



## 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.

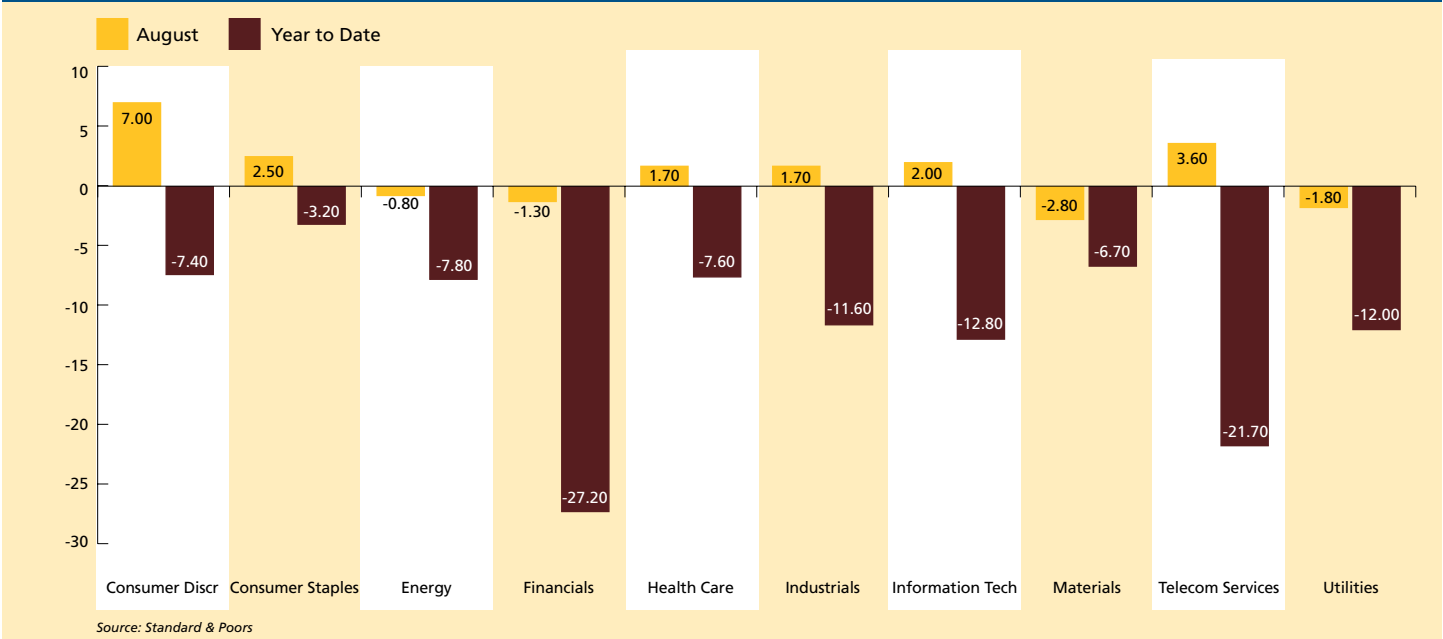
Guy Lebas addresses the second major issue that could impact stocks this month. The fate of the government sponsored enterprises (GSEs), Fannie Mae (FNM) and Freddie Mac (FRE), will be significant. Our view is that there is a wide range of outcomes that would be acceptable to the market if the resolution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

As this month began, the Treasury move to place Fannie Mae (FNM) and Freddie Mac (FRE) under conservatory control was a significant step toward easing the credit market logjam. This move does not fully remove mortgage issues from consideration, but it could make them less of a drag on stocks.

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

## Fannie and Freddie Government Intervention

By Guy LeBas, Vice President



For the second time in twelve months, governmental authorities exercised the nuclear option and assisted in the takeover of a major U.S. financial institution. Last March, it was the Fed-funded buyout of Bear Stearns; this September, it was the Treasury takeover of mortgage companies Fannie Mae and Freddie Mac. Treasury Secretary Henry Paulson announced that the Federal Housing Finance Authority (FHFA) would be placing the two government sponsored enterprises (GSEs) into a conservatorship, a legal mechanism that allows regulators to eliminate shareholder rights and seize the reigns of a company. The move follows several months of speculation with regard to the future of Fannie and Freddie, speculation which was touched off by extensive losses in the two companies' mortgage portfolios. As Paulson himself alluded to, Fannie and Freddie are unique in that they are required by charter to invest exclusively in the mortgage sector; given growing homeowner default rates and the resulting losses that sector has experienced, it's no surprise that the two companies experienced stresses. It is, however, somewhat of a surprise that the Treasury elected to take such aggressive action that will likely end the tenure of Fannie and Freddie as profit-generating public corporations, at least in their current form.

As the ongoing mortgage crisis spilled over from the subprime sector into the prime mortgage arena in early 2008, government agencies Fannie Mae and Freddie Mac, which guarantee the credit of a combined \$5.2 trillion in mainly prime mortgage loans, began to accrue significant losses. The resulting declines in the market value of GSE equity was a strong indication that the companies would face challenges in servicing their mortgage guarantees and paying on their own \$2.3 trillion in debentures without government support. In recent weeks, the debate shifted from the stand alone credit quality of the two entities to how the Treasury would choose to support the companies. The recent announcement from Treasury Secretary Paulson ended that debate rather abruptly.

The Paulson plan to support Fannie and Freddie centers on protecting the financial markets from the systemic risks that the default on \$7.5 trillion of mortgage guarantees and debt would pose. In fact, the total outstanding obligations of the two GSEs dwarf those of the U.S. Treasury, which has approximately \$5.1 trillion of bills, notes and bonds outstanding. In order to provide the necessary support, the Treasury is embarking on a four stage process that will ensure mortgage and debt holders are protected against credit losses:

**Step 1:** Fannie and Freddie have been placed into a conservatorship which permits the FHFA to operate the companies in a manner they see fit; namely, in such a way as to protect mortgage and bond holders at the expense of other categories of GSE investors. We believe this move is arguably the most destructive to common and preferred stock value, as it effectively permits the companies to ignore the legal right of equity investors to manage a company in their best interests. One of the conservator's initial actions has been to suspend all common and preferred

stock dividends indefinitely, thereby preserving capital and irrevocably impairing the value of outstanding common and preferred equity.

**Step 2:** The Treasury will exercise its recently-achieved ability to invest in the two companies by purchasing \$1 billion of a new class of 10% "senior preferred stock" and warrants that equate to a 79.9% ownership in each of the GSEs. In addition, the Treasury has entered into agreements to provide up to an additional \$100 billion (chosen more for its symbolic significance than for any expectation of actual losses) investment in senior preferreds in the two companies over time, such as to ensure that the net worth of the firms remains positive. While the general form of this investment is as expected, it's the attachment point that is likely to prove most troubling. The Treasury is making its investment at a level senior to currently-outstanding preferreds and, as we've seen, will effectively have the ability to manage the company as it sees fit. The net result is that the Treasury can be expected to take actions that protect its investment as well as those higher in the capital structure (i.e., mortgage guarantees, outstanding bonds, and subordinated debt) at the expense of those lower on the capital structure (i.e., common and preferred stock). Beginning in 2010, the two GSEs are scheduled to pay the Treasury a quarterly fee in exchange for providing this guarantee of positive net worth. In addition, the Treasury has placed a cap on the two companies' mortgage portfolios of \$850 billion by year end 2009, declining by 10% per year thereafter until that cap falls to \$250 billion.

**Step 3:** The Treasury will establish a lending facility to the two entities—as well as the Federal Home Loan Banks—dubbed the GSE Credit Facility. This GSECF will provide an unlimited liquidity backstop for the three agencies in exchange for eligible collateral, which consists only of GSE-wrapped mortgages and FHLB "advances," which are loans the GSE makes to banks and thrifts. This GSECF backstop is an important measure in protecting current bondholders against insolvency risks that stem from the GSEs' potential inability to roll over maturing debt. While the risks of such inability are slim given the new government backing, this liquidity protection does provide for the elimination of short-term "run on the bank" type problems that could theoretically threaten the companies' debt.

**Step 4:** In order to "promote market stability, ensure mortgage availability, and protect the taxpayer," the Treasury will begin using its authority to purchase agency-guaranteed mortgage-backed securities. While details of this last element remain few, the Treasury plans to hire independent asset managers to acquire mortgages in the open market. This last maneuver should go a long ways to reducing the cost of mortgage credit; as the Treasury begins to buy Fannie/Freddie guaranteed mortgages, spreads in the sector will begin to narrow, thereby pushing mortgage rates lower and providing cheaper credit and greater availability for homeowners.

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