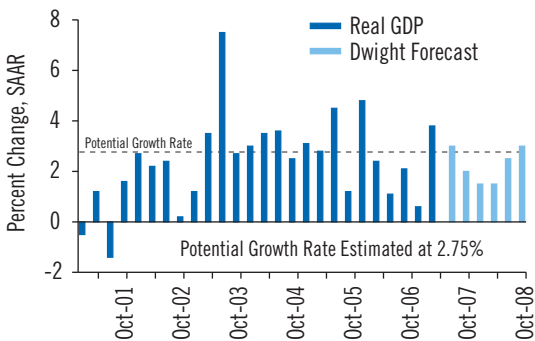


ECONOMIC UPDATE

In September, the Fed surprised market participants with a 50 basis point cut in the target funds rate, from 5.25% to 4.75%, marking the first change in the official policy rate in more than a year and the first reduction since 2003. Investors generally expected a rate cut, but few expected such bold action because just prior to the FOMC meeting, Fed officials were still talking tough on inflation and showing little sympathy for struggling credit market participants. Despite inflation and moral hazard risks, we were pleased with the size of the cut because we felt it was necessary to jump-start the credit markets and ward off an impending credit crunch that would threaten the economic expansion.

Figure 1: Real GDP: Actual Versus Forecast

Downside Risks Are Significant



Source: Global Insight and DAMCO

FOMC members' opinions evolved significantly during the six weeks between the August 7 meeting and the September 18 meeting. In that period, it became obvious that financial market turmoil, if allowed to continue, would restrain economic growth. The Fed initially pulled a number of policy levers to restore liquidity without loosening monetary policy. Importantly, the Fed pledged to act as lender of last resort, and it lowered the discount rate to back up that claim. Credit turmoil eased in reaction to these and other actions, but not

enough to prevent a downgrading of the Fed's economic forecast. As a result, the FOMC voted to ease monetary policy at its September 18 meeting in hopes of mitigating some of the fallout on the economy.

Is it "one and done" for the Fed? We doubt it. While capital is now flowing to most regions of the credit markets and the level of angst has appreciably subsided, market participants are noticeably more risk averse. In the go-go days of yesteryear, it was unchallenging to securitize and sell a loan backed by deadbeat collateral. We feel that those days are gone. While this change is positive for the long-term health of the financial markets, it will exacerbate the housing market downturn because borrowers, even responsible ones, are now finding it more difficult and more expensive to get a loan. We expect weakness in the housing sector, coupled with slower employment growth, to lead to slower consumption growth, and we have marked down our GDP and federal funds rate forecasts accordingly. Economic growth should be decidedly subpar over the next few quarters, and this sluggishness should encourage another 50 to 75 basis points in policy easing by next spring.

Real GDP growth should slow by more than a percentage point over the next two quarters, compared to an expected 3% pace in the third quarter (see Figure 1, left). In this environment, the unemployment rate will start to increase; consumption will slow; capital spending will be restrained; finally, residential construction will decline further. The danger is that a feedback loop will form, whereby slow activity perpetuates itself and the economy grinds to a halt. Or worse, the economy could back up. We feel that there is a 30% chance of this danger coming to pass. The odds would be higher but for lean inventories, no capital overhang, strong export growth, and the potential for easier monetary policy. In the past, downturns have often caused sharp



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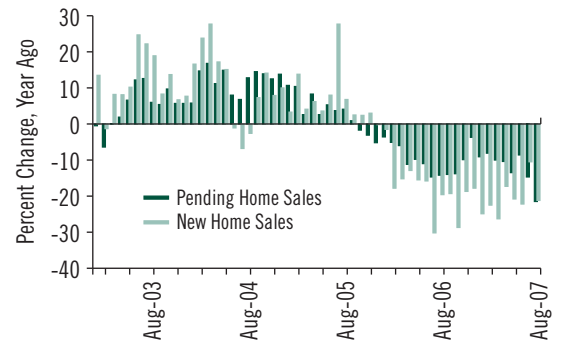
Economic Update, continued from page 1

- ▶ cutbacks in production, employment, and capital spending because corporate managers found themselves with bloated inventories and unused capacity. Corporations are leaner and meaner today, which augurs for a slowdown rather than a recession.

Our main worry is the housing market; it is in the deepest downturn seen since the 1990-1991 recession. As of August, new home sales were down 21% from their year-ago level, while pending home sales, a proxy for existing home sales, were also down 21% (see Figure 2, right). Meanwhile, inventories of homes for sale are at 17-year highs (see Figure 3, below left). Not surprisingly, these conditions are depressing construction. August housing starts were down 27% from their year-ago level and down 46% from their 2006 peak

Figure 2: Home Sales: New and Pending

No Sign of a Turnaround in Home Sales

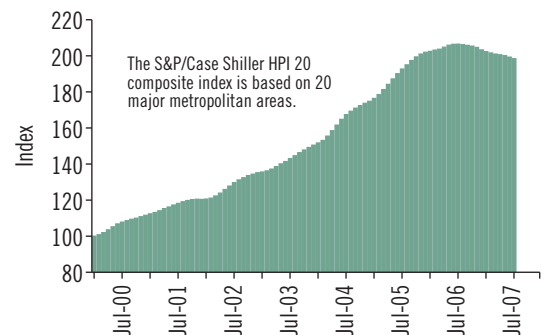


Source: Global Insight

level. Home prices are following suit, but with a lag. The Case-Shiller home price index shows a 4% decline from the peak 2006 level, and some experts believe that the trough is another 10 percentage points lower from here (see Figure 4, below right). The housing market recession has not yet seriously disrupted consumption because income growth has acted as an offset. In August, inflation-adjusted disposable income was up 4.4% on an annual basis, providing consumers the wherewithal to maintain their consumption patterns. This tailwind is starting to fade, though, as income growth slows in line with slower employment growth. Moreover, the monthly savings rate remains very low, and consumers may choose to save more, now that their homes are no longer acting as piggy banks.

Figure 4: Housing Market: Case-Shiller Home Price Index

Despite Recent Declines, Index is Still Nearly Twice the 2000 Level

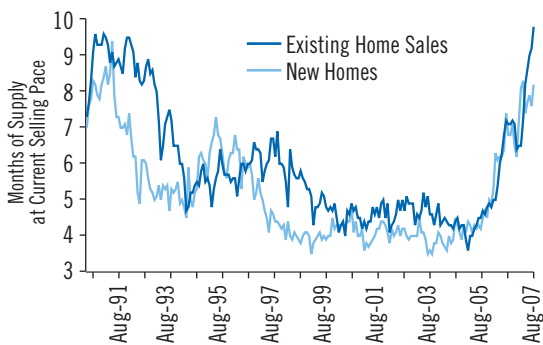


Source: Global Insight

average of 114,000 and the 2006 average of 169,000. We expect this trend to continue, leading to a moderation in income growth and an increase in the unemployment rate to 5% over the next couple of quarters.

Figure 3: Housing Market: Inventory-to-Sales Ratio

Rising Inventories Portend Lower Prices



Source: Global Insight

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Recent employment reports whipsawed markets with unexpected weakness in August, followed by unexpected strength in September. Most of the

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▶ With the housing market acting as a serious headwind and the labor market offering a diminishing tailwind, we look for real consumption to slow by 1.5% or more, from an expected growth rate of 3.5% in the third quarter. The danger is that corporate management will overreact to this slowdown by seriously curtailing investment spending and new hiring. Robust export growth should help offset some of the concern about slower domestic demand, but clearly it is domestic, not foreign, demand that drives our economy.

We expect the Federal Reserve to loosen monetary policy another couple of notches as the economy slows and core consumer inflation remains inside the Fed's comfort zone. A rate cut at the October 31 FOMC meeting is possible, but not likely in our view. It is possible because housing market data have been hideous; it is not likely because the credit crunch has been forestalled, and the Fed will want to collect more data before making another move. Indeed, the next move could be in 2008 rather than 2007. We expect that by the spring of 2008, the funds rate will be 4% or 4.25%.

I further predict that I will have finished reading Alan Greenspan's book *The Age of Turbulence: Adventures in a New World* by the time the funds rate reaches 4.5%. Also, I will have made it through Ben Bernanke's *Essays on the Great Depression* by the time the funds rate gets to 4.25%. Fortunately, Bernanke is indeed an expert on the causes of past recessions. With him at the helm, we stand a good chance of avoiding one in 2008. ■

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