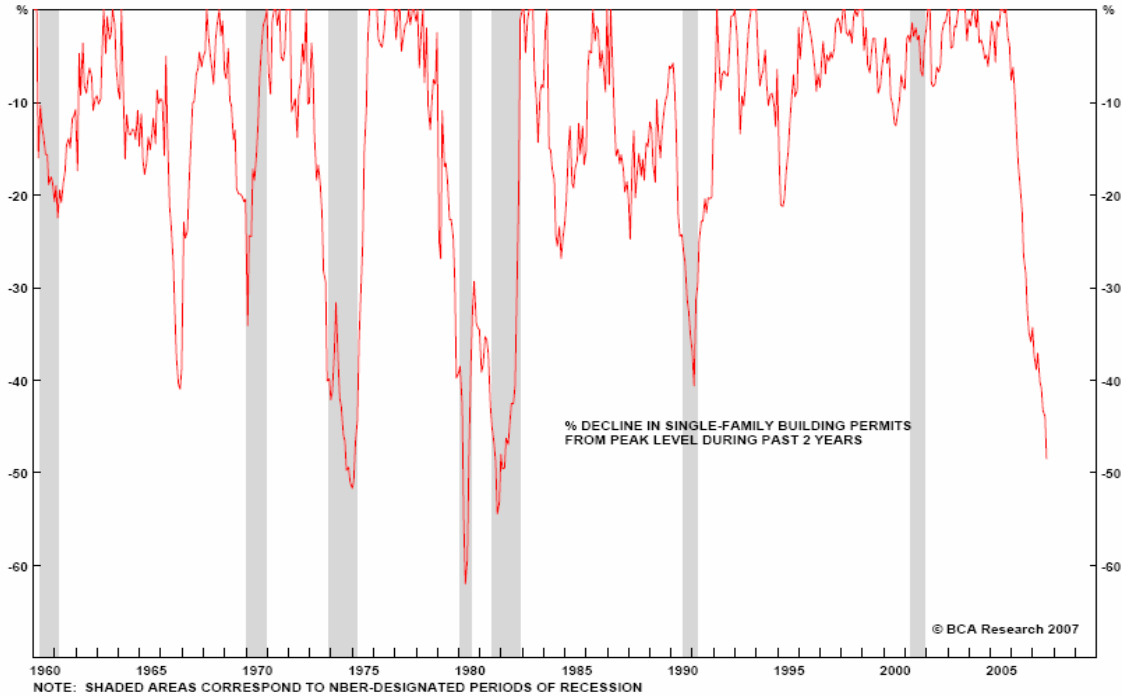


Building permits, new single family home sales and existing home sales as a percentage of housing stock have all peaked and are experiencing cyclical declines. As shown below, all of the measures of housing activity relative to the total housing stock generally bottom below current levels. We are in the midst of a normal cyclical decline in housing, albeit from high real price levels.

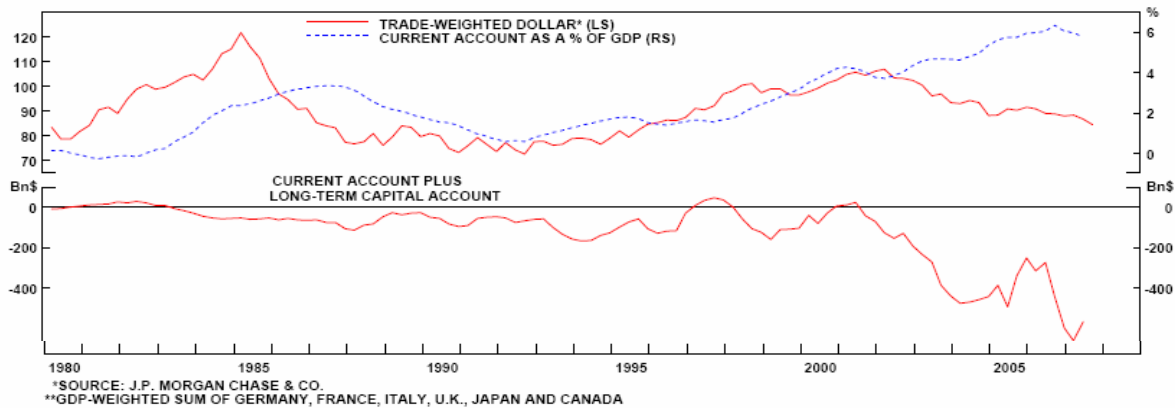




Single family building permits are adjusting quickly to the overbuilt housing market. As shown below, permits are almost half of their recent peak. Building permits are a leading indicator of housing's impact on employment and GDP.



We expect continued contraction in housing construction employment and the associated industries that finance or supply housing. This contracting employment should be a drag on overall consumer spending and could have a negative multiplier impact on overall GDP growth above and beyond its direct impact. In addition, the related impact on the mortgage market and financial firms is already creating a loss of jobs in the financial services sector. We expect this to spill over into retail and autos as well. In our view, the full ramifications and fallout will be a drag into 2008, and we expect GDP growth to be below trend. The 2008 elections and its related campaign rhetoric may create additional uncertainty, causing businesses and consumers to be even more cautious.





The Federal Reserve is, in our opinion, fully aware of these ongoing issues as shown by the September 18th half of a percent Fed Funds and Discount Window cuts. However, these cuts did accelerate the decline in the dollar. While U.S. based exporters are a beneficiary of a weaker dollar, a dollar panic is in no one's best interest. The current account and related long-term capital account are both in need of adjustment and an orderly decline in the dollar would help both of these items. A dollar panic, on the other hand, could result in a spike in long-term interest rates as foreign investors flee en masse, with a resulting financial squeeze on our over-levered consumers. A weaker dollar causes higher import prices and less price competition in the U.S. market, which negatively impacts U.S. consumers who have become addicted to inexpensive foreign imports. This change in relative pricing should result in a decline in foreign imports and the trade deficit but could create an uptick in consumer goods inflation.

The good news for our readers who have persevered through all this market negativity is the Fed seems to be acutely aware of its conundrum and will attempt to skillfully manage these treacherous waters. The Fed's decisive moves in rates calmed the credit and stock markets, allowing the markets to stabilize and partially clear, thus avoiding a panic. The Commercial Paper market and the High Yield Bond market are now operating smoothly but at reduced dollar volumes. The other bit of good news is that most international economies are in good shape. U.S. multinationals will benefit from this exposure and will get the added benefit of translating foreign earnings into more dollars, albeit each dollar is worth less.

In conclusion, the housing market's full impact is still ahead, but the Fed is proactively trying to address this problem, while simultaneously watching the dollar. While there is little margin for error, the U.S. economy should be able to avoid a recession and thus allow modest corporate earnings growth in the new year. With interest rates and inflation still low, many stocks have room to appreciate into 2008.