Quarter Notes

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# Volatility Spikes in August but Markets Recover

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**Fed Cuts Rates**
In recognition that the US economy may, in fact, be slowing, the Federal Reeserve cut interest rates by one half of a percent at its September 18th meeting.

**Quotes**
"Wall Street indices predicted nine out of the last five recessions!" *Paul A. Samuelson, Economist*

"Wall Street people learn nothing and forget everything." *Benjamin Graham*

"I've found that when the market's going down and you buy funds wisely, at some point in the future you will be happy. You won't get there by reading 'Now is the time to buy.'" *Peter Lynch*

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Extreme volatility marked a quarter in which the Dow marched to an all-time high, topping 14,000 on July 19th. Less than a month later, on August 15th, it had dropped 8.6% to 12,800. During the same time the S&P 500 fell nearly 9.5%.

In the ensuing month the markets have recovered from most of the losses. For the quarter, most portfolios have remained flat or eked out small gains. This quarter, the Dow gained 3.6%, while the broader S&P 500 index was up 1.6%. The NASDAQ Composite index climbed 3.8%. The small-stock Russell 2000 index lost 3.4%. International stocks gained less than 1%.

For the year to date large-cap stocks have outperformed small, though the tech-heavy NASDAQ composite has slightly beat the Dow. The broader-based S & P now trails the Dow for the year by nearly 4%.

Bonds recovered as interest rates were cut. The yield on the 10-year Treasury fell to just under 4.6%. The Fed funds rate now stands at 4.75%.

| | 9/30/2007 | % YTD |
|---|---|---|
| Dow Jones Ind. | 13895.63 | 11.5% |
| S&P 500 Index | 1526.75 | 7.6% |
| Nasdaq Comp | 2701.5 | 11.8% |
| Russell 2000 | 805.45 | 2.3% |
| MSCI EAFE | 2300.38 | 10.1% |
| 10 Yr. Treasury | 4.60% | 4.25% |

## Interest Rates and the Falling Dollar

As stocks were falling in August, the Fed decided to move. In order to avert a credit crisis steming from the sub-prime mortage mess, it first lowered the discount rate at which banks borrow money from the Fed. A month later the Fed lowered the discount rate again and also lowered the Fed funds rate by 50 basis points, in an attempt to keep growth from slowing too much.

Lower interest rates stimulate the economy by reducing the cost of borrowing and increasing the money supply. Another consequence of lowering interest rates was that the value of the dollar declined versus other currencies. The effects on foreign investors are two-fold: 1) they are earning lower interest rates, and 2) they have the added risk of losing money relative to stronger currencies. If returns are not high enough, they will take their money elsewhere.

With the Euro topping $1.40, travel and imported goods have become painfully expensive. The dollar's fall is not unprecedented. Looking back at 1995, the German mark hit a level that would now be the equivalent of $1.45 per Euro.

A falling dollar is not all bad. When the dollar is worth less, our exports become cheaper and more attractive to other nations. This is a major boost to large-cap companies, which generate significant revenues in foreign markets, where growth is outpacing that of the US.

Even smaller companies, with fewer overseas sales, get some relief from the competition as the cost of imports increases. Further, the pressure on American companies to send jobs offshore should slow down with a weakened dollar, as foreign labor becomes more expensive.

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**Smart Charitable Giving**

Americans have a long tradition of charitable giving, and the trend is projected to increase. In 2006, we donated $295 billion, an increase of over 40% since 2001. The majority of this money came from individuals rather than corporations or foundations.

Although the vast majority of charities are legitimate, a little research can help ensure that your contribution gets used as you expect. Be especially wary of overly emotional appeals, especially those involving patriotism or natural disasters. Request information in writing. Reputable charities will provide you with their IRS Letter of Determination. This is important if you wish to take a tax deduction for your contribution. Review their mission, goals and financial reports, including a copy of the latest 990A, the IRS filing for non-profits. Many charities have information online at www.guidestar.org.

If you are solicited by a professional fundraiser, be sure to ask whether they are receiving a percentage of your donation and what that percentage is. Don't allow yourself to feel pressured. Be skeptical if anyone thanks you for a pledge you don't remember making. It's always best to pay with a check. Don't give your credit card number over the phone if a solicitor initiated the call.

In Florida, all charities are required toregister with the Florida Department of State. Finally, charities are required to send you a receipt for contributions over $250 and indicate the value of any gift or services you may have received.

## Problems in the Sub-Prime Markets

Problems in the sub-prime markets were created when unqualified or marginally qualified borrowers were given mortgage loans. Non-bank mortgage companies offered loans with economically unsound terms and conditions. The key term here is "non-bank".

Banks and mortgage companies rarely hold onto the mortgage debt they extend. Instead, mortgages are packaged into large pools that can be divided up and sold to investors in a process known as *securitization*. Banks, however, face more stringent regulations, higher lending standards and reserve requirements, and monitoring by the Federal Reserve. In return, banks have the benefit of deposit insurance through the FDIC, and banks can borrow directly from the Federal Reserve to maintain their liquidity. Non-bank financial companies do not have Federal insurance, nor can they borrow money directly from the Federal Reserve.

In theory, by pooling these mortgages, the diversification of many borrowers in different geographical locations made these bonds reasonably safe from default. In a decade of rising home values, it worked. Rising real estate values bailed out borrowers, who could simply refinance or sell if they were in danger of defaulting their mortgage payments.

As interest rates rose and the real estate market began to sour, mortgage defaults increased, and demand for the mortgage-backed bonds vanished. As a result, non-bank financial companies lost their access to capital, and they got stuck with bad loans on their balance sheets. This exposed the true risks in the mortgage markets, and lending standards instantly increased.

This meltdown brought the mortgage market to a screeching halt, which is directly affecting the real estate market. Consumers are now getting squeezed as their teaser interest rates are expiring and adjustable-rate mortgages are being reset to higher levels. The options of refinancing a mortgage to withdraw additional equity or selling a house are difficult in this environment. To help ease the pressure on American homeowners, the Federal Reserve

### Sub-Prime Mortgage Troubles

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has lowered the discount rate twice and the Fed Funds rate once by 0.5%. The rate cuts were received with cheers by the markets. Lower interest rates stimulate growth and investment by companies, as well as spending by consumers. In the short term, this is positive for a couple of reasons. First, it is a psychological sign that the government is trying to help, and lower rates will ease pressure on homeowners and businesses. Second, more liquidity is available to the system, but it will now be used more carefully as lenders have already instituted much higher lending standards.

Critics argue the Fed moved too aggressively. They are concerned that the government was simply bailing out the non-bank financial firms and the consumers who borrowed imprudently from those firms. Some analysts fear that the longer-term consequence of lowering interest rates will be the reigniting of inflation.

### Falling Dollar

*(Continued from Page 1 Column 2)*

Overall, a falling dollar should boost US exports and begin to rein in the US trade deficit. At the end of 2005 the trade deficit was 6.7% of GDP, but we are already seeing some signs of slowing.

We don't know how long, or whether, the dollar will continue to fall. Central banks around the world may act to prop up our currency, as a falling dollar is not in their best interest. Other nations still want their exports attractive to US consumers. In addition, they already hold trillions of dollars which they don't want to see depreciate.

If the dollar's decline accelerates, foreign investors who stand to lose value in their US assets may try to unload them too quickly. If dollars flood the market, the Fed will have to raise rates to shrink the money supply and stave off inflation. If the slowdown in US growth hurts overseas markets, the anticipated US recovery next year should coincide with rate cuts overseas and a corresponding rise in the dollar.