H.M. Payson & Co.

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RESEARCH NOTES

WITH VOLATILITY COMES OPPORTUNITY **JANUARY 22, 2008**

Citing deteriorating market conditions and tighter credit for "some businesses and households", today the Federal Reserve cut the Federal Funds interest rate by 0.75% in an emergency move a week before members of the Fed would normally take such a step. It is the largest single reduction in the rate since 1990 and the first 'emergency' rate reduction since a week after the 9/11 attacks. In and of itself this action by the Fed is newsworthy.

Yesterday, however, while our markets were closed due to the holiday, equity markets around the world sharply accelerated their declines on the heels of their poor performance year-to-date and last week, in particular. For many markets such as Tokyo, Hong Kong and our own Russell 2000 (An index of US Small Cap stocks), this year's declines have extended losses from their peaks last year to -20%, to many the definition of a Bear market.

Big market moves in either direction make news; but we would remind our clients that it is the nature of markets to be many times more volatile than their underlying economic fundamentals such as overall economic growth and profits.

While it is true that the confluence of recent economic data out of the US suggests a recession may be imminent, if not already upon us, growth outside of the US continues to be strong in many major economies. Indeed Asian economies driven by China continue to grow at low double-digit rates - admittedly, due in some measure to continuing strong exports to the US. Generally these economies are low in debt and well capitalized. It is worth noting that the US accounts for less than 50% of the world's stock market value - reflecting the decreasing importance of the US economy on global growth and profitability.

The rapid growth over the last several years in emerging market economies, in particular, combined with a falling dollar fueled exceptionally strong stock market returns in these emerging economies, attracting an enormous flow of new stock market investment chasing those returns. The bulk of the stock market declines globally have been in markets that have been the hottest, such as Asia, Latin America, Russia and specifically India - as this hot money now seeks safer confines, such as sovereign debt in developed countries.

Over the last several years, as our clients know, we have increasingly postured our portfolios to weather the kinds of conditions we are witness to today. While we may have been somewhat early in this move, we sure don't look as early now!

Low-grade bonds, mortgages and all nature of derivatives thereof appeared for several years priced for absolute economic and market perfection. We steadfastly avoided these riskier asset classes in favor of cash and shorter-term, investment grade and treasury notes. There is no doubt that impaired credit conditions have led to a credit crunch, of sorts; however, we view recent stock market behavior as equal amounts fear of slower global economic growth and rapidly-changing short-term change in investor sentiment which can engender this kind of volatility.

At the end of the day, as is so often the case, this episode is all about liquidity. For better or worse, there are no practical limits to how far the Fed and other central banks can and will go to assuage short-term uncertainty and to keep borrowing costs low to promote continued economic expansion. We expect the 75 basis point decline in the Fed Funds and Discount Rate will go a long way to see the markets and economy through. When the dust clears, however, it is likely asset classes of all descriptions will be more realistically priced.

If you have questions or comments regarding this Research Note, please click here to contact the Research Department.