

Economic Conditions & Market Outlook

The global stock markets continue to deliver unprecedented and unnerving daily volatility despite several significant efforts by multiple sources to restore a sense of calm and confidence. It is for this reason that early yesterday morning we as well took the unprecedented step of reducing our clients' already sharply-pared equity exposure even further. Short term risk overshadows potential return and a prudent stance is warranted.

As a result of these defensive moves, most of our client portfolios are now at least 40% below their targeted minimum equity level, as defined by individual investment policy parameters. As previously communicated to clientele, this contingency had been planned for in the event of continued market unrest and should provide some sense of stability and comfort in these tumultuous times.

Despite this rollback in overall equity exposure, diligent efforts have been made to maintain an appropriate level of portfolio diversification as investments were selectively reduced or eliminated. The portfolio and equity repositioning was designed to additionally buffer downside risk during this gut-wrenching market ride, while still allowing for participation in the occasional bounces along the way. While we view these shifts as being tactical and temporary, 'temporary' in this instance might be measured in weeks or months versus days.

Part of what is sustaining this stubbornly erratic stock market is the fact that there is a very diverse array of factors contributing to the consternation plaguing most investors. First, there are well-founded worries about the health of the worldwide credit markets. Second, there is the specter of significantly slowing global economic growth and recessionary fears. Third, as redundant as it may seem, there is the frenzied behavior of the market itself; fanning the fires of investor insecurity, which then further exacerbates market instability, etc. Other lingering concerns; such as a hobbled U.S. housing market, unpredictable fuel/commodity prices, and even the uncertainty of the political landscape after November 4th, add to the current state of angst and anxiety.

While these larger issues contributed to our previous minimum equity positioning and then our subsequent drop below minimum equity level toward the end of September (see last *Investment Update* for details), the additional equity reduction outlined above was prompted by some very specific concerns surfacing during the past several days. Some concerns were credit related, some were economic related, and others were market related. But all pointed toward the investment climate remaining unstable and unpredictable in the near term.

To begin with the larger picture, the stock market started off last week with a monstrous 778 point decline in the Dow Jones Industrial Average after the U.S House of Representative's voted down the Troubled Asset Rescue Plan (T.A.R.P.), the governmental rescue package aimed at alleviating potentially debilitating restrictions in the credit and financial markets. Manic gyrations remained the norm throughout the week as the markets fixated on that bill's success and T.A.R.P. was probed, prodded, and padded by Congressional members until it finally passed last Friday afternoon. The stock market's response to this debated bailout? Immediately after passage, the DJIA promptly fell 157 points to close the week on a dismal note.

As noted in our Investment Update from the end of September, this program's passage was certainly never expected to be a panacea, nor would it provide an immediate fix to our ailing financial system. However, even acknowledging that some mid-week upward pricing moves suggested the bill's eventual passage was anticipated by the market, the less-than-enthusiastic response after the bill passed was a clear indication that the market's financial worries had already shifted elsewhere.

This week proved no better. Early on Tuesday morning, the Federal Reserve made an extraordinary move designed to assuage liquidity concerns and announced it would lend directly to U.S. corporations, a tack not taken since the Great Depression. The Fed also suggested that additional interest rate cuts would be imminent. Normally, either announcement alone would be enough to cause the stock market to at least pause, if not celebrate. Instead, the market chose to view the glass as half empty, seeing such aggressive moves by the Fed as perhaps indicative of deeper problems, and then continued its unabated downward trend.

The credit contagion reached pandemic proportions this week as banks across the globe are being bailed out by their respective governments at a dizzying pace. From Europe to Asia, individual nations have either been forced to step in and backstop guarantees on depositor dollars or intervene directly by nationalizing their troubled financial institutions. There is no indication that this international banking bailout will end anytime soon and the eventual impact of these unprecedented actions on the global economy has yet to be determined.

In yet another move of notable proportion, prior to the U.S. stock market opening on Wednesday morning, several of the world's major central bank's, including those in the U.S., Europe, U.K., and Canada announced a coordinated effort to combat the widening financial crisis, boost confidence, and stem a global economic slowdown by simultaneously lowering interest rates. Central banks in China, Brazil, South Korea, Taiwan, and others soon followed suit.

The market's reaction? After a flurry of pre-open futures activity, the market convulsed its way through the day, only to end lower again. Keep in mind, none of the monumental actions listed above were implemented with the sole intention of placating a disjointed stock market. And additionally remember that most of these stimulative steps will take some time before their intended effects are felt directly.

But the lack of positive market response to these extraordinary measures makes one wonder what exactly will it take to turn this market around? Our suspicion is that there no single action that will make a whit of difference in the near term; the concerns are too deep and the issues too multifaceted. Similar to a case of the flu, the illness may just have to run its course before any medicine kicks in and the patient may very well feel worse before eventually getting healthy again.

In addition to these broader credit/economic-driven issues, several specific market-driven factors currently give us pause and have contributed to our additional tactical reduction in equity exposure. Most prominent is that the current quixotic state of the investment markets has temporarily suspended basic market fundamentals.

For example, present pricing volatility is being driven by emotions, not facts. Day to day price movements of individual securities are not occurring in the somewhat disciplined and incremental norm but are instead lurching one direction or another, often being motivated by nothing more than the movement itself. While current and expected price momentum is certainly one of a series of criteria we examine in making investment decisions, this needs to be tempered with investment fundamentals and even common sense. And while certain sectors are more vulnerable than others to stampeding price moves; none are immune. Being on the right side of that price movement is currently more a function of luck than skill; a good time for a time out.

Second, the upcoming quarterly corporate earnings reports and future earnings guidance will be a mixed bag at best. Alcoa led off the earnings season and surprised on the downside, with its share price promptly being pummeled. IBM reported third quarter earnings that were above estimates and reaffirmed positive guidance going forward. But after a brief pricing uptick, its shares again drifted downward in the day's trading. We suspect that this will be the norm this go around; negative earnings surprises (of which there will be many) being severely punished and positive earnings announcements being met with a yawn.

Finally, the spate of emergency weekend maneuverings and unforeseen deal-making may likely continue for a bit, resulting in surprise mergers that are often not beneficial to current shareholders. Likewise, in an effort to raise capital, several high profile firms have cut their dividend payouts despite recent assurances to the contrary and/or unexpectedly launched additional public offerings of their stock, which is dilutive to the value of current shareholders. While much of this activity has thus far focused on financial sector stocks, other companies will likely follow suit if corporate capital is needed in this restrictive credit environment.

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