

September 30, 2007 Market Commentary and Outlook

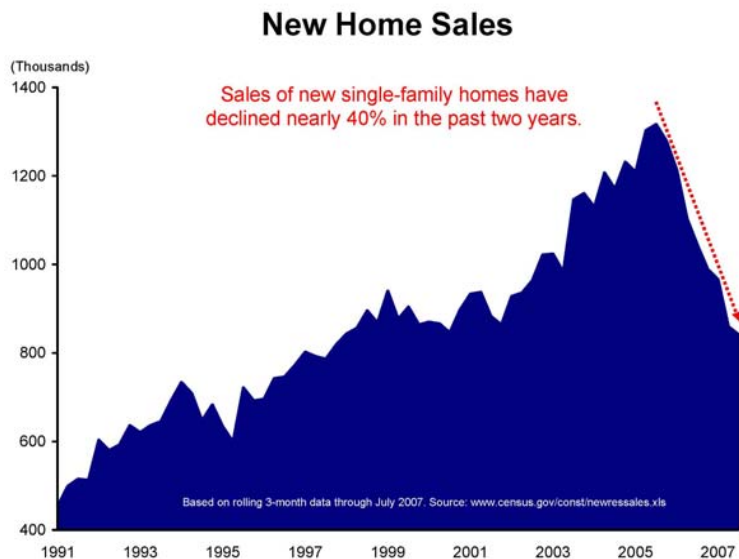
When the U.S. Housing Market Sneezes...

In the 3rd quarter of 2007, the U.S. subprime mortgage crisis turned contagious, infecting financial markets worldwide. Investors, surprised by the extent and severity of the meltdown, reassessed their portfolios and their willingness to accept risk in a rapidly changing economic environment.

Housing Trouble from Main Street to Wall Street

The U.S. housing market has been in a near-tailspin. With new home sales the weakest in seven years, inventories of unsold homes climbed to an 18-year high, while existing home prices fell -3.9% from the previous year. The portion of subprime adjustable rate mortgages past due or in foreclosure reached nearly 15% in July, roughly triple the low seen in mid-2005.

As home prices fell, many homeowners found their mortgage debt to be greater than the value of their home. Interest rates on many adjustable rate mortgages increased to levels many homeowners could no longer afford, while refinancing opportunities became increasingly difficult to find. As a result, many distressed borrowers walked away from their homes, leaving their lenders to absorb their losses.



Despite its ferocity, the housing downturn comes as no surprise. For months, analysts had predicted that overbuilding, speculation, lax lending practices, and natural fluctuations in interest rates would eventually trigger a rise in defaults among subprime loans that would precipitate a broad-based housing market reversal.

But few analysts predicted that Main Street's housing problem would soon become Wall Street's credibility problem — until droves of investors began to frantically purge their portfolios of subprime exposure. Concerned that bond ratings did not accurately assess the risk of their subprime-related securities, many bondholders took a “slash and burn” approach to subprime-related investments — selling first, and asking questions later. Such concerns may well prove to be justified. In September, the U.S. Securities and Exchange Commission announced that it had launched an investigation to determine whether banks and other debt issuers had pressured ratings agencies to give high ratings to bonds backed by subprime mortgages.

Broad Market Fallout

The repercussions from the housing downturn are currently working their way through global markets. While the channels of cause and effect can be murky at times, we believe the housing downturn is at least partly responsible for the following conditions:

- **Tighter credit; restricted growth.** Lenders and investors have adopted stricter standards, putting a squeeze on the spending and growth plans of many would-be borrowers.
- **Stock price volatility.** Sharp fluctuations in earnings of homebuilders and lenders have caused stock price volatility to rise to a four-year high.
- **Lower short-term interest rates.** Investors' flight to ultra high quality investments has driven short-term Treasury yields down by nearly 1% during the quarter. In response to the liquidity crisis, the Federal Reserve cut the Fed funds rate from 5.25% to 4.75% in September.
- **Decline in the exchange value of the U.S. dollar.** Foreign investors, stung by losses related to U.S. subprime loans, have become increasingly wary about investing in dollar-denominated debt. Lower U.S. short-term interest rates and growing fears of a recession have pushed the U.S. dollar to an all-time low.
- **Restrained consumer spending.** Higher interest rates on adjustable rate mortgages have drained consumers of discretionary cash, while sagging home values have limited home equity borrowing opportunities. Corporate earnings, as a result, are now under significant stress.

What's Next?

It is likely that the housing slowdown will play a large role in driving investment results in coming quarters. Should the subprime crisis continue to expand, there is the possibility of one or more of the following events:

- **Recession.** Tighter credit and the “negative wealth effect” of declining home prices may choke off economic growth in coming months. In a September 13th Wall Street Journal survey, economists pegged the risk of a recession at 36%, up from 28% a month earlier.
- **Corporate earnings slowdown.** Even if a recession does not occur, the ongoing credit squeeze may restrain business and consumer spending, leading to slower economic growth and weaker corporate earnings in months to come. On September 27th, Standard & Poor's estimated that third-quarter profits for the S&P 500 index will be up just 2.4% from the third quarter of 2006 — the weakest year-over-year increase in over five years.
- **Lower short-term interest rates.** On September 18th, the Federal Reserve explained its ½% Fed funds rate cut as serving to “forestall the adverse effects on the broader economy that might otherwise arise from the disruptions in financial markets.” There is a reasonable likelihood that the Fed will continue cutting rates in coming months to relieve distressed home borrowers and to stimulate growth over time.
- **Stock market volatility.** A downshifting U.S. economy could drive investors to seek opportunities elsewhere. However, falling short-term interest rates and a weaker U.S. dollar may make U.S. corporations more attractive buyout targets, especially to foreign investors.

The Sky Isn't Falling

Despite the challenging housing environment, U.S. large company stocks, as measured by the S&P 500 Index, returned +2.0% during the quarter, closing the quarter near an all-time high. Stock prices were supported by a remarkable 4% decline in the U.S. dollar that made shares of U.S. companies significantly cheaper for foreign investors to buy, while making U.S. goods more attractive on overseas markets.

While the dollar's decline tends to support stock prices, it has a potential major drawback — it can make imported goods more expensive, thus leading to inflation. The weak dollar also may be less helpful to smaller, non-exporting companies. In the 3rd quarter, mid- and small-sized companies returned -0.9% and -3.1%, respectively.

What's Your Risk Tolerance?

During the 3rd quarter of 2007, we saw above-average stock market volatility. By mid-August, the S&P 500 Index had dipped by slightly more than 6%. Fortunately,

the Index recovered to close the quarter with a modest gain. But had the market not recovered, would a 6% decline have been considered an unusual market occurrence?

During the past decade, there were many calendar quarters that experienced declines of 6% or greater, with one quarter's decline as great as -17.28% — nearly three times worse than the recent intra-quarter dip.

Worst Quarters of the Past Decade		
Quarter	Decline in S&P 500 Index	Ending Value of a Hypothetical \$10,000 Starting Portfolio*
3 rd Quarter, 1999	-6.24%	\$9,375
4 th Quarter, 2000	-7.81%	\$9,218
3 rd Quarter, 1998	-9.94%	\$9,006
1 st Quarter, 2001	-11.85%	\$8,815
2 nd Quarter, 2002	-13.39%	\$8,661
3 rd Quarter, 2001	-14.68%	\$8,532
3 rd Quarter, 2002	-17.28%	\$8,272

(*) Ending values assume hypothetical indexed portfolio tracks perfectly with S&P 500 Index.

The recent recovery in the stock market is an opportunity to reassess your tolerance for investment risk. When stocks declined during this past quarter, did you wish you had less exposure? As stocks recovered, did you wish you held more? The challenge during today's market turbulence will be for each of us to prepare for the possibility of stock market volatility, and to verify that our chosen investment mix is appropriate for our long term goals and risk tolerance.

Not knowing with certainty what the future will bring, we continue to believe portfolios can benefit from asset class, management style, capitalization and geographical diversification. While diversification is not a miracle cure, it can help protect a portfolio from catching cold during a period of market contagion.

Investment Committee
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