

Credit Crunch Thawing

Welcome to the first edition of Pacwest's Mid-Month Market Cycle Monitor. The purpose of this monthly communication is to provide regular updates as to the current stage of the domestic economic cycle, our view as to what we expect in the near term, and how we expect to adjust the asset allocation of investment portfolios in light of changing economic conditions.

As I am sure you are most likely aware, the U.S. economy is currently in the downward stage of the business cycle. The Index of Coincident Indicators declined in September at a higher rate than the Index of Lagging Indicators, which implies that the economy is not yet seeing a light at the end of the tunnel.

However, the financial markets tend to lead the economy because investors take actions based on expectations of the near future. Therefore, we expect the stock and bond markets to advance prior to any reversals in the Coincident or Lagging Indicators. The S&P 500 Index is actually one of the components of the Index of Leading Economic Indicators which actually turned up in September despite a declining stock market.

The path of the business cycle follows a regular pattern, however, the timing of that pattern can vary widely, which is one reason why market timing is so difficult.

In a normal business cycle, we would expect that peaks in the Coincident and Lagging Economic Indicators to be followed by downturns in Consumer Credit, the Producer Price Index (PPI), and the Consumer Price Index (CPI). Indeed, as all three of these indicators have peaked and turned downward, inflation is no longer considered a current concern, which facilitates the Federal Reserve's ability to lower interest rates and thus stimulate the economy back to expansion.

The Fed actually began reducing short term interest rates in September 2007 (despite inflation concerns at the time) in order to ease pressure on the financial industry that is coping with troubled mortgages and real estate loans.

While the Federal Funds Rate, 3 Month T-Bill Rate, and the Prime Rate have all declined considerably over the past 13 months, **longer term interest rates have remained stubbornly high** due to the credit crunch. The 10 Year U.S. Treasury Bond remains in the 3.5% to 4% range in which it has been trading throughout 2008. Conventional Mortgage rates also

remain in the 5.5% to 6.5% range. Meanwhile, Corporate Bond rates and Municipal Bond rates have turned upward since the summer in response to illiquidity in the credit markets.

In the average business cycle, **it normally takes a little over 6 months for declines in short term interest rates to result in lower longer term interest rates**, however, in the past 10 business cycles since 1948, this time frame has varied from 1 month to 10 months. Given that, **in this current business cycle we have now waited 13 months** for declines in short term rates to affect longer term rates indicates that the mortgage crises and credit crunch are prolonging this stage of the cycle.

Historically, in 3 of the past 10 business cycles since 1948, the stock market bottomed prior to the peaks in long term interest rates and in 5 of these 10 cycles, **the stock market bottomed in the same month that longer term interest rates peaked and turned downward.**

In a normal business cycle, we would expect that lower interest rates would result in a credit expansion as evidenced by an upturn in the M2 Money Supply. Normally, by the time we see the increase in M2, the stock and bond markets have already bottomed and turned upward.

Therefore, **we are currently watching for evidence that the credit crunch is abating** so that longer term interest rates can decline and thus begin the next expansionary stage in the business cycle.

Since mid October, the 1 Month and 3 Month LIBOR rates, as well as the 1 Month U.S. Commercial Paper rate have peaked and turned downward. **This provides the first signs that the frozen credit markets are thawing.**

While the media is currently reporting all the bad news, please have faith that **the business cycle will turn up again**, as it has after each of the prior 10 downturns since 1948.

ASSET ALLOCATION: We have been raising cash by selling stocks on stock market rallies, and slowly reinvesting this cash back into stocks where we see opportunities. We expect to decrease excess cash, reinvesting back into bonds and stocks as we see more evidence of declining long term interest rates.

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