



<u>3rd Quarter 2007</u>	<u>Close</u>	<u>Performance</u>
Dow Jones Industrial Average:	13,895.63	↑3.6%
Standard & Poor's 500 Index:	1,526.75	↑1.6%
10-Year Treasury Yield:	4.579%	

Investment Outlook **September 30, 2007**

Dear Investors,

The third quarter of 2007 was the most eventful quarter for the global capital markets in recent memory. It began quietly, with stocks pushing their way higher on the back of favorable earnings reports. The Dow Jones Industrial Average and several other stock indexes around the world reached their all-time highs in mid-July. Then July 19th arrived, and with it the beginning of a harrowing 9%+ drop over the next four weeks for the U.S. markets. The cause: a sudden evaporation of the risk appetite of investors that was triggered by a deepening U.S. mortgage debt crisis.

The selling gained momentum in August and a rare global credit crunch seized the markets, nearly putting a halt to inter-bank transfers, mergers and acquisitions activity, and the critically important commercial paper market. The Federal Reserve responded by dropping the discount rate (the rate at which it lends to banks) by half a percentage point to 5.75% and, along with other central banks, injected more than \$400 billion of liquidity into the global banking system. This seemed to be the proper prescription for the moment, for the selling subsided and credit markets began to thaw.

As September arrived, however, U.S. economic data worsened. Perhaps the biggest negative surprise was the August employment report. Instead of adding an expected 112,000 jobs, we lost 4,000 jobs. While employment has been soft for a number of quarters, this report marked the first employment decline in four years and was the first tangible indication that the housing downturn is beginning to broadly affect the job market. These weak numbers on the back of the lingering effects of the credit crunch prompted the Federal Reserve on September 18th to change its monetary policy and slash the Fed Funds rate by 50 basis points to 4.75%.

The milestones we reached in the markets during this tumultuous quarter are numerous and telling. Inflation fears ignited, sending gold to a 27-year high and oil to an all-time high of \$83 per barrel. Dollar bearishness increased as currency traders saw lower short-term rates as likely to cause further weakness in the U.S. currency. The greenback reached an all-time low versus the Euro (\$1.40 to €1.00) and is now equivalent in value to the Canadian dollar for the first time in thirty years.

Had you left at the beginning of the quarter and come back at the end, however, you would scarcely have known that anything significant had happened. By quarter's end, the S&P 500 Index had

clawed its way back from the depths of its July/August dive to post a gain of 1.6%--its fifth consecutive positive quarter.

Despite the quarter-ending numbers, the investment landscape has changed significantly since June. Credit is tighter for businesses and individuals alike. Banks are reluctant to loan. Subprime mortgage lenders are closing up shop by the dozens. Retail sales have softened. Broadly speaking, the U.S. economy continues to lag a runaway global economy and signs point to further slowing in the next quarter or two.

As regular readers of this letter know, it is my view that a slowdown in U.S. consumer spending is all but inevitable because of two factors: high energy prices and the continuing malaise in residential real estate. I believe many investors are in agreement with this view—yet the U.S. stock market has posted a very respectable year-to-date increase despite clear signs of a weakening domestic economy. Why?

Today, like no other time in history, the globalization of business and of capital markets is having a salubrious effect on U.S. equity markets. First, because the S&P 500 companies generate nearly half of their revenue overseas, they are taking advantage of the rapid economic growth overseas—particularly that in emerging markets. Second, while low short-term interest rates here put pressure on the value of the dollar, U.S. multinationals benefit from a declining dollar because it makes their products more competitive to foreign buyers. Third, a weak dollar makes U.S. assets cheaper for foreign investors—and the amount of investment capital controlled by individuals and institutions outside the U.S. is growing rapidly. Fourth, stocks still appear to be reasonably valued relative to real estate and bonds, their two main competitors for the affections of investors. Finally, the Fed's rate cut has offered investors a glimmer of hope that the housing and employment downturn will be softened, and they have begun to look ahead to an economic upturn.

In my view, the probability of a consumer-led recession has decreased markedly since the Sept. 18th 50 basis point rate cut. Business and personal spending depends greatly on confidence, and investors and consumers alike got a big boost of confidence from the Fed's larger-than-expected rate cut. It is hardly scientific, but the reality is that poor economic data simply matter less to the markets when an aggressive Fed is trying to stoke the economy.

As usual, I welcome your comments and feedback.

Best Regards,

Peter

Peter C. Thoms, CFA
Orion Capital Management LLC
1330 Orange Ave. Suite 302
Coronado, CA 92118
Tel: 619-435-1701 Fax: 619-435-1706
www.orioncapitalmgmt.com