



The increased volatility we predicted in our earlier letters materialized with a vengeance this quarter. After surging to new highs in July, stocks pulled back sharply on concerns that the problems in the mortgage market would spill over into the rest of the economy. Indeed, numerous mortgage banking firms did collapse and many others were threatened with failure. Caught by surprise, the mechanisms that funded the mortgage industry locked up and the entire U.S. financial system nearly froze.

Against this backdrop, the S&P 500 ended up 2.02% for the quarter and was up 9.19% for the first nine months of the year. The bond market was a little more robust as a “flight to quality” rally dropped the yield on the 10-year Treasury note to 4.58% by the end of September. The broader Lehman Index returned 2.76% during the quarter and stood at up 4.01% going into the final quarter of the year.

The markets could not have rallied during this period of turmoil without the actions of the Federal Reserve Board. While media attention was mainly focused on the plight of foreclosed homeowners, a far greater danger lay in the fact that the financial markets had virtually shut down by early August. Bonds could not be traded, commercial paper and short term loans were not being rolled, and financially solvent firms were having loans called in. Mortgage lenders and their Wall Street bankers were caught in a liquidity squeeze. Exposure to this squeeze went well beyond hedge funds and major brokerage firms. Even money market funds and high grade bond funds, investments that were believed to be ultra safe, turned out to have hundreds of billions of dollars at risk to these borrowers. At least one European bank was declared insolvent because of its holdings of U.S. sub-prime mortgage debt.

To its credit, the Federal Reserve acted quickly and decisively. By aggressively injecting reserves into the system, slashing

the discount rate, and jawboning nervous bankers, the Fed restored liquidity and prevented the spread of the contagion. For good measure, the Fed cut both the Fed Funds rate and the discount rate when the Open Market Committee met on September 18th. These cuts were designed to cushion the underlying economy from the impact of the housing crisis, although some economists argue that stability had already returned to the economy and the markets by the time they acted. This last point prompts a vexing question – did the FOMC overreact when it cut rates in September? Unfortunately, “yes” and “no” are both troubling answers to this question.

If the rate cuts were an overreaction to the crisis, the move will probably be temporary and could damage the economy in the long run if they are not reversed quickly. Unduly low rates are inflationary. As we saw in the 1970’s, when the Fed keeps rates too low for too long, they weaken the dollar and monetize commodity inflation. The remedy to the situation was painful. Furthermore, as recent economic data has shown, the U.S. economy is still in fairly good shape leading skeptics to believe that the Fed did nothing more than bail out financially extended hedge funds and speculators.

Given the prevailing low inflation rate and optimistic outlook, we are more concerned by the implications for the economy if the Fed sees the cuts as a needed change to their interest rate policy. The cuts were a dramatic reversal of prior statements and investors must ask where the economy is heading if the Fed felt compelled to cut so aggressively. The move implies that the Fed governors were looking at some stark numbers when they took this action. We should also remind readers that most recessions are well under way by the time the Federal Reserve begins to cut rates. Even if Dr. Bernanke is acting faster than previous chairmen, interest rate policy has historically been more effective at slowing economic growth than it has been at

stimulating it. Rate cuts are often compared to “pushing on a string” since they limit the scope of recessions rather than prevent them. If a downturn is coming, it will not be avoided because of these cuts. If the FOMC plans more cuts, investors should be very nervous about why.

Investment Strategy

It would take far more space than we have here to fully debate whether the Fed’s rate cuts were too aggressive or whether they were a needed strike at a looming economic downturn. We will let far more telegenic experts debate the matter on CNBC while we seek to identify those companies and themes that should do well under either scenario.

Consumer staples companies are a good example of a group that we have confidence in. People will buy products such as toilet paper, soda, and toothpaste even if the economy slows. Admittedly, job losses do push consumers towards generic alternatives, but revenues for these companies are far more resilient than for those in many other industries. They also offer a degree of inflation protection since they can simply pass along most cost increases. These companies also give us international diversification since most are multinationals that derive a majority of their revenues from overseas.

Technology is another favored sector. Companies are in the middle of a worldwide upgrade cycle. Adopting better technology is one of the most efficient ways to cut costs. Corporate balance sheets are flush with cash, giving firms the flexibility to make significant investments in their systems. With the number of households connected to the internet increasing daily, technology is also becoming an

indispensible part of everyday life.

Select banks, such as Keycorp and Susquehanna Bancorp, should do well in the months ahead even though broader financial firms may lag. We look for consolidation to provide a floor for these stocks while a normalized yield curve implies that earnings can rebound even with flat top line growth. Furthermore, many weaker competitors were wiped out by the mortgage meltdown and the remaining players should benefit.

Healthcare remains one of our most over weighted sectors relative to the market. Valuations remain low and people get ill regardless of economic conditions. Demographics help, too, since the aging global population will require more of these services. The drag on the sector – and certainly something that has hurt our performance on a year-to-date basis - is the political risks going into an election cycle. It is easy to bash drug companies and HMOs when running for office so many investors are waiting until the rhetoric is over. In the mean time, this is providing us with some great buying opportunities.

Bonds continue to look rich relative to the opportunities in stocks. We remain underweight relative to client benchmarks. However, balanced accounts that require bond holdings will still find that U.S. Government agency bonds and mortgage backed securities are cheap. We will continue to avoid high yield bonds for our clients as the spreads on these securities are not sufficient to compensate investors for the added risk. Our target range for the yield on the 10-yr Treasury note remains 4.75% to 5.25%.

As always, we welcome your questions and comments.

Composition of US GDP

	Growth Rates					
	2003	2004	2005	2006	2007 (E)	2008 (E)
Personal Consumption	2.8%	3.6%	3.2%	3.1%	2.8%	1.5%
Residential Fixed Investment	8.4%	10.0%	6.6%	-4.6%	-16.0%	-15.5%
Business Fixed Investment	1.0%	5.8%	7.1%	6.6%	3.7%	2.1%
Government	6.8%	4.2%	1.5%	2.2%	1.4%	2.9%
Exports	1.3%	9.7%	6.9%	8.4%	7.9%	7.9%
Imports	4.1%	11.3%	5.9%	5.9%	2.5%	2.9%
GDP	2.5%	3.6%	3.1%	2.9%	2.0%	1.8%
Domestic Final Demand	2.8%	4.1%	3.1%	2.8%	1.4%	1.1%

Source: Goldman Sachs Economics Research