

ECONOMIC REVIEW & MARKET UPDATE

September 2007

The saying “May you live in interesting times” is very appropriate given our current market environment. Since February of this year, the primary issues weighing on the markets have shifted away from geopolitical unrest and volatile energy prices to an ailing housing market, subprime mortgage woes, and liquidity concerns. Each of these factors has affected the equity and fixed income markets alike, with the ultimate fear being a recession. While volatility in the equity markets spiked in the latter part of the first quarter due to the suggestion of an impending recession by the former Federal Reserve Chairman, Alan Greenspan, it had settled down during the second quarter, and the equity markets began a series of record setting finishes. However, the third quarter saw volatility rise again to the highest level in four years as the declining housing market and concern over foreclosures surrounding subprime mortgage lending spread out like a web affecting the secondary market for these mortgage loans, as well as the financial institutions and funds that hold them in their portfolios. As mortgage defaults rose, some lenders were forced to close their businesses, while others tightened their lending standards. The combination of the increased need for credit and decreased availability of credit created ripple affects throughout the broader economy. When individuals and businesses find it difficult to borrow money, the economy typically slows down.

Despite these sector-specific concerns, much of the economic data had remained positive. We are just now beginning to see evidence of a slowing economy. Employment for the month of August fell by approximately 4,000 jobs. This marks the first time in four years that the US economy has lost jobs. Additionally, some recently released economic data has indicated that risks of inflation have decreased. The August producer price index showed prices paid to US producers rose just 0.2% after a mere 0.1% increase in July, indicating that the weakness in the economy is making it difficult for companies to pass on price increases to its consumers. The August report on import prices showed a decrease of 0.3%, the first decline in this inflation gauge in seven months. While gross domestic product came in at just 0.6% during the first quarter, it came roaring back in the second quarter with 4.0% annualized growth due to accelerated business spending and a surge in exports. However, the outlook for the second half of the year has soured as many economists are now forecasting below trend GDP growth of just 2.0% for all of 2007 due to the anticipated slowing of the economy.

As previously stated, July of this year saw equity markets repeatedly reach new record-setting highs. However, given the increased volatility driven by the housing and credit markets, equity markets experienced a very different August. During the month of August, the equity markets pushed through the first 10% decline threshold, marking the first “correction” in the equity markets in five years. Through 9/30/07, the S&P 500 is up 9.1%, the NASDAQ is up 11.8%, the MSCI EAFE, the benchmark for international stocks, is up 10.9% and the Russell 2000 Index, the benchmark for small cap stocks, is up 2.3%. Within the S&P 500, the leading industry sectors have been energy (+27.2%), materials (+20.5%), and industrials and technology (+15.8% and +15.6%, respectively). Both the financial and consumer discretionary sectors have shown negative performance year-to-date with returns of -6.8% and -4.3%, respectively.

Fixed income markets have been roiled by the repricing of credit risk. For some time now, investors have not been compensated adequately for the added risk that comes from purchasing corporate bonds. The yields on triple-A rated US agency bonds and single-A corporate bonds were nearly the same. However, during the past couple of months, we have experienced a divergence in these markets as the prices on corporate bonds have fallen and their yields have risen. Investors are finally demanding a greater return for assuming a greater degree of risk. The decline in corporate bond prices has presented excellent opportunities for fixed income investors. However, while corporate bond prices have fallen, investor’s flight to quality has pushed up prices on the high quality bonds, such as US Treasuries and agencies. Through the end of the third quarter, the Lehman Bros Aggregate Bond index has returned just 3.85%, with higher quality and shorter maturities outperforming the broader market.

Through the first eight months of this year, the Federal Reserve had maintained the current 5.25% target for the federal funds rate, noting that inflation was their primary concern as a threat to continued economic growth. However, when liquidity began to affect all areas of the financial markets, they stepped in. The Federal Reserve has been vigilant in ensuring adequate liquidity exists. Initially, they achieved this goal by purchasing securities during their daily open market operations. However, when that strategy proved insufficient, they lowered the discount rate, the rate at which banks can borrow money from the Federal Reserve, from 6.25% to 5.75%. This move was significant in that it was the first time the Federal Reserve acknowledged the volatility in the markets and the deteriorating liquidity situation. It wasn't until their September meeting that they decided to lower the federal funds target rate, which is the rate at which banks lend money to each other and is the rate which is most closely followed by market watchers. In a somewhat surprise move, they changed the target for this rate from 5.25% to 4.75%. They also reduced the discount rate another 0.50% to bring the rate to 5.25% at month end. They noted in their statement that "Today's action is intended to help forestall some of the adverse effects on the broader economy...and to promote moderate growth over time". They did, however, maintain their concern about inflation noting that they believe some inflation risks remain despite modest improvement.

While the futures markets are anticipating at least another ¼% reduction in the fed funds rate by year end, we do not believe that any additional rate cuts are necessarily imminent. We do believe that the Fed will continue to monitor the economic data as it is presented and make adjustments accordingly. We anticipate that the Fed will hold rates at its October meeting and, if necessary, reduce rates again at its December meeting. Fixed income markets should show marked improvement during the latter half of 2007 due to the Fed's recent decisions and provide fixed income investors with more normalized annual returns between 4.5% and 6.0%.

Given the Federal Reserve's recent policy change and continued strength in the corporate sector's profitability, we are still forecasting that equities will return between 7% and 10% for the year. Corporate profits remain strong as second quarter earnings for companies in the S&P 500 are coming in around 8%. While that is down from the double digit growth that has been reported over the past several years, it remains a solid number. Share repurchase programs and dividend increases continue to be announced as companies utilize their cash positions to increase shareholder value. We also believe that while the housing sector and consumer spending may have a negative affect on the domestic economy, there are other areas that will remain strong. For example, the industrial sector remains solid as evidenced by the positive industrial production numbers over the last several months. Finally, we believe that large-cap stocks continue to trade at a discount to their historic P/E multiples and present compelling opportunities for investors.

With the exception of Japan, international growth remains extremely strong with many economies reporting growth between 8% and 10%. China has seen its economy expand 11% in the last 12 months, while India's economy has grown 9.3%. Europe has seen more moderate growth of between 2.5% and 3.0%. Through the end of the third quarter, international markets have returned 10.9% as indicated by the MSCI EAFE Index. The weakness in the US dollar also contributes to strength in overseas markets. International markets still represent exciting opportunities for well-diversified portfolios and we continue to advocate international exposure in all of our diversified portfolios.

Given this outlook, we believe that both the equity and fixed income markets are poised to provide our diversified portfolios with solid returns over the next twelve months. We do not recommend any policy changes at this time and recommend that investors stay the course with their existing asset allocation strategies. If you have any questions or concerns or wish to discuss your account further, please contact your account representative.

Respectfully,

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