Investment Update
3rd Quarter 2008

Writing this on the afternoon of September 29, the news has just broken that the House of Representatives has voted against the Paulson Plan to provide up to $700 billion of funding for the purchase of distressed securities. This comes as a big disappointment to many investors who had been hoping for quick passage, and the Dow Industrials average has fallen more than 700 points, or just under 7% on the day. Most other stock market indexes have suffered similarly.

Recognizing that the daily flow of events is as fast and volatile as we have ever seen, here are our current thoughts.

Is the economy, and by implication the stock market, doomed without passage of this version of the Paulson Plan today? No. Going into the weekend, many investors were hoping for Congressional approval of the Plan as a short-term solution to the ongoing credit and liquidity squeeze.

Currently, the short-term credit markets are gummed up by a great deal of uncertainty centering on the value of some kinds of mortgage-related assets, which financial institutions hold them, and what additional losses might result. The plan might have accelerated the process of determining realistic values for these difficult-to-trade securities, and in time would have helped the market to better differentiate between truly troubled institutions and those whose stressed investments will ultimately pay off.

But this sorting process has actually been under way for some time and will continue with or without a plan. Since the first sub-prime mortgage problems cropped up more than a year ago, some financial institutions have been able to attract major capital investments from private and foreign sovereign wealth funds, some more than once. Other institutions with problems judged to be more fundamental have not been able to attract this capital, and some have not survived. More private capital is waiting in the wings. While it is less visible and perhaps less comforting than a single giant government buyout entity, this widely dispersed private capital will continue to become available to some financial institutions as the shakeout continues.

What happens to the economy in the short run as the Paulson Plan is revised? There is no question that lenders have made credit more difficult and expensive to get for many. But outside of Wall Street and the short-term interbank lending markets, the new credit standards look more like a return to traditional, conservative standards than a true credit crunch. For realistic home buyers, stricter mortgage terms like 20% down payments and verifiable income are not the end of the world. Lending is still available on reasonable terms to credit-worthy individuals and companies.

For example, in the corporate commercial paper market, Bloomberg reports that short-term rates for industrial and retail borrowers have actually fallen to their lowest levels in several years even as the rates for financial borrowers have increased to very high levels. Microsoft, which has never issued debt before (and does not need to borrow given the $20+ billion of cash on its balance sheet), is taking advantage of the low rates to begin its own short-term commercial paper borrowing program, and may issue small amounts of long-term debt simply because the rates at which it can borrow are now so low.

The credit markets that are experiencing the most difficulty now are the short-term commercial paper market for financial borrowers and the inter-bank lending markets. In the short run, the Federal Reserve's extraordinary efforts to make liquidity available to these borrowers are helping to replace much of the liquidity that the private market is currently unwilling to supply, and so far has worked to keep things from grinding to a halt.

We think that credit will continue to flow for many borrowers, from the Fed or from the public debt markets or from private sources, enough so that the broad economy can continue to muddle along without falling into a severe recession. While the situation now is serious, casual comparisons being made between now and the Great Depression grossly exaggerate the dangers that we face. The important differences have been in the policy responses at the government level. In the 1920's and 1930's, Congress, the Fed, and the administration got trade policy, monetary policy, and fiscal policy very wrong. Today, free trade dominates, monetary policy is accommodative, and tax policy is much more favorable, and these are critical differences.

Eventually, passage of some revised version of the Paulson Plan seems likely. Given the speed with which the original legislation was written, the unanswered questions at the time that it was brought to a vote, and the legitimate objections from both parties to what was presented, improvements can and probably will be made as the plan is revised.

Changes to eliminate mark-to-market accounting requirements for some long-term investments could help significantly. In our opinion the plan could also be improved by including some measures aimed at improving economic growth prospects, such as making the low current tax rates on capital permanent. But any plan is unlikely to be a magic bullet that completely frees clogged credit markets quickly, and difficult credit market conditions will take time to clear. It will be a good start, but that's all.

Difficult credit market conditions are surely a headwind for the economy, but it is not all doom and gloom. Here are a few positives:

- Throughout the credit upheavals of the last year, real economic growth has continued. Real GDP growth in was 2.0% for 2007, and 0.9% and 2.8% respectively in the first two quarters of 2008. Outside of the housing sector, growth has been reasonably strong. Without the drag from housing, second-quarter growth would have been 3.4%.

- Strong U.S. exports continue to be a big part of our economy's growth story. While growth in Europe has slowed and many emerging economies are slowing as well, growth in much of the rest of the world is still likely to be better than ours. Exports will likely still be a source of growth for us.

- Corporate profits are still healthy, if we exclude the write-off-plagued financial sector's very poor results. For non-Financials, the low valuations that we are seeing in today's stock market sell-off make some sense only if a severe recession that dramatically reduces future profits is in the cards.

- Although the employment picture is less rosy than a year ago, unemployment levels are still relatively low. The unemployment rate in August rose to 6.1%, versus averages of 5.1% in 2005 and 4.6% in both 2006 and 2007. So far, the rising mortgage delinquency and foreclosure rates relate more to loans that were originally made without much chance of being repaid as agreed and so were always at great risk. Unless the employment environment deteriorates a lot, borrowers with jobs and incomes that are able to keep up with their mortgages will probably continue to do so.

- Energy and other commodity prices are dramatically lower, from extraordinarily high levels earlier in the year. Crude oil has declined about 30% from the July peak, natural gas is down 45%, and wheat and corn are both down by more than 35%. Consumers' discretionary incomes are under less pressure and widespread concerns about the likelihood of global shortages and runaway food prices have been replaced.

The volatility this past year has been unnerving. But we have always stressed the importance of adequate diversification and advance planning to make sure that short-term funds will be available to meet clients' foreseeable spending needs. These are the times when the real value of these fundamental policies becomes clear. Having always been guided by them, we believe our clients are well-positioned to ride out what tomorrow may bring.

The situation continues to evolve, and we should expect more alarming headlines from time to time. When this happens, please call or write rather than worry in silence. We will do our best to help.