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This is an update of our mid-August letter – we're getting to be real pen-pals. However, we know clients are concerned about the headlines of financial distress, and we want to keep you current on our assessment.

One thing that is happening is a purging of financial market speculation in low quality debt. The news on this will continue to surface for several weeks as there is still a search for who owns the bad mortgages which were sliced and diced and sold in parts all over the world. The holders are not admitting problems before they have to, probably in the hope that they can find ways to minimize the impact. So far, holders admitting problems are hedge funds, special purpose financial subsidiaries of brokers and banks, and a few foreign government investment funds; much more distress will likely surface in coming weeks. Ultimately, we think the purging will be good for the markets.

A second thing that is happening is that home prices are falling and mortgage credit is being curtailed. A sharp reduction in home construction is a force in the real economy of materials and jobs. Falling home prices may also influence consumer spending and could cause a recession. Since the ultimate impact of the excess U.S. housing construction is not known, we have no way of knowing its longer run impact on growth of the economy. Since speculative building and investing in real estate went on for several years, one has to assume that it will take most of 2008 to clear this problem and return to anything like a normal residential real estate market.

Finally, the excess origination of sub-prime mortgages is a terrible problem for the families who got sucked into buying a home they could not afford. Although their down payments were small, most can ill afford to lose their homes. Their bad decision was encouraged by the mortgage bankers originating the mortgages and selling them at large profits in sliced and diced pools to holders who had no idea how precarious were the finances of the mortgage obligors. Frequently these sliced and diced pools were rated by rating agencies as AA and AAA debt securities. There will surely be Congressional hearings and a far-reaching search for the villains as the distress increases in the fall.

A lot of these mortgages were sold in Europe, and European investors are particularly aggrieved with U.S. "rating agencies." Rating agencies are firms – mainly Moody's and Standard & Poor's - which assign quality ratings to debt. In hindsight, the ratings assigned to mortgage pools were far too high and left uncorrected for far too long. Hence some holders had bonds which went from AAA to default with stunning speed. However, it is widely known that the rating agencies are paid by the debt issuers, so the biases of the system were no secret. Both the rating agencies and the buyers of mortgage debt look very foolish, in hindsight, and there will probably be litigation.

There are impassioned calls for Fed Chairman Bernanke to "cut interest rates and save the economy." The Fed will cut rates if it sees unmanageable pressures on the banking system, or a collapse of consumer confidence and spending. The economy is weakening, but it grew at a 4% annual rate in the second quarter and it is not yet clear that either of those dread events will happen. The Fed does not want to bail out the Wall Street firms and hedge funds which helped get us into this mess. The mortgage banking firms, which are the leading villains, in many cases have already died. So the Fed will probably watch the data as it comes in and respond in a measured way.

Since our last letter, our portfolios have bounced back a bit as the Fed has supplied liquidity to the market, restoring some confidence. Also, the first wave of forced selling of securities due to margin calls has passed. We have enclosed the summary statistics on your portfolios through the end of August. We expect the markets to remain turbulent through the end of September. We have kept cash at an elevated level and plan to do so until we are reasonably confident the worst of the news is out. We are finding the values in the market to be much more attractive than in June. This is a mortgage, housing finance crisis and, so far, the corporate world outside the financial sector is doing quite well. When we are ready to buy we hope to deploy the cash in stocks with excellent prospects for the next two years. One is never sure, but growth in the rest of the world remains strong. It appears the world economy should be powering ahead while we sort out our housing excesses in the U.S.

Garnett Keith

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