Stocks flat, bonds down, and oil price at record level on Wednesday –

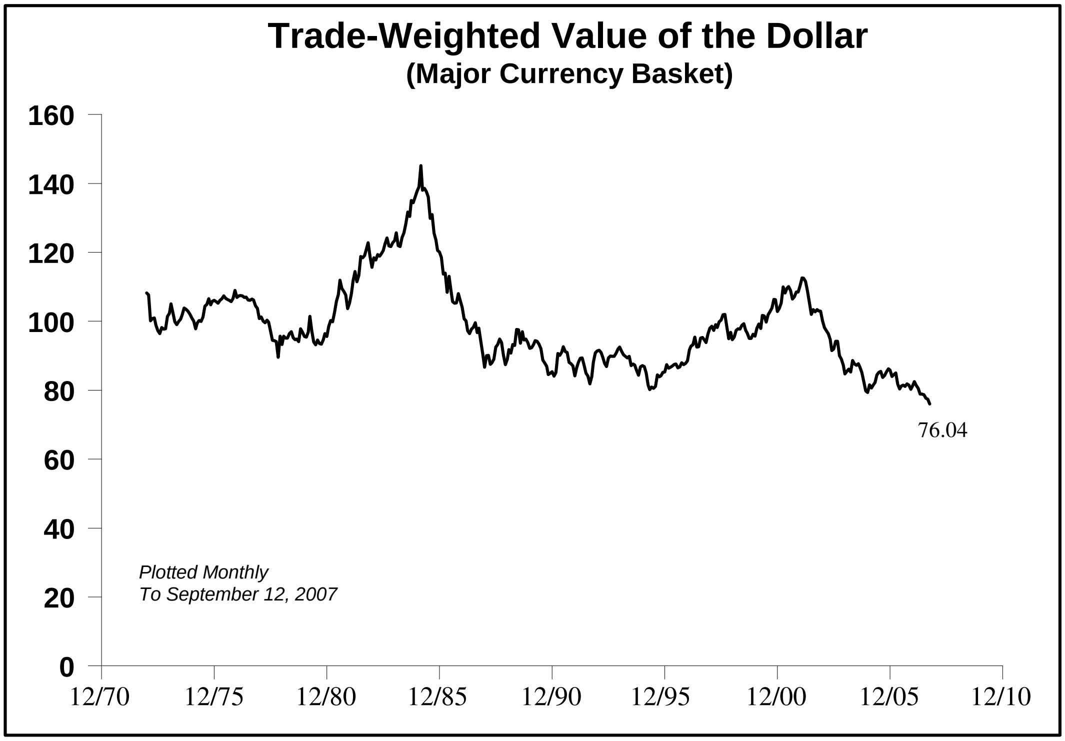
September 12…Oil prices hit a record high today, with the nearby WTI crude oil future briefly topping $80 a barrel. The weekly oil inventory report from the Energy Information Agency showed that crude inventories fell by 7 million barrels last week, more than twice the decline expected on Wall Street. Changes in distillate and gasoline inventories were more in line with expectations. Crude inventories still look quite adequate for this time of the year, but the decline in supplies was enough to send the price of crude up by more than $1.50 a barrel to $79.90. The rise in oil from under $70 in mid-August seems excessive in light of the inventory situation and the likelihood that slower economic growth will be reflected in oil demand. Yesterday the International Energy Agency reduced its forecast for oil demand growth in 2007-08. Still, the rise in oil prices will have the same unwelcome effect on businesses and consumers whether it is warranted or not. To keep oil prices in perspective, it is helpful to remember that the inflation-adjusted peak in crude oil prices occurred in 1980 at roughly $100 in 2007 dollar terms; our view is that oil prices are still in a range where the latest increase is more inflationary than recession-producing. Commodities prices have generally moved higher with the recent weakness in the dollar.

- **The dollar hit a record low against the euro, as the greenback has declined six days in a row.** The euro was valued at $1.3904 at today's close, putting the dollar down 9% from its year-ago level. The dollar also moved lower today compared to the yen and the British pound, although the 12-month change against these currencies has not been as severe as against the euro (-3%, yen; -8%, pound). Recent dollar weakness, which really continues the trend of the past two years, is a reflection of the high probability being put on a cut in the fed funds rate at next week's FOMC meeting. (Indeed, in the fed funds futures market, the most likely case is now for a 50 basis-point cut to 4.75%.) The 10-year Treasury bond was down roughly one-third of a point in price today, as its yield backed up to 4.41% from 4.37% Tuesday.

- **Although they struggled early, stocks were solidly on the plus side by mid-afternoon before fading to flat by the close.** At its best for the day – around 2:15 EDT – the S&P 500 was up 0.5%, with energy stocks (up 1.4%) contributing more than its share of the market's total gain. There were no major economic releases out today; mortgage applications did manage a 5% increase in the latest week. In addition, the National Association of Realtors reduced its home price forecasts for this year and next, saying that by the end of 2008 existing home prices won't quite have recovered to record levels. (That certainly seems an understatement.) But, for most of the day Wednesday, both stocks and bonds seemed to be giving the economy the benefit of the doubt.

INVESTMENT OUTLOOK….Stock prices are a little more than one-third above their levels six years ago on the eve of September 11, 2001; that represents a 5% compound annual rate of share price appreciation over the interim. Perhaps more important, after the recent retreat and subsequent bounce, the S&P 500 is now 4% below its 2000 bubble top. Provided recession is averted and corporate profits do not suffer a big setback – no small provisos, these – we believe that stock prices are well supported by the near doubling of profits since Q1 2000. The

declining competition from yields on fixed-income securities is another factor favoring equities.

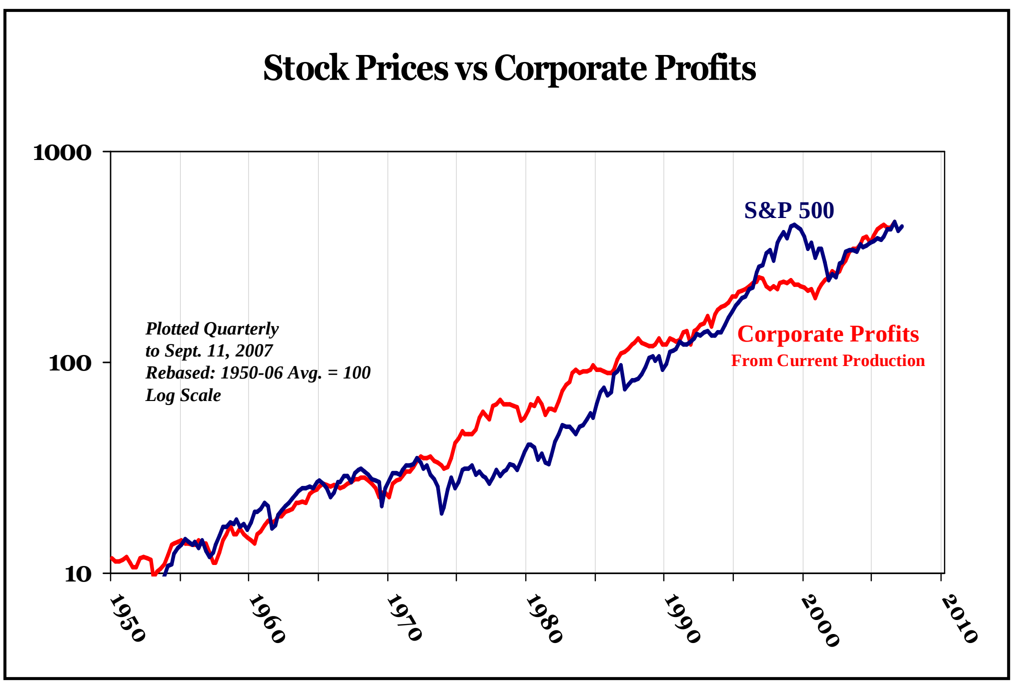


September 11…Some good economic news helped stocks move higher today, with the S&P 500 recouping three-quarters of its Friday-Monday slide. Today's economic news was actually quite sparse: the Commerce Department reported that the trade deficit was just about unchanged in July, in line with expectations, at $59.2 billion. The important aspect of this report was the continuing growth in exports, which increased 2.7% for the month, the most in three years. Imports rose 1.8% in July, in part due to the higher value of oil imports. (In July, for the first time ever, China topped Canada as the largest source of U.S. imports, which figures to raise protectionist sentiment in Congress.) For the first seven months of 2007, exports rose by nearly 12% compared to the first seven months of 2006; imports increased 4.6% for the same period.

- **Healthy foreign demand for U.S. goods is a key reason why we expect that the U.S. economy has a better-than-50% chance of avoiding recession despite the fallout from the mortgage crisis.** However, because the level of imports is more than 40% higher than exports – the residual result of two decades of greater increases in imports – the U.S. is not yet to the point where faster export growth translates directly into increasing GDP. Still, our forecast is for net exports to make positive contributions to GDP growth over 2007-08.

- **In addition to the relatively positive trade news, OPEC's decision to increase oil production quotas by 500,000 barrels a day in November may have also helped stocks.** Although the announcement didn't have much effect on oil prices, which came close to hitting a record level despite the OPEC news, it may have reassured investors that OPEC appreciates the increased risks in the global economy. (In any event, many OPEC cartel members have been producing above their quotas for months, so there may be little practical effect of the nominally higher quotas.) Stocks also benefited from upbeat comments on their businesses from McDonalds and General Motors, offering hope, at least for today, that the consumer isn't ready to close his wallet yet. At Tuesday's close, the S&P 500 was up almost 1.4%, where it sits roughly 5% below its July 19 peak (as do the Dow and Nasdaq) and up 3.8% for the year to date. Treasury bonds traded lower Tuesday, with the 10-year T-bond down about a third of a point and its yield up five basis points to 4.37%, with today's move just about offsetting Monday's price rise.

- **Finally, Fed Chairman Ben Bernanke delivered the Bundesbank lecture today in Berlin, making little mention of the current problems in credit.** Bernanke continued his earlier comments about the U.S.'s big external imbalances and the longer-term need to get the national savings rate higher or, the less attractive alternative, its investment rate lower. There appears to have been almost no correlation between Bernanke's comments and the stock market's strength Tuesday, other than perhaps some relief that he didn't rule out interest rate cuts at next week's FOMC meeting.

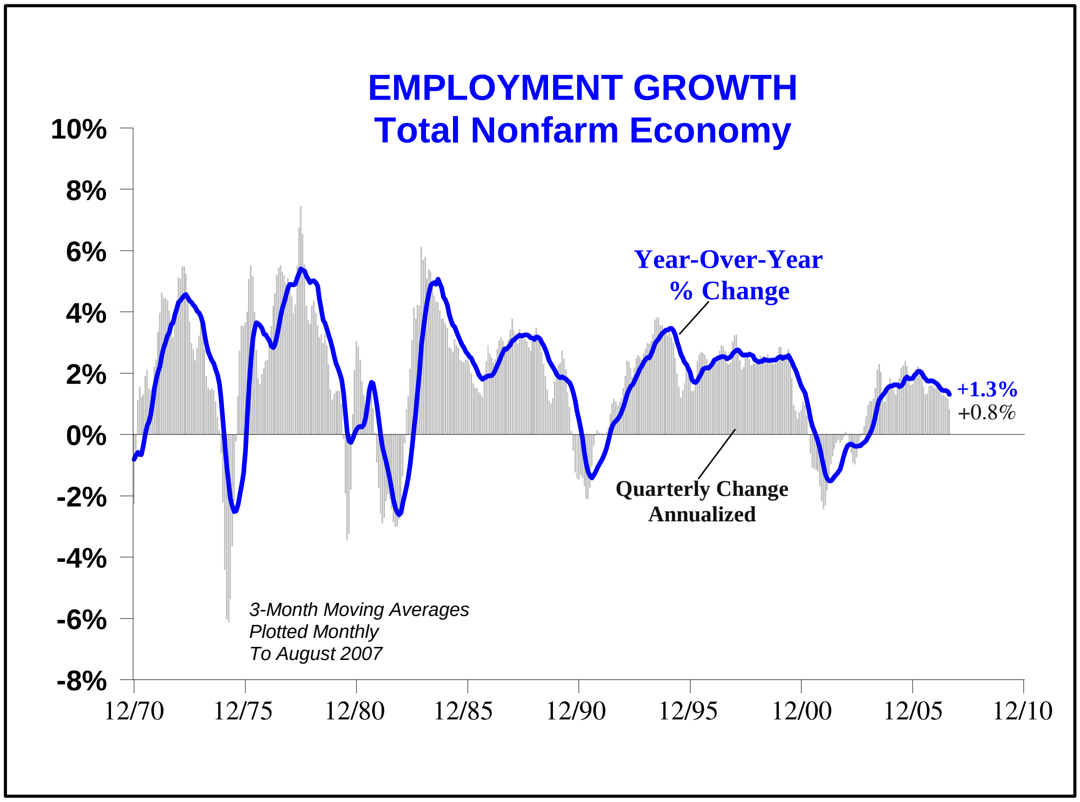


September 10…Stocks got off to a roller coaster start in this data-starved week. Increased earnings guidance from Intel and Home Depot contributed to the positive momentum at the open on Monday, but it didn't take long for investors to start worrying again. This concern can probably be traced back to Friday's weak employment report and its implications for the economy. More weakness in the jobs numbers cannot be ruled out. For one thing, the fact that jobs in financial services were about flat last month suggests that recent layoffs announced in that sector will be reflected beginning with September's numbers. Comments from two Federal Reserve Bank Presidents fueled the stock market's jitters today. Janet Yellen of the San Francisco Fed and the Atlanta Fed's Dennis Lockhart both expressed caution on the direction of the economy. But this view wasn't unanimous; Richard Fisher of the Dallas Fed said that he was "generally encouraged" about the state of the economy. After opening up about nine points (0.6%) from Friday's close, the S&P 500 moved to a loss of 14 points (-1.0%) at its low for the day, before turning again to the plus side and nearly recapturing the morning's high ground, but then frittering away its gains in the last hour of trading to close with a 0.1% loss for the day. Nasdaq also ended Monday with a small loss (-0.3%), while the Dow ended 14 points to the good on the day.

- **The 10-year T-bond was up nearly half a point Monday as its yield continued to move lower, hitting a 23-month low of 4.32%.** Despite indications that the impact of the mortgage crisis is spreading, we believe that the exuberant bond market rally is overstating the possibility of recession. The soft landing of 1995-96, which the Fed may have been hoping to reproduce in 2007-08, also had a couple of months of job losses without coming anywhere near recession.

- **Most of this week's important data releases will come on Friday.** On Tuesday, the Commerce Department will report the merchandise trade deficit for July. The weekly jobless claims report, out on Thursday, will undoubtedly be scrutinized by investors after Friday's employment blow-up, since claims tend to lead payroll employment. But because the data covers the Labor Day holiday week, it may be difficult to interpret. This Friday we'll get July business inventories and readings on August import prices, retail sales, industrial production and capacity utilization, along with the preliminary September reading on consumer sentiment from the University of Michigan. Friday's disappointing jobs report and the turmoil in the financial markets would seem to make a downturn in sentiment likely.

September 7…Four thousand jobs were lost in the nonfarm economy last month, signaling some spreading of weakness from housing into manufacturing and service industries. The surprisingly poor jobs report for August (-4k versus +110k expected) reflected a soft private sector (+24k vs a +133k average over the prior 12 months) and a decline in government hiring (-28k vs +16k). Manufacturing lost three times as many jobs in August as in the typical month (-46k vs -15k), while service-producing industries created far fewer new positions than normal (+60k vs +165k). The nation's unemployment rate stayed at a relatively low 4.6%, but only as a result of a nearly 600k leaving the work force. Aggregate hours worked were flat from July to August, and average hourly earnings have yet to show much of a slowdown, increasing at a 4.2% annual rate over the past three months, up from 3.9% for 12 months.



- **Coming just days after Federal Reserve officials said that the nation's housing woes and market volatility were having little effect beyond real estate markets, Friday's employment report seemed to say otherwise and the disparity was a jolt to the stock, bond and currency markets.** Down from the start, the S&P 500 ended the day down 1.7% and 6.4% off its July peak. The Dow and Nasdaq were each a bit weaker for the day (-1.9% and -2.0%, respectively), but are down less from their 2007 highs (-6.3% and -5.7%). These declines still put the stock market in the correction camp, while the bond market seems to be giving a weaker signal on the economy. On Friday, the 10-year Treasury dipped 13 basis points to 4.38%, the lowest yield since January 2006; the two-year Treasury fell below 4% and closed at 3.90%, lowest in nearly two years. The U.S. dollar, sold by investors on expectations that U.S. interest rates will decline relative to rates in other markets, fell 1.7% against the yen and 0.6% against the euro; overall, the major-currency dollar index hit a more than 30-year low on Friday.

- **While the employment report may exaggerate the threat of recession, and market reactions may have been excessive – particularly in the bond market – volatility is likely to stay high at least until the Fed meets on September 18.** Right now, the markets are anticipating several interest rate cuts over the next six months, starting with a 25 basis-point reduction (possibly 50) in the fed funds rate a week and a half from today. We don't entirely agree, but it is certainly true that today's weak jobs figures increase the chances that the six-year economic expansion will come to an end before long. At this point, though, we still rate the probability of recession at less than 50%, and expect the Fed and the markets to negotiate this tricky patch, although not without occasional days like today.

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