

BOND INVESTORS

We continue to emphasize high quality short to intermediate term bonds. While the U.S. faces inflationary pressures from a rising money supply and taxpayer bailouts (Fannie Mae and Freddie Mac - the largest ever), interest rates are unlikely to rise any time soon in this sluggish housing / low job growth environment. Rates are being kept artificially low to stimulate the economy and support the housing market (and at the same time shore up bank and other financial company capital positions).

Throughout this decade, Europe has consistently maintained higher interest rates than the U.S. (in its effort to combat inflation). Currency traders have taken advantage of this interest rate differential, selling the dollar and buying euros to pocket the interest margin. That is one of the reasons the dollar fell to new lows as the euro hit new highs. The U.S. cannot afford to raise rates for fear of recession and further damage to an already compromised banking system. But recently the dollar has begun to rise - having declined too far (on a speculative, emotional level). Another factor in the dollar recovery is a slowing European economy and the assumption that they will lower interest rates to avoid a recession.

Despite the low 2% Federal Fund rate, which normally controls general interest rate levels, it is the housing / mortgage crisis that dominates interest rates and bond prices. Total bank write-downs now exceed \$400 billion – expect that number to grow to \$1 trillion before pricing stability returns to the housing market. With an excess supply of about 800,000 homes, prices will continue to fall, however each and every real estate market is different – there are over 40,000 zip codes in America. Some areas have suffered up to 50% declines; some have actually gone up. Neither this slow economy, nor the credit crisis, nor the housing slump will be alleviated until home prices stabilize. Previous down cycles in residential investment have bottomed at about 3.5% of GDP - recently, it was at 3.1%. We think the end is in sight, but it is certainly unwinding very slowly. In many of the hardest hit areas, prices are at “utility value” – the point at which sellers take their houses off the market and wait for better times. Despite the excess supply of homes, prices will not fall below the bottom line utility value and we are very close to that now.

STOCK INVESTORS

Bear markets have a way of triggering and perpetuating negative thinking – investors see just the darker aspects of good news and only the blackest parts of bad news. Alarmists, particularly in the financial media know that reporting a crisis assures a bigger audience than simply conveying the mundane “steady as she goes” basic news that can be communicated in just a half hour segment each morning. News has become all day entertainment – much of it is literally made up just to fill time. It is not politically correct to suggest that the economy is sound when all the other pundits are downbeat.

But, the built-in redundancies of free market economies have a way of righting themselves if left well enough alone – certainly true of the U.S. economy. Unfortunately, political fidgeting, adjusting, interfering, re-aligning, stimulating, protecting, even bailing out this or that aspect of the economy delays (and often worsens) the inevitable healing process. The Fan and Fred discussion (below) is one of the most egregious examples of government meddling. It is oft and correctly said that a free market economy is not a house of

cards – it is more like a beehive. Parts of the hive may become obsolete, suffer damage, even fail, yet the healthy parts continue to thrive and fill in the injured gaps.

Case in point is the recent announcement that second quarter GDP growth was 3.3% - clearly no sign of recession. Another positive surprise is second quarter productivity (defined as output per unit of labor). It increased 3.4%, well ahead of the 2.5% seven year average. At the same time, labor costs (one of the key components of inflation) fell .5%. Although unemployment edged above the “full employment” 6% barrier for the first time in many years, there are still about 146 million jobs, just slightly below the number employed a year ago. Unemployment is up because 1.5 million new people (mostly graduates) entered the workforce this year.

Certainly, it is better if employment were rising, but the really strong part of the beehive keeping wages steady and jobs in place is exports. Consider that developing countries now have a total market capitalization of \$17.8 trillion vs. the \$17.5 trillion U.S. market cap. Prior to 2005, American consumers were the growth engine of the world economy, consisting of one half of all consumer spending. The spending rates of the largest emerging countries are rapidly catching up, now 65% of U.S. spending. Developing nation consumers want all the wonderful products and high standards of living we have enjoyed for years – extremely positive for the U.S. economy, since the efficient, low cost production knowhow (if not the actual manufacturing) of most of the things they want is here in America.

Earlier in the year, it seemed clear that stocks would not turn around until oil prices subsided and the dollar stabilized. That is now beginning to happen as exports continue to grow. Corporate profit margins and balance sheets are strong and quite healthy (excluding the banking, airline and auto sectors). Stocks now sell at 13 times earnings (below the average of 16). The earnings yield (inverse of the PE ratio) is 7.7%, substantially higher than the 3.67% 10 year U.S. Treasury bond yield. This is a solid basis for an improved stock market. Stocks are significantly undervalued vs. bonds and keep in mind, in the dark days of a bear market, it is tempting to “throw in the towel”, sell your stocks and turn to whatever seems ultra safe. But, here are the facts (in a recent 10 year period): the fully invested annualized rate of return was 12%. Miss the best 60 days – returns were negative 7.9%! Miss the best 10 days – returns were 6.9%! The lesson learned? Stocks spike in very short durations – trying to time those spikes, either up or down can be fatal.

FAN AND FRED

Federal National Mortgage Association and Federal Home Loan Mortgage Association (Fan and Fred) the two well known Government Sponsored Enterprises (GSE's) were reconfigured as quasi governmental institutions in 1970 by Congress to enhance liquidity in the U.S. mortgage market and to keep mortgage rates stable and affordable. Fan and Fred do this by purchasing loans from originators (banks and other lenders), then securitizing or packaging the mortgages into bonds called mortgage backed securities or MBS. Private investors buy GSE stock, providing capital for them to invest in mortgages. The GSE's also borrow money from the public at rates just above U.S. Treasury yields by issuing debt that has the implicit guarantee of the U.S. Government.

They make a profit from the spread between the borrowing rate and the higher mortgage rate. Fan and Fred also generate revenue (and free up more capital to buy additional mortgages) by selling MBS to investors at marked up prices.

Neither entity is subject to state or local income tax, nor SEC regulation or supervision. Investor oversight from both stock and bondholders is lacking, given the implicit government backing. This factor along with zero SEC supervision has resulted in dangerous corporate hubris and arrogance. Both GSE's have spent hundreds of millions contributing to political campaigns and lobbying Congress to avoid even cursory supervision – this predictably spawning rampant accounting irregularities and outright fraud. Instead of reigning in these giants, Congress has rewarded the lobbying blitz and campaign manna by recklessly expanding GSE portfolio caps, lowering reserve requirements and doubling the size of loans Fan and Fred are permitted to purchase and guarantee.

Fan and Fred now own or guarantee about \$5 trillion in mortgages or MBS (about one half of all U.S. mortgages outstanding). Of this total, approximately \$700 billion "Alt A" and subprime mortgages were purchased between 2001 and 2007, mostly now packaged into the lowest quality MBS – this is the source of the big write-off's, jeopardizing Fan and Fred's thin capital base. In the mortgage world, prime loans are top quality – typically 80% (or less) loan to value; documented financials; strong credit ratings; normal 15 to 20 year amortization. Alt A loans are lower quality – above average credit scores, but short on financial information, sometimes paying interest only. These are often called low or no doc (document) loans and typically feature adjustable rates. Subprime mortgages are the bottom feeders – 100% or more loan-to-value; no documents; interest only; no other collateral; borrowers often having no job or income. Delinquencies in the Alt A and subprime categories are up four fold since 2003 while real estate values have fallen 30% or more.

The credit / housing crisis has exposed the "soft underbelly" of these enterprises – contrary to the original purpose of liquidity and smoothing out rates, they have become a source of risk and instability – another example of a well intended government program run amuck – this time leading to the largest government bailout in history. Sustained losses could ultimately reach \$1 trillion, easily

wiping out Fan and Fred's combined capital of only \$64 billion. Fearing the worst, their stock prices have collapsed – equity holders will be fortunate to salvage anything.

In July, the U.S. Treasury stepped in with an unlimited line of credit, hoping to shore up confidence among Fan / Fred bond buyers (particularly foreign buyers) while the GSE's muddle through the housing crisis. It hasn't worked – Bank of China announced it was cutting back GSE bond positions by one-quarter. So, instead of unwinding and phasing out GSE's, Congress and Treasury have opted for a bailout – a "conservatorship" for a period of time ultimately leading to a complete nationalization or some kind of restructuring of the two entities. Either way they go, common and preferred stockholders will likely suffer an immense loss while bondholder positions are protected.

A GSE debt bailout will enrich bondholders by hundreds of billions of dollars. Looking for a definition of "moral hazard"? The message is that debt holders are relieved of their normal duty to police balance sheets and constrain management from excessive leveraging activities. This is the problem with government fidgeting in the free market – in this case GSE debt holders relying upon a perceived government guaranty were relieved from fulfilling their responsibility to analyze the balance sheet, thereby failing to exact fiscal discipline on the GSE's.

Would taxpayers be facing a \$1 trillion bailout of the GSEs if debt holders had questioned their credit status in 2005 or 2006? The problem wasn't that equity shareholders wanted them to over-leverage - equity investors like leverage and eye popping returns, especially when the taxpayer guarantees the debt. The failure in the system was that armed with implicit government warranties, debt investors gave the GSE's money too cheaply, allowing them to reach high levels of leverage. Now, debt investors are assured – taxpayers will cover their risk, encouraging the same behavior in the future – call it the socialization of losses, sure to contribute to a weaker dollar and inflation down the road.

By: ECA Investment Group, Inc.

FEATURED INVESTMENT MANAGER AND MARKET INDICIES:

	1 Year Ending <u>8/31/08</u>	3 Years Ending <u>8/31/08</u>	10 Years Ending <u>8/31/08</u>
<i>This quarter's featured Investment Manager is:</i> Okumus Capital Long Only (One of ECA's equity managers)	(9.0)%	7.1%	NA
STOCK AND BOND MARKET INDICES:			
S & P 500 Stock Index	(11.1)%	3.7%	4.7%
Lehman Bros. Aggregate Bond Index	5.9%	4.3%	5.6%
Balanced Index	1.3%	7.9%	4.8%
90 Day U.S. T-Bills	2.2%	3.8%	3.3%
Consumer Price Index	5.8%	3.9%	3.0%

OUR SERVICES TO YOU

-Investment Management
 -Asset Allocation Consulting and Performance Measurement
 -Cost Tracking and Control
 -Personal and Institutional Trust Services through Counsel Trust Company

-Investment Manager Search and Selection
 -401(k) / Employee Benefit Plans
 -Manager Monitoring

