



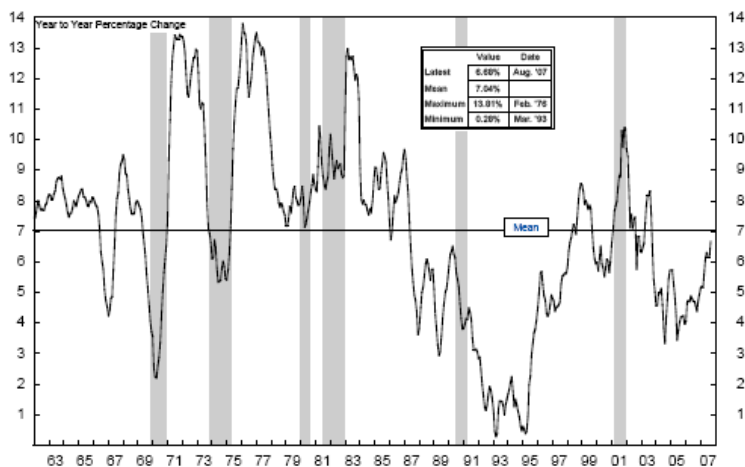
## Federal Reserve Policy Change

*On September 18th the Federal Reserve's Open Market Committee voted unanimously to reduce the target rate for Federal Funds from 5.25% to 4.75%. We believe that this move will change the economy's path. Usurping an old movie title, we offer "The Good, the Bad and the Ugly" for your consideration.*

## Background Leading to a Crisis

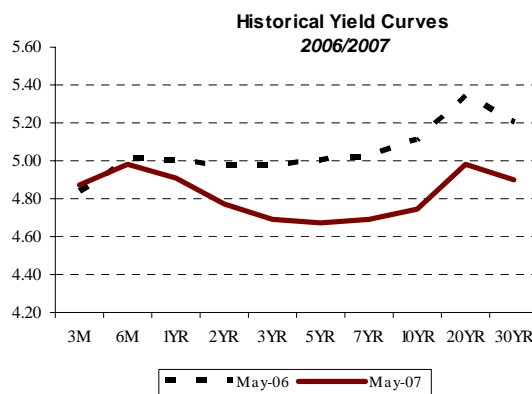
In the last recession the Federal Reserve was concerned that the deflationary wind damaging the Japanese economy could spread across the Pacific impacting our economy. As a result it reflat with gusto in 2001, pushing interest rates to lows that had not been seen in decades and, thereby, expanded the money supply at double digit rates. Reflation worked yet again: cheap money facilitated government expansion by under-pricing the cost of deficit spending; it encouraged businesses to refinance their balance sheets and then start buying each other; and it propelled consumers into more debt, particularly to buy houses. With this demonstrable success, the Fed started ratcheting up the cost of money to slow money growth in 2004. By September of 2006 it concluded that it had tightened enough and locked its interest-rate gears in place.

## Money Supply (M2) Growth



Shaded areas represent recessionary periods.  
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For a year, Treasury interest rates hovered around 5% regardless of maturity. This flat yield curve was damaging to financial institutions that typically borrow short-term funds and make long-term investments to earn the spread. The 5% level of risk-free return also dismayed investors who needed higher returns to make their pension, retirement or spending plans work. Many of them innovated, using creative financing techniques and leverage, assuming more risk that they thought they could statistically track and control.



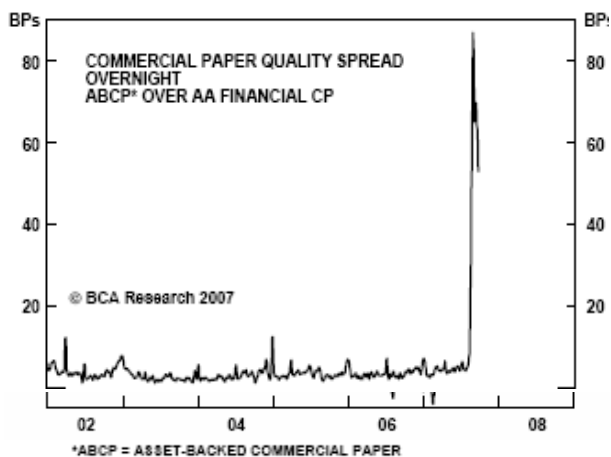
During all economic expansions the benefit of each additional sale is so prized that the risk taken to achieve it is often misunderstood and minimized. When the expansion reaches bubble proportions, like the housing market in 2003-05, it is always safe to assume that the underlying assumptions are stacked like a house of cards. When the bubble pops, then the assumptions collapse. So, despite countless articles about the housing bubble, few spent any time analyzing the forces that created the boom, the risks in one part of the evolved structure – the subprime mortgage market – or the consequences of the bubble bursting.

***We have had no subprime mortgage exposure in our portfolios. In our April 2007 Focus Points we said: Take little or no credit risk. Needless risk is correlated with greed, not returns.***

### Liquidity Crisis

In today's world a liquidity crisis means an inability to roll over current debt for one more day. Certain mortgage investors had turned negative on the subprime market and turned down deals. Those investors were irreplaceable and rates jumped, triggering greater concern and more difficulty raising funds. Concern reached panic proportions when the illiquidity of a few organizations spread to the whole subprime market.

The Fed moved to deal with the liquidity crisis in a traditional way, opening up the discount window with cheaper and easier to borrow money. For several large banks, it also waived a banking regulation to allow them to make additional loans to their brokerage affiliates. These steps might have worked if the character of the problem did not morph from being a narrowly based, subprime mortgage liquidity crisis into a broader crisis. Because investors have no way of determining whose assets are illiquid – perhaps some banks or some insurance companies or some hedge funds – the broader markets started to seize up, even internationally.

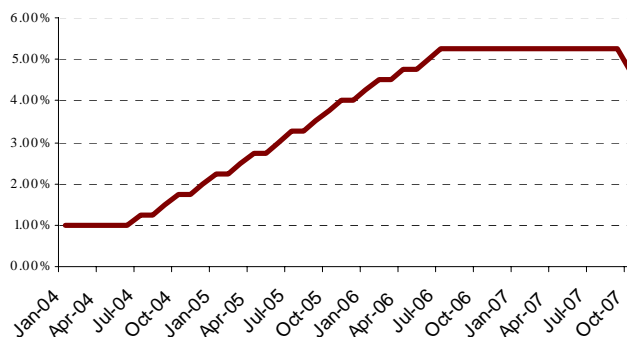


### The Good

Recognizing that a broad liquidity crisis could endanger real growth worldwide, the Fed cut rates and urged other central banks to consider the same. **Will reflating the economy work one more time?**

First, it is important to acknowledge that when the Fed chose 5.25% as “the rate” at which to lock the gears, it was a forward looking decision. Now, a year later and with 20-20 hindsight, it is possible to argue that it had already raised rates too much and the economy would slow unnecessarily. Perhaps 4.75% is a more ideal rate at which to lock the gears.

Federal Funds Target Rate  
2004-2006



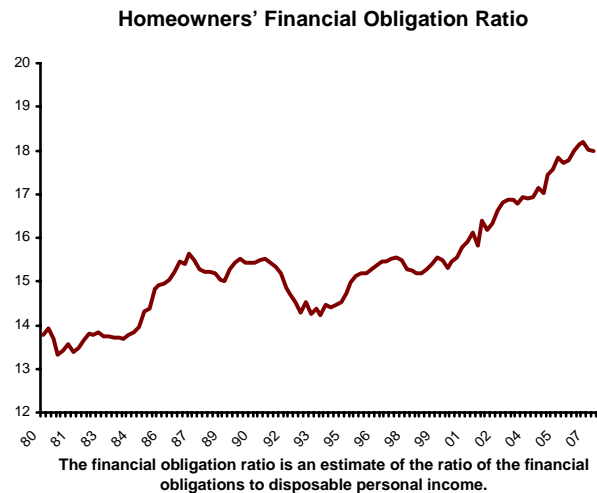
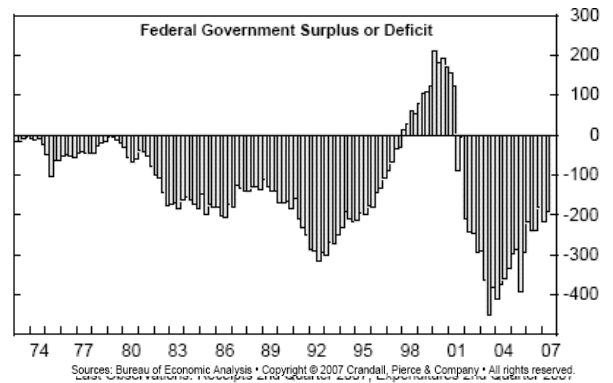
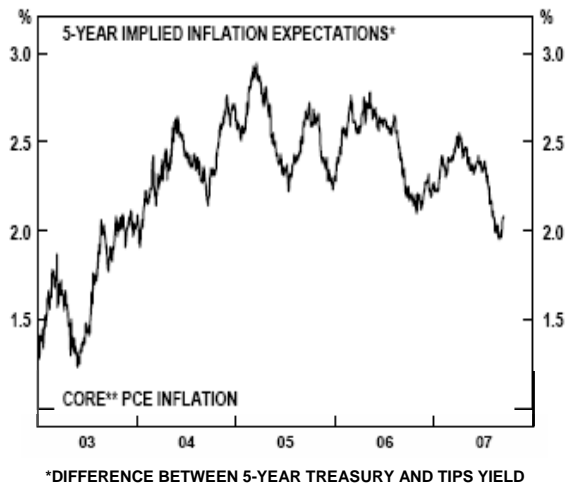
Source: Federal Reserve Board

*If this new rate creates normal liquidity in the money market, a positively sloped Treasury yield curve and rational credit spreads off that curve, then real growth will accelerate.* First, the dollar will be marginally weaker, improving domestic business confidence, particularly among exporters. Second, financial institutions will be profitable following their standard business model and will encourage credit expansion. In turn, businesses and consumers are likely to use that credit availability to purchase additional real goods and services. ***We see this as the most probable outcome.***

### The Bad

We are not in a recession laden with underutilized resources nor are our trading partners. Many diverse assets are already priced far above where they were at the last economic trough -- housing not the least of them. Meanwhile, most raw material prices, like energy, are also close to new highs. The additional new money will validate those prices and may encourage others to raise prices and wages.

The resulting upturn in inflation could force the Fed back into a tightening mode early next year. *If this new policy leads to fear of inflation and a flat yield curve, then more financial innovation will occur, hungry investors will again fail to adequately price risk, and a bubble will develop in some new sector of the economy. The odds of this scenario are high enough that it bears close monitoring.*



Source: Federal Reserve Board

### The Ugly

International politics have made the dollar the primary reserve currency, allowing U.S. citizens to buy goods and services around the world with paper currency and notes. The administration seems likely to secure an expanded debt ceiling (\$9.815 trillion) to fund “guns and butter” programs expanding the deficit. Consumers now support mortgages, credit card debt and personal loans at historically high levels relative to their income. At some point, one would think that the Fed would be unable to stop an imploding bubble, with dire financial consequences for some individuals and corporations. Yet, a systemic crash may still be so far in the future that occasional monitoring of its increasing probability may be sufficient.

### Investment Implications and Outlook

We think the Fed’s new policy will extend the economic expansion and improve the outlook for employment and profits. Because that raises the probability of higher inflation, our assessment of the potential risk-adjusted return from fixed income investments continues to be low. *We are maintaining our maximum equity asset allocation strategy.* Based upon our projections for the economy, we think the outlook for earnings is particularly good in supply-constrained industries. *We are maintaining our positive equity posture and are targeting an average duration in our fixed income accounts.* In the short run the Fed’s policy will enhance the return from taking credit risk, but one always needs to be watchful to avoid being a participant in markets that under-price risk.

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