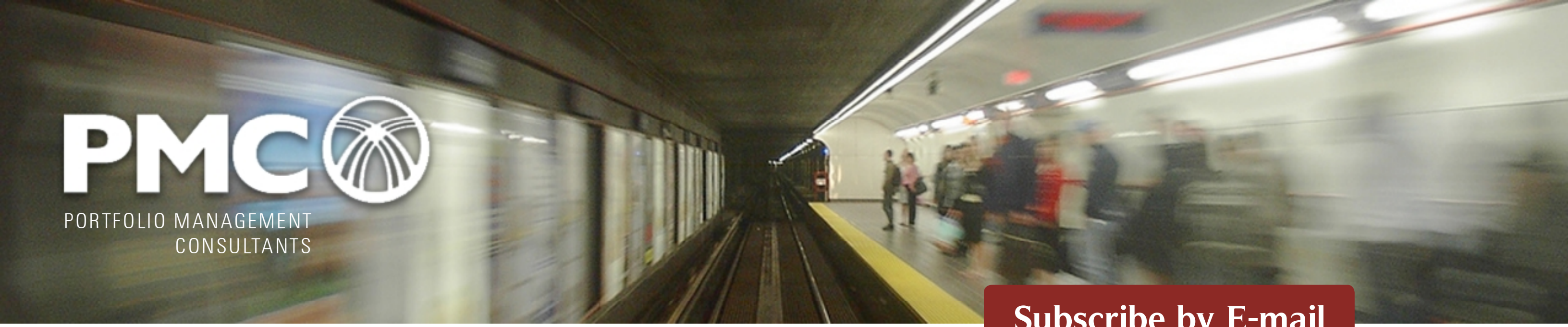

Reaching for Perspective

By: Bob Andres, Chief Investment Strategist
Bill Gaine, Research Strategist

We initiated publication of the *Weekly Perspective* in early July to provide our advisor partners with what we believe to be an informed perspective of the current state of the global economy. Our views are formed from the synthesis of the many complicated forces at work in the global economy. As part of this analysis, we also look to identify and access those technical and fundamental factors that influence current asset valuations while providing insight into future valuations. Our goal is to provide quality analysis and opinion so that we can assist our advisor partners in making informed decisions and, in the process, help them grow their businesses more effectively.

Our favorite definition of the word "perspective" derives from the American Heritage dictionary of the English Language – *"The ability to perceive things in their actual interrelations or comparative importance."* Ironically, these words could easily define our role as strategists.

First Component

Let us look at the first component of the definition – *"the ability to perceive things in their actual interrelations."* The investment industry has (incorrectly) borrowed a term from engineering called a "negative feedback loop" to describe how forces in one segment of the economic cycle affect another segment in a negative or destructive manner and so on until the cycle completes itself by negatively reinforcing the originating force. The implication within this context is that the process becomes a self-perpetuating and reinforcing destructive cycle. We have argued since last November that the housing crisis is the "epicenter" of our current economic problems. As housing prices fall, loan to value ratios increase dramatically thereby increasing default rates. This, in turn, causes housing prices to fall further. These declining prices also negatively affect consumer wealth and equity, prompting consumers to reduce spending. This leads to tremendous reductions in asset base for the banking industry since they are required to mark-to-market the

About PMC

PMC, with $12 billion in assets under management, is the Investment Consulting unit of Envestnet, a firm with $85 billion in assets under management and administration. Since 1986, PMC has been "advising the advisor" and is focused today on providing the tools, strategies and insights advisors need to build better investment portfolios for their clients.

About Bob Andres

Bob is the Chief Investment Strategist for PMC and is responsible for the communication of our economic viewpoints and investment strategies to the marketplace we serve. Bob serves as a source of insight and perspective to advisors and their clients. He regularly engages with advisors in support of their client meetings, presentations and conference calls.

His business pedigree includes:

- President of Merrill Lynch Mortgage Capital Corporation.
- Vice President and Manager of Merrill's secondary corporate bond trading division.
- President and Co-Founder of Martindale Andres & Company, a firm that managed in excess of $2 billion in assets.

Bob has been featured in Barron's, Institutional Investor and a broad array of financial publications throughout his career.

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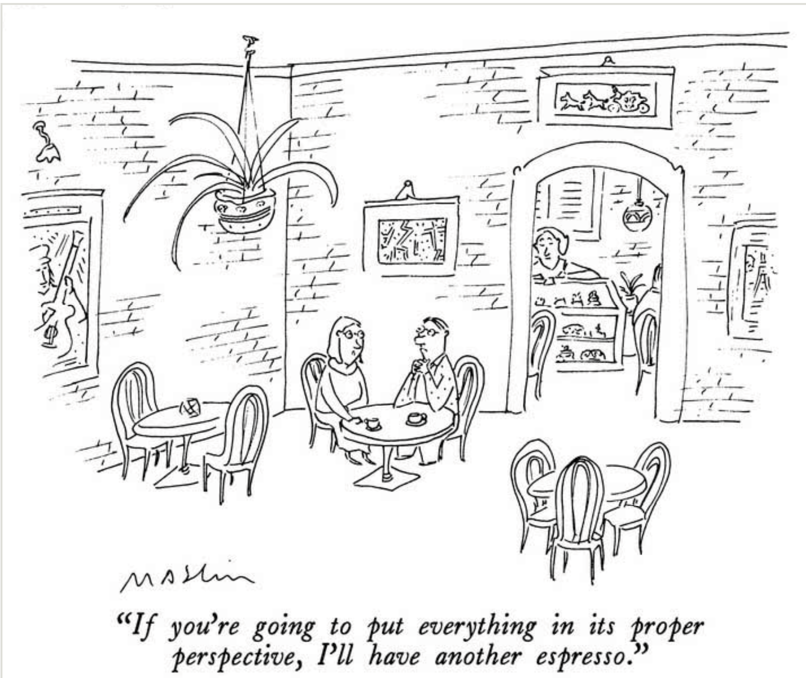

"If you're going to put everything in its proper perspective, I'll have another espresso."

value of their mortgage portfolios, resulting in billions of write-offs. These institutions are then forced to rebuild their own balance sheets by tightening lending standards, reducing the availability of credit, and increasing the cost of borrowing. This reduces both the consumers' ability to borrow and spend in addition to negatively effecting housing prices even further.

This past Friday non-farm payrolls declined for the eight consecutive month. The economy lost 84,000 jobs in August and revisions accounted for an additional loss of 58,000 in the June /July period. Unemployment rose from 5.7% to 6.1%. Consumers are faced with slowing income creation, declining values in their homes, rising unemployment, near record debt burdens, and a restrictive credit system. A weakened consumer will extend the broad economic downturn while exacerbating the housing crisis. In mid July, we stated, "Until we see stabilization in housing prices, we expect a continuation of volatility, uncertainty and a concern for risk taking."

Second Component

Let us look at the second component of the definition – *"comparative importance."* We believe that the mortgage market/housing crisis poses a systemic risk to the financial system. Systemic risk and the concept of a negative feedback loop are related in that they both prompt us to be more concerned about the macro financial system and somewhat less concerned on a "comparative" basis to individual components of the system. It has been our opinion that market participants have all too often "missed the forest but for the trees" by not fully understanding the systemic risk posed by the broad housing crisis. We have suggested that 5% headline inflation and high-energy prices were technically driven, not a systemic risk, and would eventually abate as the consumer began to de-leverage and the global economy continued to weaken. We remain confident in this viewpoint.

Send a request to pmc@envestnet.com and we'll be happy to add you to our *PMC Weekly Perspective* mailing list.

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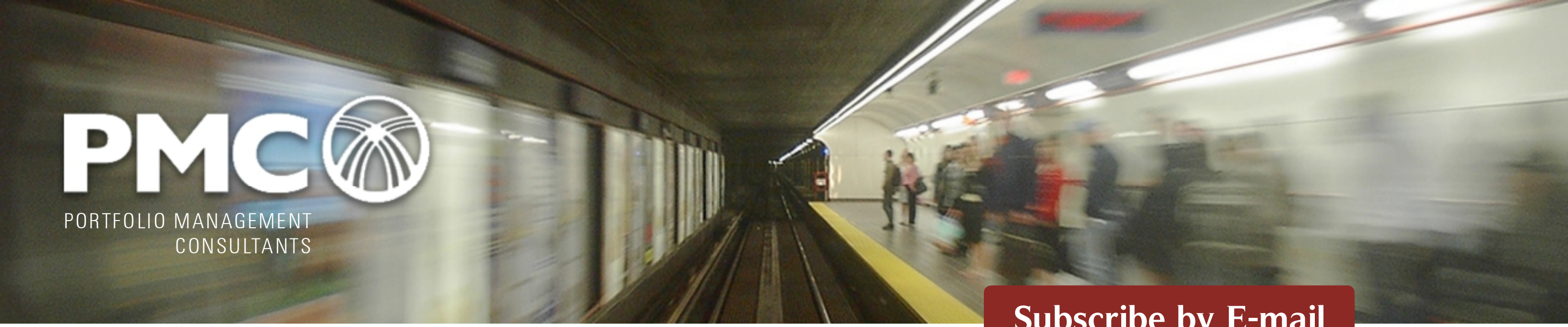

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Too often, we institutionalize denial. This practice allows us to pretend that we did not know and affords us the opportunity to justify ealier inaction.

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Almost one year ago, we posed the question – How did we get to this point? Our answer suggested, too much liquidity, too much leverage and significant excesses in the financial engineering phenomenon. The situation was exacerbated by greed, a broad under pricing of risk by lenders and a false sense of value supported by a questionable rating system. We estimated that loses would reach $400 billion (losses are currently over $500 billion and perhaps headed a lot higher). Confidence in securitized "risk transfer" products has been severely reduced, causing liquidity to virtually evaporate. Other essential banking related products have suffered the same fate as "risk aversion" polices took hold and the concept of "guilt by association" gained acceptance. Our answer reflected our abbreviated view on what caused the current debacle and what impact it was having on liquidity, risk taking and asset valuations. Ironically, a year later, we now answer the question exactly the same way with the one caveat; that consumers greatly impact and influence GDP growth.

Too often, we institutionalize denial. This practice allows us to pretend that we did not know and affords us the opportunity to justify earlier inaction. In our view, plausible deniability is not a credible defense from the so-called "experts." We all need to look beneath the surface.

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Additional Assessments

By: Bob Andres, Chief Investment Strategist
Bill Gaine, Research Strategist

Fannie/Freddie – In the August 25th edition of the *Weekly Perspective*, we expressed our view that a government infusion of capital was required and would occur.

On Sunday, Secretary Paulson announced the takeover of both Fannie Mae and Freddie Mac. Both GSEs have been placed in a conservatorship run by the Federal Housing Finance Agency (FHFA). The Treasury will take a $1 billion equity stake in each company in the form of senior preferred stock. The preferred stock will be senior to existing common and preferreds and will carry warrants that increase the government's ownership to just under 80%. A secondary program has been structured which allows the Treasury to purchase mortgage-backed securities held by either GSE in an attempt to provide an additional flow of new funds into the mortgage market.

We do not see this as a panacea but as good news that will remove a level of uncertainty and provide a boost of confidence. This event should exact downward pressure on mortgage interest rates over time. In addition, we should expect an immediate narrowing of agency to treasury spreads. The bad news is that common and preferred shareholders line up behind the new senior preferred shares. We unfortunately have more questions than answers at this time. We expect to be able to provide more clarity and answer a broad array of questions later in the week.

Equities

Near record corporate spreads and excessively high volatility have been leading indicators suggesting trouble for the equity market. It now seems that some past friends i.e., declining oil prices and a stronger dollar may be shifting allegiance. Equity prices followed oil prices down this past week possibly signaling that investors now recognize that a slowing global economy threatens equity values more than lower oil prices help equity values. Declining oil prices may have reached a point of diminishing returns in support of equities, as the extent of the global slowdown has become more apparent. Is it also ironic that three months after most analysts

Economic Calendar

Tuesday

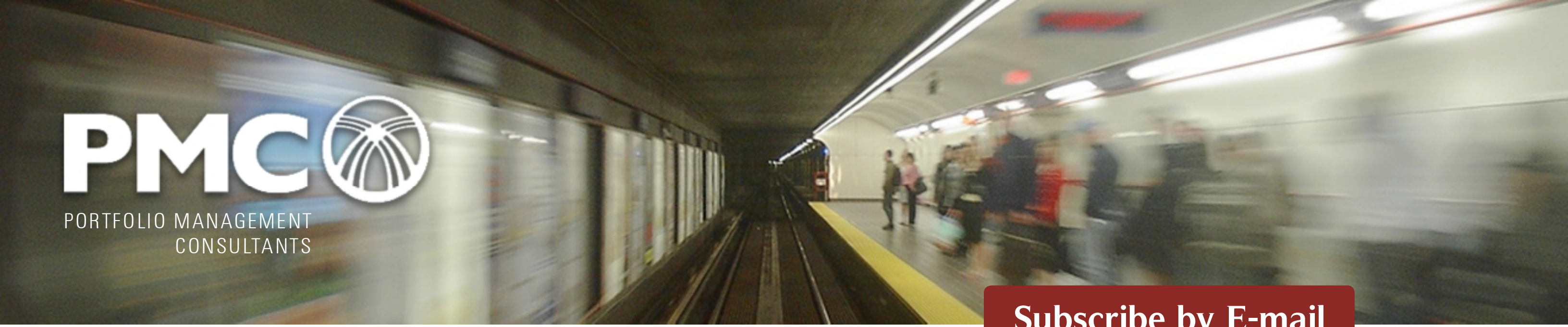
Pending Home Sales and Wholesale Inventories

Thursday

Trade balance, Import Prices, Initial Jobless Claims, and Budget Balance

Friday

Producer Price Index, Retail Sales, Business Inventories, and Consumer Sentiment



bemoaned the weakness in the dollar, we are confronted with the combination of a stronger dollar and a rapidly falling G7 economy? These events will cause export growth (the only remaining strength in the U.S. economy) to decline precipitously and further pressure equity levels.

Bonds

We continue to think that the bond market is the beneficiary of the problems facing the economy and the equity markets.

Inflation

In early July, we made an extensive case for declining inflationary pressures. We identified these elements as deflationary:

- declining real estate
- prolonged below trend GDP growth
- moderating money supply
- a narrowing of the U.S. trade deficit
- solid productivity gains

Today, we provide additional data in support of our viewpoint - The correlation between energy prices and bond yields are negative. The fact that yields did not rise as energy prices rose suggests that the bond market understood higher prices would lead to lower aggregate demand, declining economic growth, and moderating inflation.

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