

Commentary on Economic and Financial Conditions - Third Quarter of 2008 -

October 7, 2008

As the first severe problems relating to the subprime mortgage market came to light in August 2007 few, if any, investors could have foreseen the series of events that occurred over the subsequent 13 months. During this period, commodity prices spiked to record levels in July, before falling sharply, and financial markets were jolted by a series of dislocations in the enormous global residential mortgage market. Even more shocking have been the events involving large financial institutions, such as the demise of Bear Stearns, and within the month of September 2008 alone, the rescue of four European banks, the Irish government guaranteeing all bank deposits and debts, the disappearance of much of the remainder of the U.S. investment banking industry, the collapse of Washington Mutual and the rescue of Wachovia, and the nationalization of Freddie Mac and Fannie Mae. By the end of the third quarter of 2008, economic growth in the G10 and smaller European Union countries had come to a near standstill, with some of them already in recession. A pan-European bank rescue plan was discussed though no agreement was reached.

The crisis was brought to a head on September 29. On that day, the U.S. House of Representatives voted to reject the Troubled Asset Relief Program (TARP), the \$700 billion Treasury funded facility for purchasing and managing toxic assets held by the U.S. banking system. This decision to reject a safeguard against asset fire sales and destructive asset depreciation drove the S&P 500 down almost 9% (the largest percentage decline since October 1987), although it was followed by a significant recovery the next day.

A modified U.S. financial rescue plan, the Emergency Economic Stabilization Act (EESA), was finally signed into law on October 3rd. The massive fiscal lifeline for troubled financial institutions should help to arrest the stampede from risk and minimize the odds of a debt deflation and a self-feeding collapse in the net worth of the financial system. For example, Section 101 of the legislation gives the Secretary of the Treasury authority to recapitalize troubled banks while at the same time taking troubled assets off their hands. This should help alleviate bank insolvency as well as liquidity problems. The legislation also allows the Treasury to guarantee interbank lending which should restore trust in interbank relationships and allow interbank lending to start up again. The interbank markets, secured and unsecured, are respectively moribund and dead. The reason banks do not lend to each other in the interbank market is counterparty risk/fear of default of the party they are lending to as a result of weakened balance sheets following the Lehman bankruptcy.

In addition to the U.S. financial rescue package, we either anticipate or have recently heard announced five policy actions that will help alleviate the current global financial crisis.

1. We expect a coordinated rate cut by the Fed, the Bank of England, the ECB, and other major G10 banks. It has been more difficult for central banks in the UK and Euro areas to cut rates because they do not have a dual mandate; their sole objective is price stability. However, in both the UK and Euro areas, real growth conditions have

deteriorated so quickly and to such an extent that the balance of risks is now for the inflation target to be undershot rather than overshoot over the horizon that the central bank can influence the inflation rate. Under these conditions, central banks in this region should be focused on reducing the cost of funds so that banks can increase their cash flow and improve the likelihood of their remaining solvent.

2. The Emergency Economic Stabilization Act gives the Treasury enough authority to clean up the Fed's balance sheet and replace many of its questionable assets (acquired through its recent efforts to stave off crisis) with Treasury securities. This should be done right away and will restore confidence in the U.S. central bank.
3. We expect some sort of accommodation in bank accounting. Mark to market accounting, which began after the S&L crisis in the early 1990s, has exacerbated the credit crisis. By requiring immediate write-downs on loans and securities that have declined in price, institutions have to make corresponding reductions on the other side of the balance sheet, forcing asset sales and depressing prices further. This vicious cycle could be broken if accounting standards were changed to allow losses to be accrued over the remaining life of the assets thereby avoiding immediate hits to book value of capital. Proposed changes in the interpretation of FASB 157, which the SEC is now considering, would prevent this.
4. The Fed has just said that it will directly purchase commercial paper from corporations, which even those corporations with strong credits have had difficulty rolling over. This would enable companies to pay down their backstop lines of credit with banks and free up bank funds for other lending.
5. Emerging market central banks, such as China, are already starting to ease as commodity prices decline or, as in the case of Brazil, have just finished raising rates.

Investment markets will take some time to recover, with the stock market leading the way. The stock market is a forward looking market (usually six to nine months). One component of the current decline in the stock market is the liquidation of equities caused by the deleveraging of hedge funds, as banks shift their lending capacity to corporate borrowers. As liquidity and confidence return, the stock market should stabilize and grow. The bond market will recover more slowly. There will be less inventory on bond desks and pricing is likely to be inconsistent. It will take some time to rebuild the confidence of overseas investors. Overseas investors may slow their investments in the U.S. debt and that will place pressure on the U.S. economy.

We expect continued, short-term volatility in the markets and the economy. Until conditions stabilize fundamentally, we will continue to hold above average levels of cash. As investors continue to unwind the global growth trade in the fourth quarter, we expect to rebuild positions in high quality companies at compelling valuations. Stock markets are looking increasingly oversold. The confluence of the business cycle and financial risks has led to an increase in the premiums required by investors to hold volatile assets, but this premium, in our view, has now become excessive. From some bottom in the near term, we expect a significant rebound in many stocks.

With respect to high quality corporate bonds and high quality municipals, there are many opportunities to buy. The market as a whole has been severely hurt by investor aversion to credit

risk and the financial stress felt by traditional bond buyers, such as banks and insurance companies. The authorities have been forced to chop away with new initiatives to reopen financial markets. As we have already indicated, they are working hard to put a coordinated bailout plan into place that will unlock the clogged credit market and all risky assets should eventually benefit from this move. If the spread between the three-month LIBOR and the U.S. Federal Funds rate declines to less than 1% from present levels which are currently in excess of 2% for a sustained period (indicating that banks are willing to lend to each other), we will seriously consider meaningfully adding to high grade corporate and tax-free bond holdings in our client accounts.

The net dissavings to the public sector as a result of the bailout plan are matched by the net increase in private sector savings in the form of capital injection. In essence, this action is to swap cash for illiquid assets and is therefore physically neutral. We believe that Treasury yields will be dictated by economic forces going forward. At least for the next six months, slower growth, deleveraging and falling inflation will be supportive for ten-year Treasuries. After that time, as the U.S. economy begins to recover, we anticipate that ten-year Treasury yields will start to rise. Shorter-term U.S. Treasuries look attractive because we expect that the Fed Funds rate will soon be cut to 1%. However, we would hold longer-term issues only temporarily because by late 2009 there will be accelerating government deficits approaching a trillion dollars and the eventual rise of inflation and longer dated yields.

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