The Economy and the Markets

The economy and markets went through the gauntlet in the third quarter, hit hard by the failure of large financial institutions, worsening economic conditions and stalled credit markets. The Federal Reserve and the U.S. Treasury launched a number of extraordinary measures aimed at preventing a severe recession or depression.

The failure or forced sale of a number of large, well-known firms dominated the financial headlines. First came the takeover of the mortgage giants Fannie Mae and Freddie Mac. Next, the federal government assumed an 80 percent share in AIG, the world's largest insurance company. Merrill Lynch was quickly sold to Bank of America. Washington Mutual's assets were seized and transferred in the largest bank failure in U.S. history. Wachovia will likely be sold to Wells Fargo or Citigroup.

In every circumstance, these failed organizations depended on funding from the short-term credit markets to do business. When they lost their ability to secure short-term credit, the speed with which these icons of our financial system unwound shocked observers and sent fear through the markets.

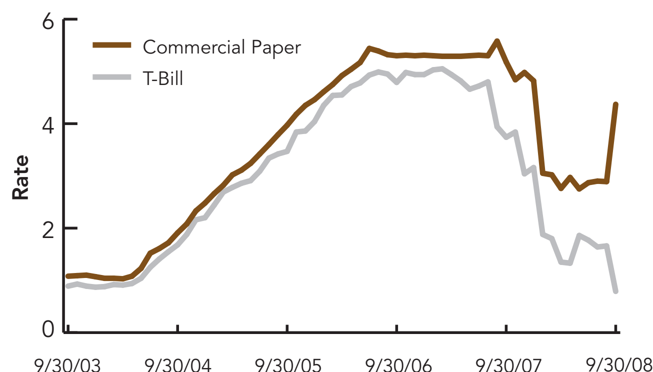
It also led to the federal government's $700 billion plan aimed at preventing the credit markets from going into a deep freeze. While the rescue plan won't bring an immediate end to the turnaround, it could limit how quickly and how far the economy falls. A lack of liquidity and lending capacity is threatening to shut the economy down, and the plan attempts to get the credit markets moving again.

The bold, unprecedented and necessary actions of the Federal Reserve, the Treasury and the FDIC very likely prevented a collapse of the financial system. Whether they are sufficient to contain the crisis in the months ahead won't immediately be clear. It is certain, however, that the changes this crisis brings to our financial system will be lasting and profound.

Equities

The equity markets tumbled over the quarter, as investors dramatically lowered their expectations for future earnings growth in the U.S. and internationally. The Standard & Poor's 500 Index returned -8.37 percent for the quarter, leaving it -19.29 percent year-to-date through September 30. Global equities suffered as well, and the MSCI-EAFE Index returned -20.50 percent in the third quarter, leaving it -28.91 percent year-to-date through September 30.

Commercial paper and Treasury bill rates



Source: Bloomberg. Based on 90-day A-1 rated commercial paper.

The spread between commercial paper and Treasury bills has spiked, as investors demand higher rates from businesses looking to fund short-term needs. Three-month Treasury bills remain in high demand in spite of low yields, given their backing by the U.S. government.

High volatility characterized the markets, peaking on September 29 when the S&P 500 fell by 8.8 percent following the initial Congressional rejection of the Bush rescue plan. A high degree of uncertainty means volatility is likely to continue for some time.

A glimmer of hope for investors comes from the likelihood that, with concerns about inflation lessening, the Fed will cut interest rates to get the economy growing. Investors would then likely reassess the future earnings growth of companies. Stocks in general, and some of the sectors such as financials that have been seriously beaten down—more downtrodden issues in particular—could get a lift as a result.

Fixed Income

The problems of financial firms significantly affected the fixed income markets, creating a

Continued

substantial drag on performance over the quarter.

Even money market funds suffered, and redemptions led one fund to "break the buck" and generate losses for its shareholders, a situation that had only occurred once previously. The Treasury Department quickly announced a guarantee program designed to stem a potential run on money market funds.

A flight to quality created such high demand for Treasury bills that yields at one point dropped to almost zero, with investors willing to completely forgo returns in exchange for safety. This occurred at the same time that the short-term borrowing rate for banks and businesses rose to 5 percent. Those rates are high by historical standards and make it very difficult to fund and finance a business.

Real Estate

The residential housing market continued to suffer, as home price declines continued and mortgage delinquencies increased. While it has been frequently stated that a stabilized housing market is the key to resolving the credit crisis, it will take some time for housing losses to work through the system. It will be an evolving process, and won't happen overnight.

Commercial real estate, on the other hand, continues to be one of the better-performing sectors of the market. The Dow Jones Wilshire Real Estate Securities Index was up 4.51 percent for the quarter, and is up 0.95 percent for the year through September 30, outperforming the S&P 500 Index year-to-date by 20.24 percent. Commercial real estate funding is typically long-term, rather than short-term, insulating it from the current stresses in short-term credit. It also provides cash flow and income, welcome advantages in this market.

Commercial real estate market fundamentals remain solid at this point, but a slowing economy will put pressure on those fundamentals. Properties such as hotels, where income is not derived from longer-term instruments such as leases, would be the most likely to feel the effects.

Outlook

While everyone's crystal ball is somewhat cloudy at this point, the effects of the economy's reduced lending capacity could become more apparent in the months ahead.

Fewer lending sources and higher interest rates will reduce the ability of Main Street businesses to get funding. When projects now in the works are completed and the money to start new ones isn't there, we could find ourselves in a very serious economic slowdown.

On the positive side, we believe the government's sizeable efforts to stimulate the economy may at some point become a powerful force. If that happens, investors who decided to get out of the market and stay on the sidelines may miss some powerful opportunities.

It is important for investors to remember the importance of a long-term investment strategy and continuing to invest in a down market. Today's markets are very different from yesterday's, and what's happened in the past does not guarantee what the future will bring. But history has shown that over time, staying in the market overcomes even the deepest downturns.

The S&P 500 Dividend-Adjusted Index is market-value weighted based on 500 common stocks, which are traded on the NYSE, AMEX and Nasdaq. The weightings make each company's influence on the performance of this index directly proportional to that company's market value.

The Dow Jones Wilshire Real Estate Securities Index is a market capitalization-weighted index of equity securities whose primary business is equity ownership of commercial real estate investment trusts (REITs). The index contains equity and hybrid REITs and real estate operating companies (REOCs) and includes reinvested dividends.

The Morgan Stanley Capital International Europe, Australia and Far East Index (MSCI EAFE) is an unmanaged index composed of the stocks of approximately 1,000 companies traded on 20 stock exchanges from around the world, excluding the USA, Canada, and Latin America. It assumes the reinvestment of dividends and capital gains and excludes management fees and expenses.

You cannot invest directly in an index.

Past performance is not indicative of future results.

Investment risks associated with investing in a real estate fund/portfolio, in addition to other risks, include rental income fluctuation, depreciation, property tax value changes, and differences in real estate market values.

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