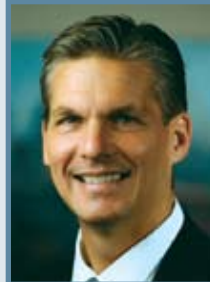


## As the Dollar Turns

By Mark Luschini, Chief Investment Strategist



The fallen but once mighty greenback might be back on the road to recovery. After being pushed to record lows against the currencies of Europe and Canada, a 26-year low against the British pound and a 12-year low against the Japanese yen, there are nascent signs that its seven year downtrend may be coming to an end.

For some, the dollar's descent has been a welcome event. A weak dollar generally makes U.S. goods cheaper for overseas buyers, helping exports and reducing our international trade deficit. On balance, this has brought job stability to those industries where a substantial portion of revenues are generated from overseas markets. That has helped the overall employment picture in a time when many sectors of our economy are experiencing job losses. It has also helped to attract an enormous inflow of foreign visitors to the U.S. with euros, pounds and loonies in their wallets. Shoppers are finding America is "on sale," which has had a positive effect in areas like New York City and in industries such as hotels and higher-end retailers.

Ultimately, an improving trade position enhances the economic vitality of the U.S., which leads to restoring the dollar's somewhat tarnished image as the world's reserve currency. In the meantime, however, our strong appetite for imported goods, which have experienced price creep due to elevated levels of inflation in many foreign markets that have been growing at a much faster pace than here, has led to the U.S. importing higher inflation. Further declines in the dollar could induce increases in commodities, ranging from oil to food, and amplify the costs of imported consumer goods. This would serve to crimp the already anemic level of economic activity in the U.S. with a large spillover to growth in markets around the world. The negative feedback loop caused by the circular effect of slowing growth and higher prices is dangerous. The fate of the U.S. dollar is so significant an issue for the export activities of major developed countries that when the G-7 countries (U.S., Japan, Germany, Britain, France, Italy and Canada) met in April, the dollar was a topic of discussion. While nothing formally surfaced to address the status of the U.S. currency, it captured a lot of attention.

Recently, however, the dollar has found its footing against the currencies of our trading partners. This was triggered by a prevailing sense that the Federal Reserve is done cutting rates at the same time that many markets overseas are becoming worried about their own economic conditions. A more hawkish Fed policy could prove dollar-positive, as investors perceive the prospects are for higher rates in the U.S. as the Fed turns its attention from fighting to resuscitate the economy to battling the threat of inflation.

We expect the recent strength in the dollar against the major global trade powers to remain intact. Even though the U.S. is not yet out of the woods in solving our economic problems, there seems to have been ample stimulus applied. The combination of an aggressive Fed policy, tax rebates, housing reform and some relief in energy prices, which pumps needed incremental disposable income into the hands of consumers, should work to eventually turn the economy around.

If efforts to reflate the U.S. economy succeed, the dollar will strengthen measurably on improving fundamentals, rather than as a better option to other countries doing worse. The dollar's secular strength will announce that America is back to fighting weight. For investors, that will be good news as the U.S. stock market will likely follow suit.



## Stock Market Commentary

By Gregory M. Drahuschak, Vice President

Supposedly, those who do not learn from history are doomed to repeat it. History, at times, however, can be misleading.

Due to some significant market bottoms set in October, many investors view October as the worst month of the year; but that dubious distinction belongs to September. Going back to 1928, September has produced an average 0.57% loss, which far outdistances February's average 0.03% loss. These two months are the only months with average losses.

The S&P 500 did not reach its current configuration until 1950. Unfortunately, considering only data from that year until now does not show improved results. From 1950 through last year, the S&P 500 has an average 0.61% loss. September also is the only month where the odds of the S&P posting a gain are less than 50% (43%).

### Ten Biggest Losses in September

1974	-11.93%
2002	-11.00%
1986	-8.54%
2001	-8.17%
1957	-6.65%
1960	-6.25%
1981	-5.38%
2000	-5.35%
1956	-5.30%
1990	-5.12%

Source: Janney Montgomery Scott LLC

### Ten Biggest Gains in September

1954	7.56%
1998	6.24%
1996	5.42%
1997	5.32%
1950	4.85%
1958	4.29%
1973	4.01%
1995	4.01%
1988	3.97%
1968	3.85%

Source: Janney Montgomery Scott LLC

In the months in which the S&P 500 has posted a gain in September, the average increase has been 3.12%. In losing Septembers, the S&P, on average, has fallen 3.43%. Historically, it has not mattered whether you were a large or small cap stock owner: both were treated poorly in September – although for small caps, September was only the second worst month. July has had the 'honor' of being the worst month for small caps. Despite September's long-term record, it is interesting that the S&P 500 has posted gains in the month every year since 2003. Additionally, in the election years since 1944, the S&P 500 has posted an average 4.4% gain in September.

In the last few years, however, seasonal factors have had much less than their normal influence on trading. August was hit with an onslaught of negative news, including the late-month threat of a major hurricane hitting the Gulf coast; but despite this, August bucked its historic trends as the Dow Jones Industrial Average, the S&P 500 and the NASDAQ

Composite all posted gains. On average, since 1950, the market has posted a fractional loss in August. This year, September will be driven much more by other factors that could allow the S&P to fare much better than history suggests it might.

Mark Luschini's article in *Investment Perspectives* addresses one of this month's key issues. As Mark points out, the dollar has been on the rise and there are solid reasons to think that it can continue its upward movement. Although many U.S. firms have benefited from the lower dollar, which has lifted U.S. export volumes, over the long-term, the U.S. equity market tends to perform better in periods when the dollar is strong.

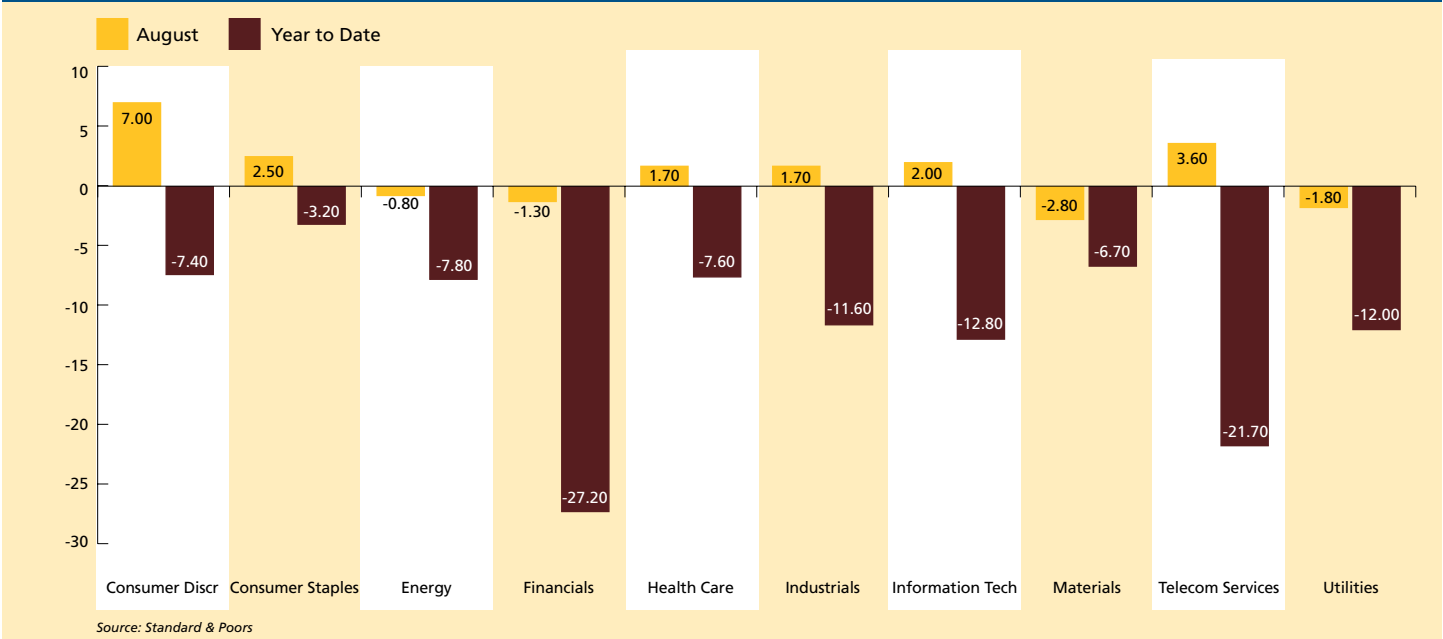
Guy Lebas addresses the second major issue that could impact stocks this month. The fate of the government sponsored enterprises (GSEs), Fannie Mae (FNM) and Freddie Mac (FRE), will be significant. Our view is that there is a wide range of outcomes that would be acceptable to the market if the resolution looks like it can remove the issue from daily headlines.

Taking into consideration recently reported data on the U.S. Gross Domestic Product, various manufacturing measures, consumer confidence and durable goods orders, it probably is not merely coincidental that August trading suggested that the market was trying to establish a base that could take the S&P 500 up and out of the trading range that has constrained the market for many weeks.

While the market appeared to spend most of August base-building, we would not anticipate that any upside move will be strong enough to break the upper boundaries of a long-term trend channel just above 1400. The primary reason we suspect this level represents an optimal intermediate-term objective is that the problems that have plagued the market for many months are far from being totally resolved. Even a favorable resolution to the GSE situation would only be one step toward easing the credit problems and the housing malaise. In addition, there is overhead technical resistance in the Dow and S&P 500 that could be restraints as we move toward the end of this year.

If energy prices continue to fall, market and consumer sentiment could improve significantly which, on a short-term basis, could provide a catalyst for the market to edge above the prior trading range. Remember that the slide in the price of gasoline from its July peak has potentially added approximately \$100 billion dollars to consumer spending in areas other than energy. Although there are many credit market issues remaining, the market at the start of September suggested that there was a growing feeling that the worst of the news is behind us. Sector activity could provide a good hint that the market is ready to embark on a longer-term recovery.

## S&P Sector Results



We would be watchful for a major change in sector leadership. Rallies led by energy and materials would not indicate that the market's prior biases have changed. After all this time of lackluster market activity, new leadership is almost a requirement for the market to establish a durable upswing.

At worst, the market could remain in an extended period of base-building. How soon the market can move out the current range could depend heavily on the fate of the dollar and how long it will take the market to discount a resolution to the credit issues. As this month began, however, the potential of breaking out of the trading range clearly was better than they had been for several months.

2008 Market Data		Prior Close	Last	Change	% Daily	% Yearly	% Jan	% Feb	% Mar	% Apr	% May	% June	% July	% Aug	1st Quarter	2nd Quarter	3rd Quarter
DJ Industries	.DJIA	11715.18	11543.55	(171.63)	(1.47)	(12.98)	(4.63)	(3.04)	(0.03)	4.54	(1.42)	(10.19)	0.25	1.45	(7.55)	(7.44)	1.72
S&P 500	SPX	1300.68	1282.83	(17.85)	(1.37)	(12.64)	(6.12)	(3.48)	(0.60)	4.75	1.07	(8.60)	(0.99)	1.22	(9.92)	(3.23)	0.22
NASDAQ Comp	COMP	2411.60	2367.50	(44.10)	(1.83)	(10.74)	(9.89)	(4.95)	0.33	5.87	4.55	(9.11)	1.42	1.80	(14.07)	0.61	3.25
SOX Index	SOX	358.81	362.83	4.02	1.12	(11.50)	(12.48)	(0.28)	(5.18)	15.26	4.04	(9.28)	(7.36)	6.45	(17.25)	8.79	(1.70)
Biotech Index	BTK	835.63	831.22	(4.11)	(0.53)	5.69	(4.72)	(3.66)	2.14	1.10	1.78	(2.76)	17.12	(3.81)	(6.24)	0.05	12.66
DJ Transports	.TRANS	5140.05	5103.40	(36.65)	(0.71)	11.66	3.97	(4.24)	5.13	8.03	5.21	(9.00)	0.25	0.62	4.67	3.43	3.14
DJ Utilities	.UTIL	486.14	477.52	(8.62)	(1.77)	(10.33)	(5.61)	(5.01)	0.31	6.58	2.18	(0.15)	(6.91)	(1.52)	(10.05)	8.74	(8.32)
Volatility Index	VIX	19.43	20.65	1.22	6.28	(8.22)	16.44	1.30	(3.50)	(18.82)	(14.24)	34.32	(4.22)	(9.98)	13.82	(6.48)	(13.78)
S&P Midcap 400	MID	824.99	815.60	(9.39)	(1.14)	(4.96)	(6.24)	(2.00)	(1.14)	7.61	5.14	(7.14)	(1.95)	1.57	(9.17)	5.06	(0.41)
S&P 100	.OEX	599.84	590.83	(9.01)	(1.50)	(13.83)	(6.21)	(4.58)	0.01	4.45	(0.29)	(9.08)	0.49	1.19	(10.49)	(5.32)	1.68
Gold EFT	GLD	82.18	81.71	(0.47)	(0.57)	(0.91)	10.84	5.23	(6.00)	(4.16)	0.92	4.52	(1.44)	(9.29)	9.64	1.10	(10.60)
Russell 1000 Index	.RUI	711.46	702.17	(9.29)	(1.31)	(12.21)	(6.11)	(3.27)	(0.84)	4.96	1.62	(8.47)	(1.30)	1.17	(9.94)	(2.37)	(0.15)
Russell 2000 Index	.RUT	747.79	739.50	(8.29)	(1.1)	(3.46)	(6.88)	(3.80)	0.26	4.10	4.48	(7.83)	3.60	3.50	(10.19)	0.25	7.23

Source: Standard & Poor's

## A Brief History of GSE Time

By Guy LeBas, Vice President



There's been a great deal of concern and speculation with regard to government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac put forth in the month of August, much of it triggered by scathing press reports of credit quality at the two companies. While the two agencies certainly do have their share of problems—after all, they are by charter required to invest in the housing markets, and everything housing-related has proven troublesome—we believe it's too early to know for certain what the outcome of the current situation will be. More specifically, we are not yet convinced that the federal government will need to immediately provide assistance to the two companies, as both firms remain well capitalized by regulatory standards. We are similarly unconvinced that any assistance will be quite as destructive to the companies' capital structures as many analysts have suggested; but against this backdrop of uncertainty, it feels appropriate to share some background on the two GSEs and differentiate among the various elements of their capital structures.

The Federal National Mortgage Association, more commonly known as FNMA, or Fannie Mae, was founded in 1938 as a component of FDR's New Deal legislation in order to provide liquidity for stressed banks to sell mortgage loans. Thirty years later, after a period in which Fannie Mae was the near-exclusive source of secondary mortgage liquidity, it was converted to a corporation which then went public in 1970. Fannie's little brother, the Federal Home Loan Mortgage Corp (FHLMC, or Freddie Mac) was formed by the government in 1970 to aid Fannie in providing secondary market liquidity for mortgage lenders and to prevent the then-public Fannie from enjoying monopoly status. While both companies are termed "GSEs" or "agencies," their ties to the federal government have been limited since going public. Recent legislation notwithstanding, those ties have largely been restricted to regulation by the FHFA (formerly OFHEO) and, what's of more concern for most investors, an implicit "moral" backing. While Fannie and Freddie debt and guaranteed mortgages are not explicitly backed by the federal government, the firms are often considered a moral obligation that the government will support in periods of stress.

Fannie Mae and Freddie Mac have grown over time to be two of the largest financial companies in the U.S., with total assets of \$886 billion and \$879 billion, respectively, as of June, 2008. In addition to these owned assets, both companies guarantee the credit quality of mortgage bonds which they then sell to investors in the amount of \$2.6 trillion for Fannie and \$1.8 trillion for Freddie. In order to fund their assets, Fannie and Freddie issue a total of around \$1.5 trillion in debt and are required

	Fannie Mae	Freddie Mac
Mortgages Owned	\$758 billion	\$792 billion
Mortgages Guaranteed	\$2,556 billion	\$1,823 billion
<b>Total Mortgage Portfolio</b>	<b>\$3,048 billion</b>	<b>\$2,202 billion</b>
Senior Debt	\$782 billion	\$831 billion
Subordinated Debt	\$11 billion	\$5 billion
Preferred Stock	\$22 billion	\$14 billion

*Source: Company Reports, July 2008*

by regulators to have outstanding a certain amount of capital in the form of subordinated debt (combined \$17 billion), preferred stock (\$36 billion), and common stock. These three types of capital serve to protect senior debt and mortgage guarantee holders in the event that losses at GSEs overwhelm quarterly revenues, which has been the case for much of the past twelve months.

In the current environment, Fannie Mae and Freddie Mac are the only real providers of mortgage market liquidity and, therefore, the only real source of consumer credit availability. While the total amount of Fannie/Freddie mortgages outstanding—approximately 43% of the total \$12.1 trillion U.S. mortgage market—represent less than half of the market, Fannie and Freddie are purchasing and/or guaranteeing an overwhelming portion of mortgage loans being originated in today's stressed markets. As such, they're a crucial component in the solution to our credit crisis. For that reason, as well as the systemic risks that the default on a total of \$7.56 trillion in debt pose, the consequences of Fannie and/or Freddie failing are quite literally inconceivable and the probability of government support of GSE debt and mortgage guarantees quite strong.

The real question with regard to the GSEs isn't the stability of these senior obligations, but rather the comparatively small amount of items further down in the capital structure, particularly subordinated debt and preferreds. While we believe that government intervention, if necessary, will ultimately support Fannie and Freddie subordinated debt and preferreds, these securities have, over time, shifted from low to moderate risk income investments to outright speculative bets. While taking such a bet may appeal to more risk-seeking investors, we nonetheless believe the GSE sub debt and preferred sectors should be approached with caution.

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