

Dynamics



3rd Quarter Market Commentary & Outlook

Market Performance

The financial markets experienced incredible volatility during the third quarter, highlighted by the dramatic changes within the financial industry in the last few days of September. Stocks were weak across the board for the quarter, led lower by developed and emerging markets which were threatened by signs of weakness in global demand. Domestically, growth stocks were hit hard during the quarter, followed by mid-caps and the tech-laden Nasdaq Composite. U.S. Treasury bonds gathered steam as the period progressed, driven higher by a flight to quality as the credit markets seized up in September. After peaking in mid-July, commodities weakened considerably and the dollar stabilized. See the accompanying chart for more details of Market Performance.

Financial Crisis & Policy Response

Over the past several weeks, the combination of weaker growth and tighter credit led to a "financial market frenzy" resulting in the biggest transformational period in the history of Wall Street. The financial crisis that began in August 2007 quickly moved into uncharted territory, as excessive leverage and growing counter-party risks weighed on investor confidence in the nation's leading financial institutions. Federal Reserve Chairman Ben Bernanke and Treasury Secretary Henry Paulson, along with other public and private sector leaders, have attempted several extreme and innovative measures in order to limit the deterioration in credit market conditions. Indeed, these changes to the landscape of the financial industry have been gargantuan, with the futures and fortunes tied to such institutions as Fannie Mae, Freddie Mac, Lehman Brothers, Merrill Lynch, AIG, Washington Mutual and Wachovia having been forever altered.

Each of these cataclysmic experiences was characterized by attempts in varying degrees to balance free-market principles along with federal support of market confidence. Moreover, many dramatic and innovative steps were taken by the Fed, Treasury, the FDIC and the Securities and Exchange Commission in order to better enable the economy, and the financial markets, to emerge from this unprecedented crisis. For example,

Market Performance as of 9/30/08

<u>Equities</u>	<u>9/30/08 Level</u>	<u>SEPT TR*</u>	<u>QTD TR*</u>	<u>YTD TR*</u>
Dow Jones Industrials	10,850.66	-5.8	-3.7	-16.6
S&P 500	1,166.36	-8.9	-8.4	-19.3
NASDAQ	2,091.88	-11.6	-8.8	-21.1
Russell 2000	679.58	-8.0	-1.1	-10.4
S&P MidCap	727.29	-10.7	-10.9	-14.3
Russell 1000 Growth	482.13	-11.6	-12.3	-20.3
Russell 1000 Value	632.15	-7.3	-6.1	-18.9
MSCI EAFE	1,553.15	-14.5	-20.6	-29.3
MSCI (Emerging Markets)	786.92	-17.5	-27.0	-35.5

<u>Fixed Income</u>	<u>9/30/08 Level</u>	<u>SEPT TR*</u>	<u>QTD TR*</u>	<u>YTD TR*</u>
10-Year Treasury	3.83	0.2	2.3	4.4
Lehman Aggregate	5.28	-1.3	-0.5	0.6
Lehman Municipal	4.71	-4.7	-3.2	-3.2
Lehman Corporate	7.83	-7.8	-7.8	-8.6
Lehman High Yield	13.92	-8.0	-8.9	-10.1
Lehman Mortgage	5.47	0.8	1.9	3.8
Lehman Global ex. US	3.19	-1.8	-4.2	0.8

<u>Commodities & Currencies</u>	<u>9/30/08 Level</u>	<u>SEPT TR*</u>	<u>QTD TR*</u>	<u>YTD TR*</u>
CRB Index	343.22	-12.4	-25.8	-4.3
Crude Oil - WTI	100.64	-12.8	-28.1	4.9
Gold	880.80	6.2	-4.9	5.5
Trade Weighted Dollar	79.36	2.4	9.0	3.5

Source: Fastrack, Lehman Brothers, Bloomberg

*Total Return includes price appreciation & dividend income for equities.

Past performance is not indicative of future results. It is not possible to invest directly in an index.



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the Fed coordinated liquidity infusions of up to \$600 billion with other foreign central banks to improve the flow of credit throughout the financial system. Secretary Paulson was given the authority to increase purchases of mortgage-backed securities to help support the housing market. Treasury also created a new guaranty program for the \$3.5 trillion invested in money market funds. The Exchange Stabilization Fund will be financed with up to \$50 billion to insure both individual and institutional investors in all publicly traded money market funds.

In addition, the SEC recently took actions to eliminate naked short selling and requiring transparency for all companies holding short positions. Discussions have also intensified relative to the potential for flexibility in “mark-to-market” accounting rules, which many believe accelerated the demise of the aforementioned financial institutions.

The biggest proposal, however, was the Fed and Treasury’s sweeping plan to create an “RTC-like” structure to systematically remove illiquid assets from the balance sheets of financial institutions. The \$700 billion facility was proposed to address the capital inadequacy of banks with the idea that once bad assets were removed from their balance sheets, the banks would once again have sufficient capital and begin to start lending to one another. To be sure, the unwillingness of banks to act as effective transmission mechanisms for the massive accommodation in monetary policy is the crux of the problem. This may be best characterized by the Libor spread, which has catapulted higher in recent weeks, as those few institutions willing to lend are demanding dramatically higher interest charges than targeted rates. Admittedly, the plan’s cost is great but the cost of inaction may be greater. The challenges in the credit markets are very real and need to be addressed swiftly for if credit remains unavailable, the pain could quickly spread from Wall Street to Main Street.

U.S. Economy

In the aftermath of Bear Stearns’ collapse last March, we suggested that the economy may not be able to fully absorb the financial crisis without contracting by the first half of 2009. In addition, we anticipated that government spending and export growth would combine to help support GDP, albeit with below-trend growth, for the balance of 2008. Since stress in the credit markets has been building for over a year, the recent dislocations may only serve to magnify the problem: if banks aren’t lending to each other, they likely won’t lend to the rest of us.

Despite the crisis in housing and credit, though, GDP has held up relatively well thus far in 2008, expanding at an annual rate of +1.9% in the first quarter and +2.8% in the second quarter. Even the September quarter could experience fractional growth as exports and inventories continued to save the day. The growth indicators excluding trade, however, point toward a different direction, suggesting that gross domestic purchases barely held steady in the first half of the year. Manufacturing indicators continue to weaken, auto sales have dropped and the unemployment rate, already at 6.1%, appears headed higher. In addition, home prices continue to decline (-15% YOY) and excess inventories of homes-for-sale remain twice their historical average, suggesting a good case scenario for a potential bottom by the middle of 2009. Therefore, as the tailwinds from government spending and exports fade, and credit remains scarce, it looks as though recession may have already enveloped the U.S. as we enter the fourth quarter.

We expect that the duration, moreso than the magnitude, of economic weakness will likely prove the biggest challenge for consumers and investors over the next twelve months. Accommodative monetary and fiscal policies may run into hurdles by early next year, as concerns escalate regarding the dollar, the deficit, and inflation. The recent strength in the greenback may very well have more to do with weakening prospects overseas than with improving fundamentals domestically. Fiscal activity and the cost of the bailout are expected to pressure the federal budget deficit, likely limiting the next president’s ability to enact campaign spending plans. Relative to inflation, we look for shorter-term pressures to ease as declines in global growth, home prices, and wages act as strong offsets to the previous surge in energy prices. As a result, we anticipate more of a malaise, rather than a dramatic pullback, to characterize economic activity through 2009.



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Federal Reserve

Since the credit crisis began in August of 2007, Fed Chairman Ben Bernanke has been extraordinarily accommodative with interest rates, lowering the target for the federal funds rate from 5.25% to 2.00%. The central bank has also been very innovative, creating a variety of lending facilities for both depository and non-depository institutions in order to provide liquidity without the associated currency or pricing consequences. Furthermore, the Fed has taken a more active role in trying to stabilize the financial markets, perhaps best illustrated by its \$85 billion emergency loan to AIG, which helped thwart liquidation prospects for one of the few organizations on the planet that has a larger balance sheet than the Fed.

It appears that monetary policy makers may be counting on moderating domestic and global demand to limit pricing pressures in the months ahead. Given the volatility in the financial markets, the pressure is on to cut interest rates. While we watch how the Fed proceeds, we look for policy makers to “talk-up” the long-end of the curve, citing concerns about inflation and the dollar. By keeping the yield curve steep, monetary policy makers can help encourage banks to start the process of borrowing short and lending long, potentially minimizing the damage from the financial crisis. As a likely recession fully materializes by early 2009, we wouldn't be surprised for the Fed to cut the federal funds rate within the next several months.

Fixed Income

Problems in the credit markets steadily grew during the third quarter, reaching their peak in the last days of trading as investors flooded into shorter-term U.S. Treasuries, essentially freezing up credit. To be sure, what began as uncertainty in the beginning of the period relative to Fannie Mae and Freddie Mac escalated into a failed vote in the House of Representatives on the bailout plan at the end of September. Absent short-term Treasuries, credit dried up as the quarter progressed as spreads widened for all types of agency, mortgage, municipal, and corporate credits. It should also be noted that unlike prior experiences entering economic contractions, when the Fed typically raises short-rates and longer-term prices climb in a flight to quality, the yield curve remained steep during the quarter.

History has shown that as the economy begins to slow down, municipal and Treasury securities tend to perform best as investors flee for safety. We consider municipal securities as attractive given the recent widening of spreads, despite the combination of solid tax receipts, good credit quality, and default rates near zero. In addition, Treasuries may also find support as a flight to quality gathers strength, yet massive issuance may increase the concerns of fixed income investors, placing a potential lid on total return opportunities in the government securities market. Compelling returns may also be in play for some investment grade credits, as spreads appear to have already discounted a worst-case scenario for the economy. Given the late cycle emphasis of our outlook, though, it may still be a bit early for us to overweight high yield bonds. Since global central banks are likely to trail the Fed with further easing in monetary policy, we are employing risk-appropriate exposure for developed and emerging market debt primarily accessed through multi-sector bond funds.

Equities

Similar to the bond market, stocks experienced increased volatility throughout the quarter, highlighted by the dramatic, 777-point sell-off in the Dow Jones Industrial Average on September 29th. Signs of weakness in the economy, surging energy prices and disappointing corporate profits combined to keep a lid on stocks for much of the third quarter, yet it was uncertainty surrounding the credit crisis and the fate of the nation's leading financial institutions that also kept investors on edge. These concerns escalated as Congress debated the merits of the bailout package in the waning days of the period, as the S&P 500 Index finished the period near its lowest levels of the past three years.

From a technical standpoint, the market has obviously been extremely weak, as the S&P 500 hovers approximately 15% below its 200-day moving average. After peaking in the range of 1560 last October, the Index



Dynamics



has now fallen by more than 25%. Typically in bear markets, which tend to last 15 months, stocks fall by an average of 33% from their highs. It is important to note that when this crisis began, stocks were trading in-line with historical valuations (P/Es of 16-17x) compared to the start of other crises, when stocks were considerably overvalued, trading anywhere from 24x to 30x trailing twelve months (TTM) earnings.

In addition to the technical weakness, fundamentals are also fragile, burdened by the stress on the bottom lines of the financial sector over the past year. A common theme we have expressed the last several months has been that excluding financials, profitability for U.S. corporations is still relatively healthy. While we still agree with that assessment, we remain concerned that the lack of lending from banks, if not corrected in the near future, will soon shift the burden of profit losses to other industries in the coming year. Given the dramatic drop-off in lending activity, we suspect earnings for the second half of 2008 will come in well below consensus forecasts. As a result, we are lowering our operating earnings expectation for the S&P 500 to the \$75.00 range for this year and next. Typically during recessions, profits drop up to 20% from their peak, which was achieved on an annual four-quarter run rate of \$92.00 in the second quarter of 2007. It should be noted that a 2009 earnings forecast of \$75.00 remains approximately \$30.00 below today's average estimate. Considering our outlook for the economy, along with below average market interest rates and a return to typical inflation readings, we believe the S&P 500 Index will likely trade within a sustainable range of 1100 – 1300 over the next six months.

In this challenging environment, we continue to incorporate fully diversified strategies for our managed client portfolios in order to participate in market gains while limiting the potential for losses. Periods of economic weakness have previously been accompanied by increases in market volatility, allowing for active managers to typically outperform passive strategies. Moreover, since stocks typically bottom six months before the economy (and similarly rebound six months before the economy does), we encourage investors to remain focused on their long-term strategies at this stage of the market cycle. Indeed, the average bull market lasts four years and climbs by approximately 125%. It should be emphasized, though, that the market tends to climb by up to 15% in the first three months of a bull and more than 30% during the first year. If an investor misses those critical first stages, the power of compounding will prove

insufficient to match/exceed returns during the entire rally. Yet another argument, in our opinion, supporting “time-in” the market, as opposed to “timing” the market.

Conclusion

We recognize the serious challenges that are evident in today's financial markets. Meaningful and complex issues must be worked for our economy to move forward. There will be no quick fixes, and time and patience will be required. We also recognize recent market volatility has been primarily driven by fear, panic, and forced selling/deleveraging. It is extreme times like these when Warren Buffet finds opportunities to put more money into the market, rather than pull money from the market. We encourage our clients, unless there has been a change in financial circumstances, time horizon, or risk tolerance, to maintain their diversified, long-term strategy and most importantly, adhere to it, because the economy and the financial markets have a long and successful history of adaptability, recovery, innovation and growth.

We very much appreciate and value your business and will continue to work hard towards helping you achieve your financial goals and objectives.

- The Riggs Capital Management Team

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