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Dear Valued Investor:

I am happy to report that, in my opinion, the mountain of a problem that sub prime mortgages supposedly represented did turn out to be more like a molehill. Yet again, the media blew a smallish problem for the economy and financial markets way out of proportion. And financial markets have largely recovered from the scare. Broad equity indexes like the Dow, the S&P 500 and the NASDAQ have completely recovered from the trough hit in mid-August. I think the Federal Reserve did the right thing in cutting the fed funds rate 1/2 percent; not because of the "credit market crisis", but because interest rates were high relative to inflation.

Yes, some companies and investments did suffer losses, but the impact appears to be contained. For the economy, incoming data for September generally do not support fears that the sub prime mortgage woes are spreading to other sectors or seriously damaging consumer or business spending. Payroll employment, first reported to be down 4,000 in August, was revised to up 89,000 and rose another 110,000 in September. Auto and light truck sales, which had been soft in June and July, rebounded in August and September. The Institute for Supply Management's purchasing manager surveys continued to show solid strength in September. Yes, housing is falling, but it looks as though consumer, business and export strength continue to offset that decline. So, I expect we had another solid rise in Gross Domestic Product (GDP) in the third quarter. All in all, I think that the economy remains strong with recession unlikely.

We are entering "earnings season" and once again the consensus Q3 earnings forecast is bearish, expecting just 1.4% earnings growth. In part this estimate is due to some big cuts in expected financial company earnings coming from losses on mortgages while other areas – including technology and healthcare – are expected to show solid earnings growth. Notably the mortgage hit on earnings looks to be a one-time event with the consensus earnings growth estimate jumping right back up to 11% for the fourth quarter.

There are areas of concern. The weakness of the US dollar exchange rate remains an issue. I think it is oversold at this point and we are seeing a dramatic positive effect on trade, with U.S. exports now growing three times as fast as imports. High oil and other commodity prices continue to dog the economy, slowing growth. Some have worried that the weak dollar and high energy prices would push inflation higher, but inflation has moved down, not up. It appears to me that downward price pressure from globalization is overwhelming upward price pressure from the weak dollar and high oil and commodity prices. Adding it all up, I continue to think that the U.S. economy is in good shape and equity markets are fairly valued with good overall earnings prospects. As always, call your financial advisor with any questions or concerns.

Sincerely,

Lincoln Anderson
Managing Director, Chief Investment Officer

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