



EARL M. FOSTER ASSOCIATES

I N V E S T M E N T M A N A G E M E N T

NEWSLETTER

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ECONOMIC UNCERTAINTY FUELS MARKET VOLATILITY

The current economic slowdown was signaled as early as mid-2006 by the Index of Leading Economic Indicators (Chart I). Since then, however, the deceleration has been quite irregular. Last year's third-quarter growth slowed to 1.1%, accelerated moderately in the fourth, only to drop again to a mere .6% during this year's first quarter. The re-acceleration to 3.8% during the second quarter is likely to be followed by weaker growth for the balance of the year.

CHART I

Index of Leading Economic Indicators



The economy faces a number of near-term challenges. First, the residential housing sector is expected to remain depressed for at least another year.

Second, a large number of adjustable rate mortgages written several years ago with low "teaser" rates are due for adjustment over the next 6 – 9 months. As they adjust

to current interest rates, higher monthly mortgage payments could impede household spending, particularly for consumer durables. Homeowners with sub-prime credit may find refinancing difficult in an environment of more stringent credit standards.

Third, households have come to rely on their home equity to fund large durable purchases such as automobiles, home improvements, travel, and other large expenditures. The general deterioration in home values is shrinking this potential source of additional purchasing power.

Fourth, the value of the U.S. dollar is quite weak compared to other world currencies. It has dropped more than 25% from its 2002 peak, and continues to trend downward. A weak dollar can aggravate our inflation rate by making imports more expensive, particularly crude oil, which is now above \$80 a barrel. While inflation currently appears to be contained, the risk of acceleration has increased, and this could put pressure on an already sluggish economic environment.

Nevertheless, stronger business conditions overseas, especially in Asia and the emerging economies, has moderated the deceleration in our domestic economy. Exports have had a positive impact on our balance of trade and helped insulate our manufacturing sector. The improvement in the trade balance during the second quarter accounted for more than a third of the growth during that period. Thus, the consensus among economists is that a recession can be averted.

Also, the half point reduction in the discount and Federal Funds rates on September 18th indicates an important monetary policy shift. The central bank appears determined to mitigate the housing crisis, alleviate the

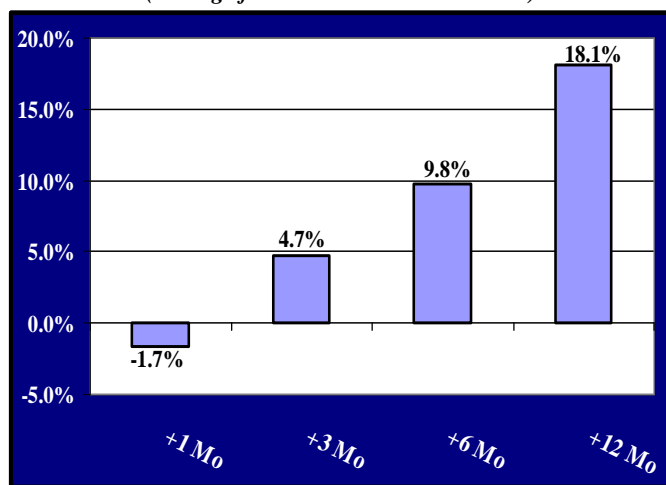
credit markets, and prevent the current deceleration in the economy from deteriorating into a recession. That, and the prospect of additional interest rate reductions later in the year, certainly reduces the risk of a recession.

Time will tell whether recent action by the Federal Reserve was soon enough and strong enough. Monetary stimulus in the form of lower interest rates has a lagged impact on the economy, and the current deceleration is not expected to quickly reverse. As a result, economic growth could become marginal over the next several quarters. While a recession is not expected, recent data on the deteriorating housing sector and consumer confidence indicate that the risk of a downturn, while not likely, has increased.

INVESTMENT STRATEGY

Stock market volatility increased in the third quarter. Of the 62 trading days over the summer, 26 had a percent change of more than 1%. During the first two weeks of July, the Standard & Poor's Index advanced 3.3%, followed by a 9.4% decline into mid-August, and a quarter-end rally of 8.5%. Ironically, the third quarter market turbulence resulted in a net price change of only 1.6% (Standard & Poor's Index).

CHART II
Stock Market Gains After Initial Interest Rate Cut
(Average for Standard & Poor's Index)



Since 1984, there have been six periods in which the Federal Reserve initiated interest rate cuts. Chart II shows the average price change from the first reduction in the Federal Funds rate, excluding 2001, which was an aberration associated with the aftermath of the technology boom. The first month following easing by the Federal

Reserve, stocks declined slightly, and then generally gained momentum over the subsequent 3-12 months. These gains were supported by additional interest rate cuts and the impact they eventually had on the economy.

The aftermath of the August-September cuts should be no exception. Lower interest rates will take some of the "edge" off the decline in the housing sector by "softening" the escalation in monthly mortgage payments, lowering overall financing costs, and generally giving consumers and investors the confidence that monetary policy is interceding to stabilize the economy and the financial markets.

Moreover, the last three months of the year are typically a transition period for investors as they shift their focus ahead to the following year. If corporate earnings continue to advance in the 7%-8% range in 2008 and the lagged effects of recent interest rate cuts re-stimulate the economy, additional stock market gains are justified.

The tentative 2008 range for the Standard & Poor's Index is 1,400 to 1,700. The lower end, which is about the same level as the lows reached last March, incorporates a stalling in the economy, while the upper end reflects an environment of continued growth with little deceleration beyond what has already been experienced. The return over the next 12 – 15 months could be as high as 13% (including dividends) with a risk of a negative return of 7%. While the outlook remains generally positive, some caution is appropriate until there is some evidence that conditions in the housing and financial markets are stabilizing.

CHART III
Preliminary Value Range for 2008
(Standard & Poor's Index)

