



FOCUS POINTS

During the first quarter the Federal Reserve woke up to the fact that there was a world-wide liquidity crisis caused by the inability to price complicated financial securities. This inability made routine inter-bank and broker/dealer loans suspect, i.e. did borrowers have adequate collateral, if the securities on their books were realistically priced? Unable to answer that question, lenders hoarded capital and parts of the credit markets stopped functioning. Thus the Fed's zealous effort to lower interest rates was not easing credit conditions. When this became clear, the Fed started to lower the standards it used for collateral on its own loans and the system started to repair itself.

6 month	1.48%
2 Years	1.58%
5 Years	2.44%
10 Years	3.41%
30 Years	4.29%

This is not to suggest that a "flat tire" was changed and everything will start rolling along nicely. The market's inability to function exposed critical flaws in regulation, caused the virtual liquidation of one of the few remaining major investment banking firms, threatens to up-root the well established debt rating companies, and may still claim a mid-sized bank or insurance company. And, all of that, before a decade of litigation begins.

In rebuilding the damaged parts of our financial system, critical questions need to be addressed. Better regulation and greater transparency will help, but taxpayer money for bail-outs needs to be rethought. If we come out of this crisis with a financial system even more geared to speculative practices, the next bust could be colossal. We'll be assessing these changes as they develop over the next few years and under a new administration.

The Economy:

While the calamities of the first quarter were destabilizing and additional negative surprises may lie ahead, we believe that the financial strength of the business sector, coupled with an accommodative Fed and expansionary fiscal programs, will limit the damage to the economic growth rate for 2008. As we have previously written, we see the real threat to the economy coming from a pronounced upturn in unemployment. That upturn does not need to happen, unless business leaders panic. We will continue to monitor employment conditions closely going forward, but subdued, **continued growth** in 2008 still appears to be the most likely outcome.

The Bond Market:

As the largest and most liquid market in the world, the U.S. bond market has been at the center of the crisis. In early 2007 we forewarned that "needless risk is correlated with greed, not returns" but even we did not anticipate the massive flight to safety that started in late 2007. We are maintaining our **below average duration** strategy, but find Treasuries overpriced from the shortest to longest maturities. There is some incremental yield from buying Agencies, but the best opportunities seem to be in the municipal market as some issues have been needlessly caught in a dysfunctional market. Opportunities may develop in the corporate market later on, but we think it is too soon to be aggressive now. On balance, interest rate levels in the bond market are only attractive to those needing fixed income securities – there appears to be little opportunity for capital gains.

The Stock Market:

For the balance of this year and perhaps longer, there may be two disparate markets, one for financial stocks and one for non-financials. In the aftermath of the Tech Sector collapse in 2000, Financials moved to a much more significant role in pacing the market and the S&P 500. We think the current reversal will extend and are pleased that we had little exposure to either sector at their respective peaks. Looking forward, it will take time for the market to assess the value and merit of many of the fallen angels, so we are choosing only a select few, maintaining low portfolio representation.

However, we think that there are many attractive, non-financials where earnings growth should remain strong and valuations are reasonable. We are having no difficulty buying stocks to maintain our **positive stance on equities**.

With the Dow Jones at such a large index number, 12250, and the media spewing mostly sensationalized news, there are going to be more 300 to 500 point declines reported in scary tones. It is a reality that we will all have to get used to, but we understand that it raises everyone's anxiety about the future. It's like driving on the interstate, surrounded by tractor-trailers doing 80 mph – not always a lot of fun!

