

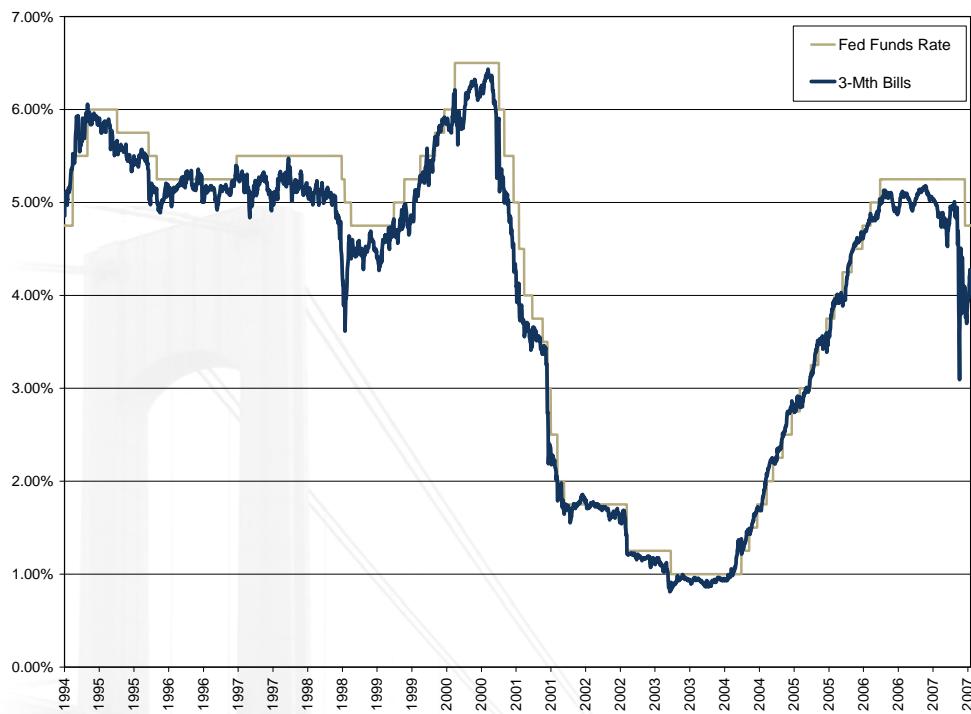
FED Watch

On September 18, 2007 the Federal Open Market Committee (FOMC) lowered both the Fed Funds target rate and the discount rate by 50 basis points. This was the first Fed Funds rate cut since 2003, and although largely anticipated, the magnitude of the reduction was more aggressive than the financial markets expected. This surprising move by the Fed has sparked a debate concerning its' motives and credibility. Specifically, market participants questioned whether or not the 50 basis point rate cut was only initiated to bailout risk takers; namely Wall Street, hedge funds, and condo flippers. It was thought that this move was a remnant of the Alan Greenspan era, as he had a reputation of bailing out the "street" and investors during their time of need. This time around however, the Fed is emphasizing the slowdown in economic activity and thus had the impetus for an aggressive rate cut aside from a speculators' bail out. Remember, the economy was downshifting even before the credit contraction fully unfolded in mid-July. And recall that the Federal Reserve Board Chairman Ben Bernanke is an expert on the Great Depression, therefore he fully understands the repercussions of a credit crunch on the overall economy.

Follow The Leader

So, does the Fed follow or lead the interest rate markets? Quite early on in Greenspan's tenure, the "Maestro" seemed to have figured out he was better off following the financial markets rather than leading them. If you doubt the concept that the market sets the level of interest rates, rather than the Federal Reserve, please see the chart below. Since 1994, by comparing the change in the level of three month bills with the movement in the Fed Funds rate, you will note that the Fed watches the market set the rates and then reacts accordingly. As U.S. three month bill rates rise, the Fed increases their target rate and as three month bill rates fall, so will the Fed's target rate. With the three month bill yield at 4.25%, and the Fed funds target rate at 4.75%, there is still room for the Fed to cut without assuming that leadership role. With Bernanke acting in a similar manner, taking his cue from the market, is it possible that the only difference between Greenspan and Bernanke is the beard?

Fed Funds Target Rate vs. 3-Month U.S. Treasury Bills **October 1994 – Present**



The Big Picture

In past commentaries, we have shared our views about the threat of a deflationary environment, while the crowd is focused on the threat of inflation. As unique as the concept may have seemed six months ago, we think the seeds are sown for a deflationary environment to unfold. Certainly, the costs of a multitude of nondiscretionary items such as food, health-care, and energy, have risen sharply. However, we believe that the increase in these pocket book expenditures pales in comparison to what could be the largest deflationary force that we have seen in decades; specifically plunging home prices. For months, this has been our "lynch pin" for forecasting a U.S. recession. Undoubtedly, we would abandon our outlook for a more sanguine outcome if the incoming housing data warranted such a shift.

Now, the chorus of "experts" who are embracing the concept of a housing led recession is steadily growing. As stated in our 2007 outlook: "If you line up the confluence of powerful shocks to the system, namely, oil, housing, and 425 basis points of Fed tightening - we would conclude that a recession is probable." While the topics above are catching the media's attention, and market participants discuss the latest headlines, there is usually more to the story. In this particular instance, the headline (sub-prime mortgages) is the smoke and

the generalized contraction of available credit is the fire. In other words, this is the inevitable outcome of lending to virtually anyone; lending to no one!

Tax Exempt Summary

The third quarter proved to be a tumultuous and unpredictable period for Municipal bond yields. During the "liquidity crisis" investors flocked to the Treasury market driving down yields. In contrast, yields on tax-exempt securities actually rose. The Municipal market seemed to experience a buyers strike from individuals, as they were virtually sidelined by the extreme market volatility. Contributing to the increase in market rates was the selling pressure generated by Municipal traders who trade on behalf of broker/dealers. Many of these professionals were directed to sell their Tax-exempt positions in order to free up assets on their organization's balance sheets. As you may recall, Wall Street firms were actively shifting capital to the areas where they needed it the most, namely distressed securities. To raise their level of liquidity, they sold the highest quality, most liquid securities.

Order and liquidity has since returned to the Municipal market. From a technical perspective, the Tax-exempt market seems to be on solid footing, as the level of new issue securities is poised to slow. Although the supply of new issuance has been heavy all year with volume up 21% from last year's pace, it should begin to subside. For example, looking out over the next 30 days only \$13 billion long-term bonds are slated for sale. This compares to the 2007 monthly average of roughly \$35 billion that has come to market. Lastly, the shape of the Tax-exempt yield curve has returned to a more traditional slope, rewarding investors for owning longer maturity debt.

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***Lehman Brothers Municipal Bond Index, is a broad-based total return index comprising investment grade, fixed-rate, and tax-exempt issues, with a remaining maturity of at least one year, including state and local general obligation, revenue, insured, and pre-refunded bonds that are selected from issues larger than \$75 million dated since January 1990. Investors cannot directly purchase an index. The returns of the index are shown for comparative purposes. When comparing the investment returns of the manager to the index, you should know the manager does not necessarily hold the same securities that comprise the index, the index may not reflect the asset allocation and portfolio characteristics of accounts managed by the manager and that the index is unmanaged.