



### ***Fed stands pat, so we lengthen duration***

As expected, the Federal Reserve left the Federal Funds rate target at 5.25% at its September meeting, opting to watch the economy for a while longer before taking any further action. Regardless of whether or not this rate level is correct, the decision to wait was a sound management decision. To do otherwise would have only conveyed confusion, adding more volatility to the markets.

The Fed's decision to maintain its course increases the probability that we have seen the highs for long-term interest rates for this cycle. With only one more Fed meeting in late October it is extremely unlikely the Fed will act again until after the election.

This increased probability suggests some further lengthening of duration and we are now in the process of moving to an ***above average duration*** in bond portfolios.

### ***The outlook for the economy and stocks***

The current slowdown in the economy does not mean we are destined to have a recession next year. Commodity prices, including energy, have already softened somewhat, probably enough to keep the consumer from further retrenchment. With the Fed on "hold" but continuing to talk about controlling inflation, long-term interest rates should continue to decline modestly. This encourages us to maintain our ***positive approach to equities***. Declining long-term interest rates should help to stabilize the pace of contraction in the housing market and support expanding stock prices.

### ***Short and long term risks***

Any change in an economy's course creates risk. The most visible ones currently are those associated with the cooling housing and commodity markets. The possibility of a deflationary spiral in housing is real, but we continue to think that housing is a unique asset, not easily eliminated from one's balance sheet, so the odds favor a protracted, sloppy market over a violent collapse. Alternatively, commodities are not something the average person deals with, but speculating on their future price is a major focus of many hedge funds. We have already seen a multi-billion dollar implosion at Amaranth Advisors and more such disasters could follow.

There are also daily reminders of political instability in the world. With currencies, commodities and securities increasingly being traded among highly-leveraged investors, distant problems can instantly destabilize our markets. Anticipating a specific problem is impossible, but we do think our emphasis on high-quality, readily-marketable securities is one of the best ways to control this risk while preserving the liquidity to respond to the changes that could suddenly occur in the markets.

Longer term the key risk continues to be the rate of inflation. If there is still too much money in the system, inflation will worsen despite an economic slowdown. Alternatively, if the Fed moves to a fixed target for inflation, it may tighten too severely.

As always, we will remain vigilant to these and other risks and respond, if and when necessary.