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Fed Cuts Amidst Global Slowdown

The United States is currently leading a global economic slowdown that has caused GDP forecasters to trim growth outlooks from the fourth quarter through 2008. Many factors are converging at once, including tightening of consumer credit requirements and oil prices above $80 per barrel – a level Goldman Sachs suggested as a tipping point for an economic slowdown. On world currency markets, the U.S. Dollar continues to weaken as predictions of a sub-2% U.S. growth rate for the next year become more widespread.

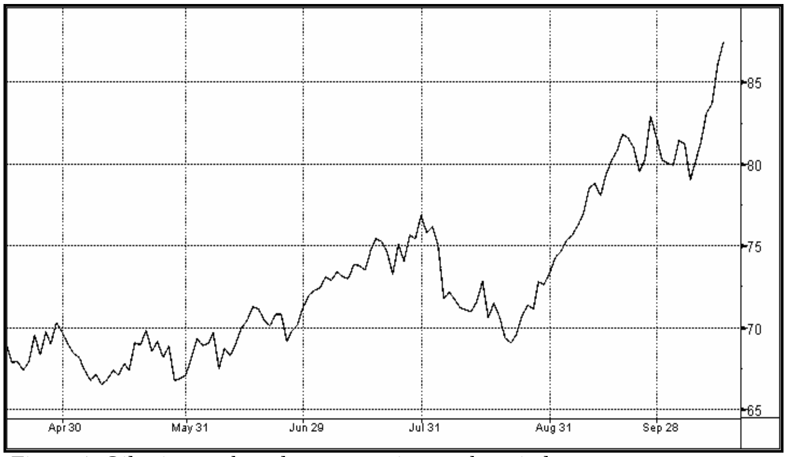

Figure 1. Oil price per barrel over past six month period

Source: Bloomberg

In the weeks preceding the Federal Reserve Board's September meeting, signals of a waning domestic economy began to emerge. The closely watched monthly new jobs report perpetuated a downward trend with smaller increases from the robust levels of prior years. Retail sales numbers continued their slow decline as hesitant consumer spending largely persisted. Our housing market has now been in a steady decline for two years, a longer period than was foreseen after the 2005 peak. Amidst the housing credit crunch, some potential homebuyers struggle to find willing lenders thus holding back any near term recovery in this market. Furthermore, it is likely that the challenges from sub-prime mortgages are not entirely behind us and this might intensify anxieties in an already nervous economy.

In response to this less robust outlook, the Federal Reserve cut the Fed Funds Rate by 50 basis points at its Septem-

Highlights:

- Domestic growth forecasts softened amidst current global slowdown
- Federal Open Markets Committee cut Fed Funds rate 50 basis points in response to economic struggles
- Further downward pressure on interest rates is expected for near future
- Caprin lengthening portfolios where appropriate to capture higher yields in longer maturities

"The Federal Reserve has a renewed interest on maintaining a reasonable level of domestic economic growth."

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ber meeting, exhibiting a renewed emphasis on maintaining a reasonable level of domestic economic growth. Most experts are predicting another 25 basis point cut by year's end, leading to further fluctuations in both the bond and equity markets.

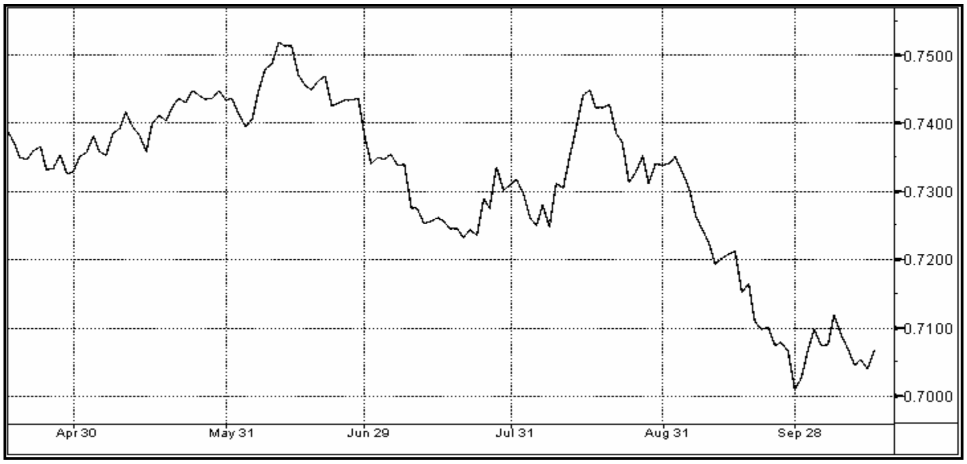

Figure 2. US Dollar versus the Euro over the past six month period
Source: *Bloomberg*

Caprin Strategy

For more than a year now, there has been an ongoing debate in the financial markets about whether real estate market difficulties would push the United States into a recession. At times, the evidence has been compelling but at other times less so. In the near term, we do expect the economy to slow from its 4+ years of robust expansion, and the extent of slowing will be largely "data dependent," to quote the Federal Reserve. At this point, though, we are not predicting a recession.

While most of our thoughts have focused on "growth" issues, we cannot overlook the value of the US Dollar on world currency markets. Because the dollar has fallen in value relative to other major currencies, market participants are worried about inflation from higher import prices. These concerns have caused longer-maturity bond yields to increase in response. At this point, the inflation factor remains only a concern as we have yet to see how growth in the world economy and the actions of foreign central bankers will respond to the weaker dollar and liquidity issues.

On balance, for the foreseeable future we expect slower growth to put downward pressure on interest rates. The markets interim concern for inflation, however, has and will create periodic opportunities to capture higher yields in longer maturity securities, and this will continue to be our means for increasing portfolio durations in preparation for the evolving longer-term trend.