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THE ECONOMIC OUTLOOK -- SKIRTING RECESSION

Recent warnings from major retailers regarding disappointing sales prospects raise questions regarding the outlook for consumer spending, which accounts for two-thirds of GDP, and, more importantly, the state of the economy as a whole. Reduced growth in consumer outlays would add to worries that a worsening housing market, credit market turmoil, and a weakening job market (not yet a certainty despite last month's weak employment report) increase the odds of a recession over the next twelve months. However, there is sharp disagreement over the likelihood of an outright contraction, with a growing minority of analysts arguing it is inevitable and others, including ourselves, believing the economy will avoid a downturn. Of fifty-five economists who recently responded to a Wall Street Journal survey, eleven said there was at least a 50% chance of recession. By contrast, thirteen thought the probability of recession was lower than 30%. The likelihood of a downturn, according to those surveyed, ranged from only 5% to 90%.

This wide divergence of views concerning the economic outlook highlights the argument over whether housing and related financial market conditions will infect the broader economy. Will tightening credit conditions dampen business investment and hiring? Will consumers, frightened by declining home values and recent stock market volatility, reduce their spending? If so, is the vigorous global economy, strong domestic business investment, and the demand for US made goods, robust enough to offset a possible decline in US consumer demand? With housing subtracting about 1.25% from growth, real GDP is likely to slow from the 3.8% pace registered from April through June to a below-trend rate of about 2.00% to 2.25% in both the third and fourth quarters. This represents a modest shading of our expectations from the 2.25% to 2.50% rate we forecast in our letter of July 20th. Our outlook is supported by the following sampling of *forward-looking* economic indicators which portend some slowing in growth but no recession:

- The Institute for Supply Management's (ISM) August factory index at 52.9, close to a 14 month high, signals manufacturing is still contributing to growth as demand from overseas remains firm. Readings higher than 50 indicate expansion.

- The ISM August index of non-manufacturing businesses, including banks, builders, and retailers held steady at 55.8 for a second month. Readings above 50 point to growth. The expansion in services, which make up almost 90% of the economy, suggests the effects of the mortgage crisis and a jump in borrowing costs have been slow to spread beyond real estate.

- While the US economy unexpectedly lost jobs in August for the first time in four years, wages continued to climb increasing 0.30% after a similar increase in July. Wages gained 3.9% in August from a year ago. Meanwhile, initial jobless claims fell to the lowest level in months in the week ended September 22. Recent steady-to-lower weekly initial jobless claims may suggest that the scary August employment report was an aberration, overstating the job market weakness and may portend a rebound in employment growth this fall. A slight dip in jobs, if reversed in the coming months, would have little impact on the economy and allay fears of a sharp contraction in consumer spending.

- The Labor Department reported on September 6th that worker productivity rose and labor costs cooled in the second quarter lowering the risk of a pick up in inflation, strengthening the hand of the Federal Reserve as they ponder whether additional rate cuts are necessary to support the slowing economy.

- Recent readings of the Conference Board's index of leading US economic indicators point toward sluggish growth. At 137.8, the index is largely unchanged since January. While the full impact of the recent Fed rate reduction will not be felt for at least a year or more, this cut, as well as expected subsequent rate reductions, are likely to cushion the slowdown and prevent the economy from spiraling into recession.

But other indicators provide clearer evidence of the business slowdown:

- In one of the first reports on business performance in August, the Commerce Department reports that *orders* for US made durable goods, meant to last at least three years, fell 4.90%, partially reversing the large 6.10% increase the

prior month. With housing in decline and access to credit more costly and difficult, US industrial demand could cool even as exports climb and business inventories remain lean. However, the same report showed *unfilled orders* for manufactured durable goods, a gauge of future demand, up twenty-seven of the last twenty-eight months, increased 1.20% -- the highest level since the series was first published in 1992 -- following a 2.40% increase in July. And, durable goods *shipments* rose by 0.80% in August. Those figures, along with previously released regional economic reports on manufacturing, suggest business is weathering tightened credit conditions with little upheaval, in part helped by huge cash positions and otherwise strong balance sheets.

- Confidence among US consumers held near the lowest level in a year in August, according to a University of Michigan preliminary index of consumer sentiment, as housing remained weak, financial market turmoil continued and the media continued to pound home the heightened risks of a recession.

HOUSING

Housing, which accounts for about 5.0% of GDP, remains the cause of serious concern as, without exception, incoming data paints a grim picture of current conditions, offering little in the way of encouragement for a near term reversal. Credit restrictions, higher borrowing costs, and concern over subprime mortgage defaults are adversely impacting sales.

- Despite huge discounts, sales of new homes in the US dropped more than expected in August and prices plunged by the most in four decades. Purchases declined 8.30% to an annual pace of 795,000, the lowest level in seven years. The median sale price dropped 7.50% from the prior year, the most since 1970. About 68,000 homes were sold last month, down from 74,000 in July. At the end of August, 531,000 homes were on the market.

- The number of signed contracts to purchase previously owned homes, a leading indicator, suffered the greatest decline since the National Association of Realtors began tracking this metric in 2001. The index of signed purchase agreements of pending home resales fell 12.2%. The inventory of existing homes on the market has climbed to 10 months, the highest reading since record keeping began in 1999.

- Sales of existing homes fell 0.20% in July to an almost five-year low of 5.75 million units. Sales were down 9.00% from the same time a year ago.

- The National Association of Home Builders reports that the 8.2 months inventory of unsold homes is at its highest level since January 1991. Builder's confidence indicators are at rock bottom and they are finally responding to the sales drought by cutting prices, auctioning unsold homes, sharply increasing incentives, and liquidating unwanted real estate.

Housing is likely to remain mired in a recession of its own until: (1) the huge inventory of unsold homes is pared to a more normal level; (2) homes become more affordable through further price reductions; and (3) mortgages are more easily obtained by a broad range of potential buyers. While we do not expect conditions to improve until the second half of 2008, the worst of the *direct impact* of the housing recession on the economy may well be behind us.

FORECAST

The US economy grew in the second quarter at the fastest pace in more than a year prior to last month's credit-market turmoil which heightened concerns the expansion might be truncated. GDP rose at an annual rate of 3.80% propelled by a surge in exports following a 0.60% advance in the first quarter. More recent reports have shown that residential construction slumped to a twelve-year low in August and manufacturing cooled, suggesting last quarter's growth rate will be the strongest of the year. Concern over the damage a worsening housing recession may wreak prompted the Federal Reserve to reduce interest rates for the first time in four years. Financial pressures and weaker growth going forward are likely to prompt further interest rate reductions over the next few months. We expect the Fed to reduce its benchmark rate from 4.75% currently to 4.25% by year-end. The Fed's preferred *inflation* measure, the Core Personal Consumption Expenditures Deflator (PCE), rose only 1.80% in the year ended August, the smallest 12-month gain in three-and-a-half years. Inflation measures are now at or below the upper end of the Fed's preferred range of 1.00% to 2.00%, giving them considerable latitude to reduce rates further.

Consumer spending is forecast to slow, growing at a 2.25% average annual pace in the second half of this year, modestly below the 2.55% rate from January through June. Quarterly gains averaged 3.70% in the last decade. The softening job market and credit market turmoil set the stage for some spillover of housing weakness into both consumer and capital spending. *Corporate profit* growth is

likely to fall to the 6.00% to 7.00% range, below our earlier expectation of 7.00% to 8.00% profit growth for the balance of this year. And the *unemployment rate*, currently at 4.60%, is likely to drift upward toward 5.00% this winter as forecast previously.

With the global economy remaining strong, US exports are expected to expand further over the balance of this year. As we have noted in the past, the weaker US dollar has made US exports more competitive price-wise than they have been for years. US based multinational companies, many of which derive over half of their earnings from abroad, will remain important beneficiaries of this set of conditions. We continue to forecast the dollar to weaken gradually underpinning this trend.

Credit conditions in the global subprime mortgage sector deteriorated this August to the point where it literally ceased to function for a period of several days until the Federal Reserve and other central banks intervened with massive injections of liquidity into the financial system. Subsequent rate reductions by the Federal Reserve have served to further ease financial market pressures. The most direct impacts of this financial market event have been felt by the mortgage originators, brokers who packaged up these subprime loans, hedge funds who concentrated and leveraged their holdings in these credits and, of course, the homebuilders. Recent readings of financial market indicators reflecting the spreads between bids and offers for instruments affected directly and indirectly by the subprime mess have shown a narrowing and there is now a willingness on the part of buyers to step up at the right price in a manner absent just a few weeks ago. We expect further improvement in credit conditions between now and year-end.

All in all then, in our view, we remain in a period of slower, sub-par growth. Financial market conditions are improving. Inflation has moderated to a point where the Federal Reserve's monetary policy is no longer constrained by near-term inflation fears and they are likely to cut rates further to avert a possible sharp slowdown in economic activity. Unemployment will drift higher until economic growth strengthens, possibly by next spring. Corporate profits will grow 6.00% to 7.00% over the July to December period. The US dollar will not collapse, as some fear, but drift lower benefiting US exporters. Importers face a profits squeeze as higher costs bite and a weaker economy makes it difficult for them to raise prices to protect their profit margins. Interest rates, as measured by the yield on the 10-year US Treasury bond, are likely to remain range-bound, trading between their recent low of 4.38% and their June 5.30% high.

FIXED INCOME STRATEGY

We continue to restrict fixed income purchases to high quality, very short term obligations as the yields on medium to longer term debt are insufficient to adequately compensate investors for the risk inherent in owning longer duration obligations. Elsewhere, while spreads on lower grade bonds widened during the recent period of credit market turmoil, we believe their yields presently to be inadequate relative to the risks entailed in owning lower quality, less marketable spread product. We are inclined to extend maturities only during periods of heightened inflation concerns and bond market weakness when rates spike above 5.00%.

EQUITY PORTFOLIO STRATEGY

Stock market returns during the current quarter are reflecting the shift we have been anticipating for some time from a liquidity-driven, speculative phase to one that is more fundamentally-based.

Index	Percent Change 6/30/07-9/29/07
S&P 500 Growth	+3.59%
S&P 500 Value	+0.02%
S&P Total	+2.42%
S&P Top 100	+3.78%
S&P Midcap	-0.81%
S&P Small Cap	-1.41%

Looking ahead, beneficiaries of this change in investor appetites for risk should be high quality, large cap multinational growth stocks whose shares represent core holdings in our clients' portfolios.

The metrics of our equity portfolios remain compelling when compared with the benchmark S&P 500.

	2008 P/E	Estimated Future Growth Rate	Dividend Yield	ROE	P/E to Future Growth Rate
FBA Average Growth Stock	**18x**	**13%**	**1.4%**	**28%**	**1.6x**
FBA Average Value Stock	**13x**	**11%**	**2.7%**	**18%**	**1.4x**
FBA Total Portfolio	**15x**	**12%**	**2.0%**	**23%**	**1.5x**
S&P 500	**15x**	**7%**	**1.8%**	**19%**	**2.0x**

While the earnings of the current FBA stock portfolio are estimated to grow at 12% per annum, S&P 500 earnings are forecast to rise significantly more slowly at 7% per year. Yet, the 15x price earnings multiple of the FBA portfolio is identical to that of the S&P. This parity is reflected in the P/E to Future Growth Rate of client's stock holdings shown above, underscoring the relative attractiveness of the portfolio.

Finally, even though we are experiencing a slowing of US corporate profit growth, we remain positive on the outlook for the broad US market indices whose price earnings multiples remain at about their average for the past generation. Stock returns are expected to rise in line with corporate profit growth plus dividends of about 1.8%. Clearly stock market investors should expect normal corrections of 5.0% to 10.0% along the way as markets react to changing perceptions of geopolitical risk, liquidity issues, and political developments.

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