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THE RAY REPORT

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Same As It Ever Was

Early alternative band the Talking Heads smartly embraced the video medium and MTV to become one of the hottest bands of the 1980's. Writing more than just simple pop love songs, there was an existential quality to their music that pointed out the inevitability of life moving forward even when we are too blind or unaware to notice. No such song or video embraced this notion more than "Once In A Lifetime." Talking Heads lead singer, David Byrne dressed in his best bowtie and suit asks questions such as "How did I get here?" and "How do I work this?" against a chorus of "Same as it ever was."

As I was trying to reconcile the Federal Reserve's actions of August 17th to reduce the discount rate (that is the rate that the Fed charges banks for direct loans) by .5% in an effort to increase liquidity and avert a brewing crisis in a number of housing and bond related markets, I had thoughts of Ben Bernanke doing his best David Byrne impersonation.

The Fed's move comes just 10 days after a Federal Reserve meeting on August 7 when the decision was made to leave rates unchanged. Even more shocking in retrospect was that Federal Reserve members continued to announce that inflation remained the biggest concern to this economy. St. Louis Federal Reserve President William Poole even went so

far as to say in an August 15 interview that only a "calamity" would justify a rate cut between meetings.

Clearly, markets are complex and can move quickly. It is also true that one of the primary jobs of the Federal Reserve is to remain vigilant on inflation. Yet, inflation has been moderated for sometime, aside from oil and certain other commodities, while economic weakness has been apparent for sometime.

In our May 21, 2007 newsletter, we wrote, "We remain convinced that the biggest risk remains economic weakness in the United States especially as it relates to housing and the consumer and it is imperative that the Federal Reserve acknowledge this weakness by the end of summer and signal the lowering of interest rates. Fail-

Market Performance For The August 2007 Quarterly Period

<i>Dow Jones Industrials</i>	-1.45%
<i>Standard & Poor's 500</i>	-3.30%
<i>Russell 1000 Growth</i>	-1.76%

ure to do so could make for a difficult fall, while an injection of liquidity by the Fed will extend the rally."

So how can the Fed be so wrong, or perhaps it is better asked, how things can deteriorate so quickly? There are a number of reasons. First, the Federal Reserve had had enormous turnover and the majority of the current voting members are academics with little real world experience. In fact, the move to cut the discount rate was done at the urging of New York and San Francisco Bank heads, Timothy Geithner and Janet Yellon, veteran

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Inflation Rate vs. the Economy



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officials who dealt with the 1997-8 Latin American currency crises.

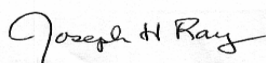
Second, Bernanke is new. Even in 2006, it was obvious his inexperience would be an issue. In our September 21, 2006 newsletter, when there was some discussion as to whether additional rate hikes were to be contemplated, we stated "While the Federal Reserve is likely done for this cycle, in my opinion, it will take some time for investors to come around to that opinion and Bernanke's inexperience will elongate this process."

The quick deterioration in the markets comes from the record use of leverage by banks, hedge funds and mortgage lenders. It is exacerbated by the reluctance or inability to sell or buy these somewhat esoteric assets once things begin to go bad. In other words, there is no market for some of the junk.

So what does this mean going forward? Is a recession likely and, if so, how will the stock market react? Importantly, the Federal Reserve blinked and acknowledged there are fundamental problems by the lowering of the discount rate. The failure to lower the target "fed funds" rate, however, shows that there remains some indecision at the Federal Reserve. It also means that consumers with adjustable mortgages will not get any immediate relief. If the Federal Reserve continues to inject liquidity, the market will be fine. In fact traditionally, the period when interest rates are moving down incorporate

some of the stock markets greatest upward moves, even in a slowing economy. The September 18 Federal Reserve meeting is important in establishing whether the Fed understands that lower rates are now a necessity not just an option. It will force the Fed to be forward thinking rather than reactionary, something they are at times uncomfortable with. In other words, it's the "Same as it ever was," as we hope the Fed does the right thing

Sincerely,



Joseph H Ray, President

Why Buybacks?

Deal flow has slowed. Is it summer or interest rates? I am not sure, probably a little of both. One thing that continues to go on unabated is the enormous share buybacks at some of our largest companies. Conoco intends to buy back \$15 billion in stock while JNJ is to buy back \$10 billion. Both announced today. Why the buybacks? Is this a better use of funds than acquisitions or dividend increases? One reason these companies look to buybacks is that it makes these huge companies that are having trouble growing look like they are growing as EPS goes up due to lower share count even if earnings themselves are stagnant. They are

also easy to do, much easier than integrating an acquisition. They are considered more tax-friendly than dividend increases although I like the latter in many respects. Maybe there are no properties worth buying that are accretive to earnings. This may certainly be true as it relates to Conoco and the high oil prices. In JNJ's case however, when growth has been so difficult, it seems like management is either lazy or paralyzed. If a stock is at 14x earnings, I'm not sure dilution is a huge worry, future growth and the finding of a potential remedy seems more troublesome. Current financing issues should not affect many of these credit worthy borrowers, yet it seems to be a very quiet market for deals.

Watch Financials

The key to this market going forward as it has been for sometime now are the financial stocks. Financials are important because they act as barometers in sentiment about the Fed. They also incorporate expectations of the yield curve and the economy in general. Traditionally, these stocks can advance even if earnings estimates come down if there is a belief that the Fed is ahead of the problem. Look for bank and brokers to do better once Bernanke makes it clear that the discount rate cut was just the first step and not a one time event. Look closely to the reaction of financials to any action taken September 18 to see if confidence in the Fed has returned.

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