



RICHMOND CAPITAL MANAGEMENT
Experience, Knowledge, Service

Third Quarter 2008

Interest Rate Trends

Quarterly Newsletter

The course of interest rates in the third quarter of 2008 was driven less by economics than by the liquidity crisis that gathered momentum throughout the period. Treasury rates fell (particularly in the short end) as investors “headed for the exits” of riskier asset classes. For the quarter, the 5-year U.S. Treasury note fell in yield by 35 basis points while the 3-month T-bill dropped 85 basis points. Meanwhile, interest rates for all other fixed income sectors rose dramatically as investors became increasingly fearful and liquidity dried up. When the market starts to return to normalcy, bond buyers will refocus on the economic picture ahead.

Index Returns			
	Qtr.	1 Yr.	3 Yr. Ann.
Lehman Aggregate	-0.49%	3.65%	4.15%
Lehman Govt/Credit	-1.64%	2.41%	3.60%
Lehman Int. Govt/Credit	-1.19%	3.13%	4.03%

Source: Lehman Brothers (Barclays Capital)

As of September 30, 2008

Treasury Market Yields		
	9/30/08	6/30/08
2 Year	1.96%	2.62%
5 Year	2.98%	3.33%
10 Year	3.82%	3.97%
30 Year	4.31%	4.52%
Commodities		
Oil (\$ bal)	\$105.26	\$140.00
Gold (\$/oz.)	\$955.60	\$928.30
CRB Index	\$345.50	\$462.74
Spread Product (Spread to 10 Yr. Treasury)		
10 Yr. “A” Corp	+2.64%	+2.03%
GNMA Current Coupon	+1.74%	+1.71%
10 Yr. “AA” Municipal	+0.54%	+0.03%

Economic Activity

➤ Second quarter **GDP** was recently finalized at 2.8% and third quarter GDP is expected to be solidly positive too. Exports have contributed significantly although with new dollar strength that trend may reverse. GDP statistics are far from recessionary by the textbook definition, but recession is here as measured by other data.

➤ The **Employment** series was released on October 3rd. Nonfarm Payrolls contracted by -159,000 jobs, while the Unemployment Rate held steady at 6.1%. Employment trends will surely weaken further in the near future as a result of the ongoing credit crisis. In the month of September, job cut announcements were 33% higher than last year according to Challenger Job Cut data.

➤ **Housing** values continue to decline. The S&P/Case Schiller Index fell 16.3% (YOY) in September and has been in decline for 18 months straight. The housing market was on the leading edge of the U.S. boom cycle and now leads the bust cycle rippling through the economy.

➤ The September **consumer sentiment** survey from the University of Michigan printed at 70.3 down from 73.1 in the prior month. The Conference Board survey came in at 59.8, up from 58.5 prior. Both surveys may be exhibiting some strength due to lower gas prices.

➤ Consistent with the sentiment surveys, consumer spending had not yet shown a decline as of the August data. **Personal Spending** held even at 0.0% with **Personal Income** up 0.2%.

Inflation & The Federal Reserve

The Federal Reserve has held the Fed Funds rate steady at 2.00% for the past four FOMC meetings. There is some speculation that the current credit crisis could force them to take the key lending rate lower at the next meeting on October 29th. However, many believe that lower rates do not matter in this environment and that non-traditional measures to restore confidence are far more important. Inflation is running at 2.4% as measured by Core PCE and at 5.4% as measured by the CPI (Core CPI is 2.5%).

Conclusions

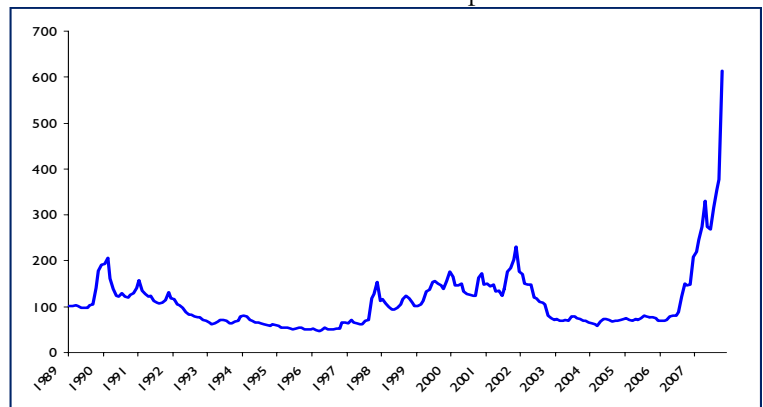
Inflation is high and real Treasury rates are far too low by historical valuation measures. Obviously however, history can be put aside in the current market scenario. The marketplace is forecasting a big economic slowdown and expecting deflationary fallout from that slowdown. By historical measures, corporate bond and mortgage bond rates are generous. But the marketplace is again willing to put history aside temporarily in a chase for safety.

Once in a Lifetime

The month of September, 2008 will long be remembered for financial volatility. In short order, the Federal Government placed Fannie Mae and Freddie Mac into conservatorship, Lehman Brothers filed for bankruptcy protection, the U.S. Treasury offered a lifeline through a secured line of credit to AIG (a large insurance company with tentacles throughout the financial system), Merrill Lynch was quickly acquired by Bank of America, Washington Mutual became the largest deposit-taking institution in the U.S. to be declared insolvent and their banking operations sold to JPMorgan, Wachovia sold their banking operations to Citigroup (Wells Fargo has subsequently made an offer for Wachovia) with the assistance of the FDIC, and the much anticipated legislation attempting to relieve stress in financial institutions failed to receive a majority of votes in the House of Representatives. Individually, each of these events could be considered a “once in a lifetime” event, yet they all occurred within the span of one month!

What were the impacts on the markets? **Credit spreads widened to levels far in excess of levels witnessed before.** In the adjoining chart, the credit spread for financial bonds (as measured by the Lehman Brothers Financial Institutions Index) is depicted for the last 20 years. Note that through all previous recessions and other financial maladies of this period, the index never approached levels seen today. **At the core of the widening was a continuous loss of confidence in financial and political institutions.** These

Financials Index Credit Spread



Source: Lehman Brothers (Barclays Capital)

events can be seen in the movement of 3 month LIBOR, which is the level at which banks loan money to each other. This rate was stable early in the month at 2.81%, but by September 30th the level increased to 4.05%, and indeed traded above 7.00% intraday during the month. Even with this elevated rate, banks were reluctant to lend to one another during this period of turmoil and credit markets saw a steep drop in liquidity.

Stocks also dropped, with the Dow Jones Industrial Index off approximately 6% for the month of September, led by the 777 point drop on September 29th when the financial recovery legislation failed. Interestingly, the Dow Jones Regional Bank Index was actually up 6% even though regional bank bonds were among the worst performing credit sectors. The uncertainty was good for gold, which registered a 7.5% gain. Positively for consumers, with future economic growth called into question, oil dropped to below \$100 per barrel. The appreciation of the U.S. dollar from 1.4516 to 1.4073 versus the euro could have both positive and negative effects on our economy. Beneficially, a stronger dollar helps attract foreign investments particularly into the capital markets which are in need of additional capital. However, the one bright spot in our economy has been strong exports, and a strong dollar tends to make our products less attractive abroad. While the rescue plan being debated before Congress could be a big step to instill confidence back into the financial system, investors still remain wary due to these “once in a lifetime” events and financial sector credit spreads from a valuation standpoint have never looked more attractive.