

October, 2005

Dear Clients and Friends,

Don't knock the weather; nine-tenths of the people couldn't start a conversation if it didn't change once in a while.

~ Kin Hubbard

Federal Reserve chief Alan Greenspan earned the nickname “Easy Al” by adding liquidity to the financial system (lowering interest rates) whenever he was faced with an economic malady. He first did it in October 1987, a mere month after taking the reins at the Fed, to mitigate the effects of a few bad days in the stock market. He did it in the 1990s to prevent a succession of financial misfortunes in Mexico, Asia, Russia and one overstuffed hedge fund from harming the general US economy. And, instead of taking away the punch bowl before the internet party got out of hand, he instead added vodka until the bubble burst in 2000. Of course, he might argue that he *had to* keep money loose through the late ‘90s – after all, he was hoping to avoid the Y2K computer crisis! While Y2k proved to be a non-event, we were soon faced with the terror of 9/11 and its after-effects. With the economy already mired in a post-bubble recession and deflation threatening some industries, Greenspan reduced rates to historic low levels.

But a curious thing happened on the way to 1% Fed Funds: As rates fell, houses became more affordable. Low mortgage rates led to rapid appreciation in home prices, and equity lines of credit kept consumers flush. The Fed didn’t seem to mind; in a February 2004 speech, Greenspan urged homeowners on, suggesting they save even more on their monthly home payments by switching to adjustable-rate mortgages (ARMs) instead of conventional fixed-rate mortgages. Home prices appreciated more than 20% a year in some localities. Let the good times roll!

And then the weather changed.

The Federal Reserve has increased the Fed Funds rate *eleven times* since June 2004. Yet in the face of an already-slowing housing market, nervous consumers, tepid corporate spending, and the devastation caused by hurricanes Katrina and Rita, the Fed is showing no signs of deviating from its rate-hike agenda. We thought it disconcerting enough to have the Fed Chairman recommend ARMs shortly before embarking on an unprecedented series of rate increases. We find it entirely unconscionable for him to effectively say to those affected by the hurricanes: “Yes, you can rebuild your homes, but it’s going to cost you more. And more!”

There is a reason for the inconsistency between Easy Al’s historical response to crises and his response to the current situation. In short, the Fed simply doesn’t have the flexibility to cut rates without fueling inflationary fires. Ironically, the imbalances that the Fed is now trying to overcome are, to a large extent, a direct result of their own misguided policies in years past. Like it or not (we certainly don’t!) the Fed is raising rates because they should never have been as low as they were. To borrow from the weather cliché, Greenspan came in like a lamb, but will end his tenure going out like a lion.

This process will likely cause short lived dislocations and increased volatility as investors adjust to “normal” interest rate levels, which by historical measures means short-term rates in line with nominal GDP growth (around 4-5%, perhaps somewhat higher.) In our opinion the markets, particularly the stock market, remain attractive for the long-term despite near-term uncertainty. We have been shifting portfolios toward more defensive holdings for the past couple of years, and believe that approach remains sound.

We recommend investors reaffirm their own long-term objectives and risk preferences. If you have not recently completed one of our Investor Questionnaires, we ask that you do so now and discuss it with your Portfolio Manager during your next portfolio review meeting. You can download a PDF version of the Questionnaire by visiting the Investment Process page on our website, <http://fbb.wealthtrust.com/process.htm>. If you do not have web access, your Portfolio Manager would be happy to provide you with a copy.

Sincerely yours,

Mitch Schlesinger
Managing Director