



ATLANTIC CAPITAL MANAGEMENT

THE CREDIT CRISIS DEEPENS

A 1930's Style Bank Run Brings Us to 1979?

SPECIAL INVESTMENT RESEARCH REPORT
NOVEMBER 23, 2007

Written By
Jeffrey P. Snider, Vice President

Additional Research Provided By
Steven Stejskal, Research Analyst

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INTRODUCTION

THE CREDIT CRISIS DEEPENS **A 1930's Style Bank Run Brings Us to 1979?**

Our August report detailed the crisis in the shadow credit market where derivatives roamed. That market has come under scrutiny since then as the trouble has spread throughout the banking system. The credit crunch we predicted in August has come to fruition, and has led to surreal events – an actual, 1930's style bank run in England. But that bank run was actually preceded by a mini run on US deposits. That event actually happened in the second week in September, where 7% of all transaction deposits were withdrawn from US commercial banks.

As unreal as that was by itself, it also occurred at the worst possible time. Left to pick up the pieces from the shattered credit markets, the banking system needed every dollar available. The Fed was forced to come to the rescue with a “surprise” 50 basis point cut. The stock market took that as sign that the Fed was trying to stimulate growth – that analysis is dead wrong.

The Fed knows that there are still inflationary pressures that need to be controlled. But on September 18 the Fed had to choose between fighting inflation or bailing out the banking system that was struggling for cash. It chose to ditch inflation to rescue the credit markets.

Ever since this crisis began banks have been loath to divulge their full exposure. That failure to come clean has fueled negative speculation. Based on our August report, we believe that negative speculation is more than warranted. Looking at the events of early September plus what we know about the credit derivatives markets, we feel that the worst is yet to come. The downside is not only a severe recession, but one with persistently high inflation. Stagflation may be our future and the Fed will have to choose, as it did in the early 1980's, between stimulating growth and inflation fighting. That choice is always a painful one.



Part One The Timeline of Events

The headlines for Monday September 17 were full of descriptions of long lines of bank customers in England trying desperately to get their money from Northern Rock Bank. The liquidity crisis that began more than a month earlier had led to speculation that the bank was no longer safe and deposits were at risk. Although England does have an FDIC equivalent, it is not as generous. Only the first 4,000 pounds are guaranteed, then only 90% of the next 59,000 pounds¹. Even smaller depositors were at risk.

But the run was really a function of the 21st century banking structure. The week before the run Northern Rock let it be known it was having trouble securing short-term funding and that it was running out of cash. By the weekend of September 15 depositors crashed Northern Rock's website trying to get cash out of the bank. Not knowing if the site would ever come back online led to the long lines of September 17 – which sounds like the 1930's when banks would close for a “holiday” and depositors were left to wonder if it would ever open.

So while Northern Rock got the headlines, the US banking system had what could be described as a mini-run. The week ending Friday September 14 saw 7.18% of all the transaction deposits of commercial banks withdrawn. That amounts to \$45.7 billion² in cash out the door. In the money supply figures it shows up in the M1 numbers, and a 2.3% (\$70 billion) decline in savings deposits at commercial banks the week of September 5. That would be distressing under normal circumstances, but these were far from normal.

Subprime mortgage derivatives started the ball rolling, but it was really the structure of the credit derivative market that was the trouble. As we detailed in the August report (Part 3, Page 7) the blackbox pricing models

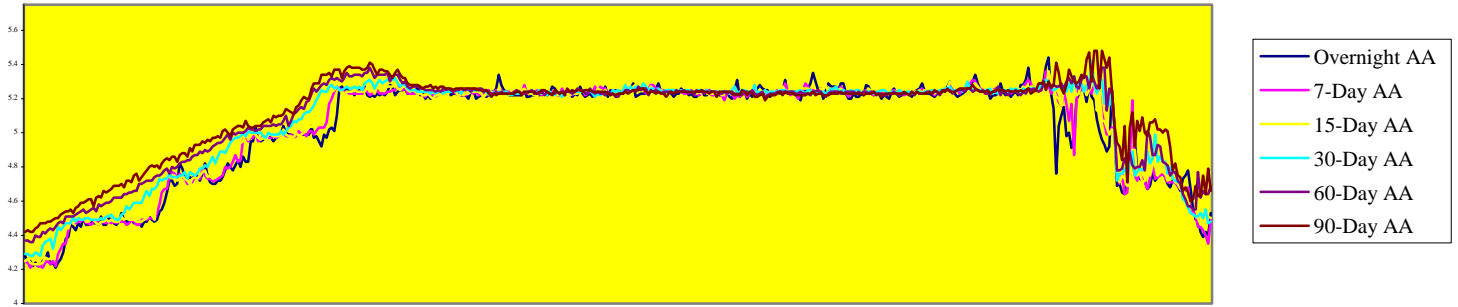
allowed losses to be hidden. But as rumors spread of losses of the Bear Stearns magnitude and analysis of the higher probability of losses (especially given the state of the housing market) lending to firms and entities to fund their purchases of asset-backed securities completely dried up in August. \$182 billion in commercial paper vanished that month alone – 15.4% of the total outstanding. Investors took their lending dollars and ran away from anything with the hidden losses or even the potential for hidden losses. The flight was to treasuries and stocks paying dividends (stocks became safer than commercial paper!).

The denial of asset-backed paper spread quickly to other sectors. Non-financial and financial commercial paper lending wilted - \$52.3 billion in the financial sector. Without access to the paper credit market companies began to access lines of credit as replacement funding since most had backup agreements in place long before the credit markets went south. Whether banks wanted to lend or not, they were stuck. And let's not forget that many of the largest banks were heavily interested in keeping the credit derivative entities afloat (August report, Part 3, Page 9). They had a vested interest in doling out additional funding to keep tide of losses in derivatives from becoming a tidal wave. The only way to do that was to make sure there were no fire sales.

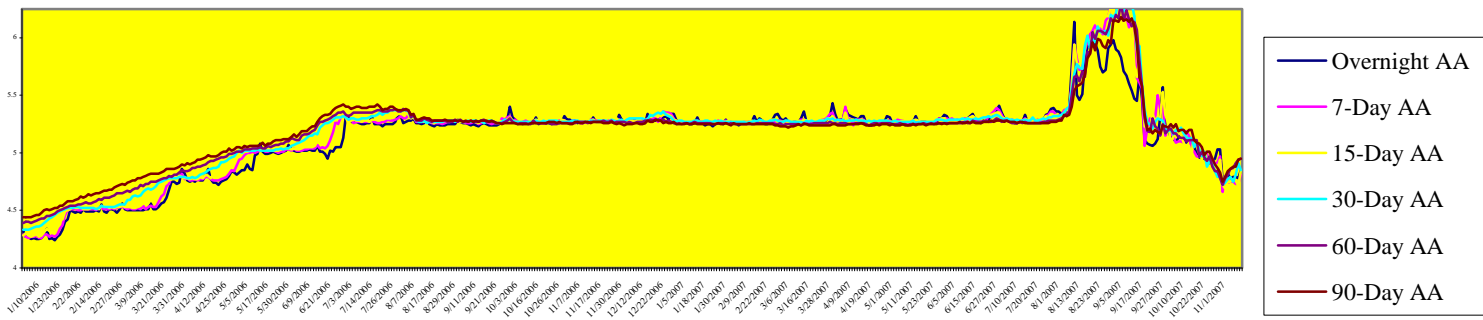
From the beginning of August thru the end of the mini-run, commercial loans increased nearly \$79 billion. Add to that a \$58 billion rise in the amount of “securities” on banks balance sheets as banks took back some loans from SPV's, and added loans that were warehoused for a securitization that was not going to happen. Although adding loans and growing bank credit sounds economically sound, these were not new originations adding to the money supply. They just



Financial Commercial Paper Rates - 1/1/06 thru Current



Asset-Backed Commercial Paper Rates - 1/1/06 thru Current



The Credit Crisis is as clear as an earthquake on a seismograph.

shifted from one balance sheet to another – shifting the burden of credit from individual investors (typically through money market funds) to the regulated world of the banking system.

Since banks have reserve requirements and capitalization ratios to maintain they needed additional liquidity to fund a large and unexpected expansion of bank credit. Suffering the same fate in the commercial paper market banks were in a tight spot. Central banks around the world bailed them out through liquidity injections (the Fed alone added \$150 billion in repurchase agreements), the amount of treasury securities on banking balance sheets declined. But even that was not enough, liquidity ratios continued to fall as lines of credit were drawn with new borrowing unavailable. With rumors of liquidity

problems from credit derivatives and subprime troubles, backed up by hard data from the credit markets, depositors began a mini-panic.

From the data available it is unclear which investors fled. But we believe that some investors made the decision to withdraw funds in accounts above \$100,000 (the FDIC limit, \$200,000 for joint accounts) and move them to another bank. This is somewhat shown by the 2.6% rise in transaction deposits the following week. But not all deposits came back and in the first days of October the withdrawals continued. Banks themselves were forced to dramatically increase CD rates to attract new depositors. One-month CD rates hit 5.8% the week of September 7 – 30bp above 6-month CD rates. The move worked as large time



deposit levels rose dramatically September 12 thru September 19.

Calm was semi-restored when the Fed lowered its federal funds target by 50bp, and the discount rate by a matching 50bp. While talking heads talked about stimulating growth with the rate cuts, the Fed was, we believe, trying to avert further disaster in the banking system – irregardless of any stimulative effects. With a declining dollar and inflation fears still burning such a cut may have been, absent a bank crisis, reckless.

The real lesson in the crisis may be that a near panic resulted from limited information about the true nature of the credit derivative problem. Fear of losses in subprime-backed securities led to a near shutdown of the \$2

trillion commercial paper market, which led to a near meltdown in the banking system as banks struggled to maintain liquidity in the face of ever-growing fears. It was a self-perpetuating cascade, the very cascade Wall Street has been having nightmares about, resulting from imperfect information. Nothing has changed since August in that regard.

If markets can meltdown over speculation of losses, what is its fate if such losses became known? The definitive conclusion from this episode is that investor confidence is severely shaken. That confidence has not in any way been restored. The next shoe to drop may be a true panic that overwhelms some institutions and forces the Fed into really hard choices.

Part 2 The Market's Indifference

In our August report we went to great detail to analyze the nature of the problems in credit derivatives, which allowed us to gain insight into the scope of the problem. That a credit crunch was coming seemed inevitable to us, and with some reservation it has been mostly accepted as reality now (some having it forced on them as panic reigned for nearly ten days). The scope of the problem is almost beyond comprehension. Losses at major banks total three to four quarters of all net income. Some banks have been punished in the stock market, but overall the market survived the scare and ran to new highs. While some may say that is evidence that confidence has been restored, we see it as a sign that there is more trouble to come as a larger proportion of investors begin to realize just how bad it is (most stock investors seem to have their heads buried in the sand, or actually believe what banks and brokerage companies are telling them).

The Dow and S&P 500 hit their lows on August 16, just as the credit crunch was in full swing. After pausing again around September 7 the stock markets rallied throughout the mini-panic and barely reacted to Northern Rock (the Dow was down 39 points). But the next day came the Fed 50bp cut and the Dow finished up 330 points, ignoring or ignorant of the full context. It peaked at record close on October 9. Since then the markets have dropped as third quarter earnings from banks and brokers have come in with huge losses in them.

The optimism that carried stocks through the banking crisis in September was borne on two beliefs: that the Fed would fix everything by stimulating growth, and that the economy was already on a solid foundation. Those two together would alleviate most of the credit crunch and the worst that would happen would be “slowing



growth”. We believe both beliefs to be seriously flawed.

The latter view of solid economic fundamentals comes from a strong labor market and a persistently high consumption levels. The strong labor market view is just wrong on its face. Unemployment does not typically occur until after the recession has already begun. In the 1990 event, economic contraction began in the third quarter of 1990, lasting until the end of the first quarter of 1991³. Unemployment did not break its trend until January of 1991 – a full quarter after the worst of the recession (the fourth quarter of 1990 produced zero growth even in nominal terms). It wasn't until the second half of 1994 (the first jobless recovery) that unemployment finally dropped to 1990 levels. The same situation occurred in the early 1980's as unemployment peaked in 1983 – a full six months after the double dip recession was over. Unemployment or labor market strength is not a leading indicator, it is a lagging indicator.

The other economic strength indicator is consumer spending. From the third quarter GDP report, consumption bounced back from a weak second quarter to post a 3% annual real growth rate. That, plus a 16% annual real growth in exports, reassured the markets that all was well on the economic front. While that rebound was impressive it was largely due to a surge in durable goods spending in August. Much of that can be accounted for by pent up demand – consumption of durable goods declined significantly in June and again in July. Consumption overall in September turned decidedly weaker, going from a 0.6% change in August to 0.1% growth in September. Consumption of services actually fell 0.1%. This picture fits the

overall situation of the mini-bank run; people that withdrew cash from the banks were not about to spend it.

As the banking system was struggling for cash taking on the load of the commercial paper market it did not have room to lend to consumers. Revolving credit (credit cards) growth dropped to .37% in September from .74% and .78% in July and August respectively. Non-revolving credit (mortgages and car loans) growth was nearly zero in September. Again there was noticeable strength in July and August. The noticeable decline in consumer credit adds to the weaker picture of consumer spending going forward.

And incomes may be under pressure in the near future as proprietor's income (net income from large and small businesses) fell in August, and then posted a larger decline in September. That caps off a trend of below average growth in business income that began in March. The effects of that trend have begun to show up in the supplement to income segment (payroll benefits like health insurance and vacations). Supplemental income growth has been noticeably below average since April 2007.

The big picture in consumer spending includes slowing consumption in September, probably due to a tightening of consumer credit, slower business income that is leading to slower supplemental income growth. If these trends continue it will not take very long before wages and salaries growth begins to fall below average. Add that to \$80+/barrel oil and gas/gallon approaching \$3.50, its no wonder Starbucks announced a lower average number of visits per store in the company's illustrious history. The big picture for consumer spending is rather bleak.



Part 3 The Next Shoe

The point we are trying to make in Part 1 is that investors and depositors lost confidence in the ability of banks to pay their debts – deposits included. The reason they lost confidence is the inability or unwillingness of financial companies to make the credit derivative market transparent. It got so bad that during the panic in the second week in September that even short-term Treasury bill rates rose significantly – even though credit holders were fleeing to treasuries for quality. During the panic even the most qualified borrower, the Federal government, was having trouble finding buyers for its shortest-term debt. And banks refused to lend to each other (the overnight fed funds rates soared leading to the September 18 rate cut).

Transparency is the prerequisite to restoring confidence in the credit markets. But banks and brokers have, as yet, refused to come clean. They have posted huge losses and issued statements to the effect that there may be more to come. Anyone who has looked at the balance sheets of major institutions can plainly see that there has to be more losses. By playing this game of chicken they are either trying to buy time or knowingly trying to avoid another panic.

Banks and brokers have trillions of dollars in assets that are at risk. They have written

off only a drop in the bucket. At the end of Q3 2007 JP Morgan and Merrill Lynch have \$125 billion in Level 3 assets combined (Level 3 assets are blackbox priced – internal formulas and models are the only way to value them). Citigroup by itself has \$134 billion in Level 3. Those three institutions have a quarter of a trillion dollars in assets that have no transparency – and that is **39%** more than the second quarter.

We examined the balance sheets of six Wall Street firms, including the three mentioned above. Within the Level 3 category Citigroup has \$7.2 billion in trading account liabilities tied to hybrid financial instruments, \$80 billion in trading securities (including CDO's and mortgage-backed securities), and \$22 billion in derivative instruments (not all tied to credit derivatives). And Citigroup is on the hook for \$53.6 billion in credit default and other swap agreements, despite the fact only \$1.3 billion appears on its balance sheet – the benefit of valuing derivatives at the fair value of the contracts, not the entire liability. Over at Goldman Sachs the company provided a look into its dealings with VIE's. Under their view of the world they only have \$20 billion of exposure to \$72 billion in VIE assets. Of course, in the footnotes they reassure investors that the exposure is

	Level 2 Assets			% chng from Q1	Level 3 Assets			% chng from Q1
	1Q2007	2Q2007	3Q2007		1Q2007	2Q2007	3Q2007	
JPM	\$793,838	\$915,581	\$926,649	16.7%	\$32,082	\$38,459	\$53,875	67.9%
C	\$803,926	\$843,171	\$939,034	16.8%	\$67,136	\$95,320	\$134,835	100.8%
BAC	\$385,825	\$608,743	\$623,089	61.5%	\$19,970	\$21,636	\$27,828	39.3%
BSC	\$159,780	\$163,228	\$188,011	17.7%	\$18,963	\$18,015	\$20,254	6.8%
MER	\$422,644	\$469,675	\$552,946	30.8%	\$15,099	\$16,037	\$27,146	79.8%
GS	\$429,067	\$404,507	\$494,635	15.3%	\$47,633	\$54,101	\$72,048	51.3%

Millions of Dollars



senior or better. We can only hope that their senior investments are better than Merrill Lynch's. Of the \$22.6 billion in "super senior" CDO's on their books they have already taken an 8% loss – and we thought "super senior" meant safe – never mind the 38% loss on the \$8 billion in mezzanine tranches of CDO's.

Merrill Lynch also has leverage commitments of \$25 billion through commercial banks, providing leverage for its hedge fund operations, \$35 billion in long term funding through SIV's, and \$16 billion in financing of asset-backed commercial paper. These commitments are recorded at the fair values of the contracts, not the \$76 billion in notional amounts that may have to be added to the balance sheet if Merrill is forced to honor its commitments because the counterparties cannot maintain funding.

The scope of the problem is huge, and it is not easily pinned down. But somewhere on Wall Street these six firms have an idea of how bad things can get. Just perusing six balance sheets we have pieced together an estimate. The amount of these assets that are off balance sheets is enough to cause a panic.

Having written down \$22.4 billion in the third quarter these six companies are hoping that it is the worst of it. But the value of these Level 3 assets is determined by formulas that include three main inputs: default rates, recovery rates after defaults, and correlation of both. For the valuation picture to improve those three factors need to improve, or at least not get worse. Knowing what we know about the mortgage business and housing market it is almost a certainty that it will get much worse.

As the losses continue liquidity again becomes a premium. The potential for another bank run is there as banks absorb greater losses and get pulled into the CDO mess even further. Investor confidence, already shaken, may take the next panic to

Summary of Freddie Mac's Q3 Earnings

- 25% drop in the fair value of its assets, or \$8.1 billion.
- Set aside \$1.2 billion for credit losses.
- Desperately seeking \$2 - \$4 billion in additional liquidity.
- Capital surplus only \$600 million above mandated level – down from \$1.8 billion in Q2.
- Considering 50% cut in common stock dividend.

Since Freddie provides a lot of financing in the mortgage market, its struggles do not bode well for a turnaround in the housing market, mortgage defaults, or foreclosure rates.

another level. We see money market funds as perhaps being the catalyst – the next shoe.

Last week several banking and brokerage firms have announced that they will step in to money market funds to avoid a decline below \$1.00 per share. A New York Times article⁴ from Wednesday, November 14 mentioned Legg Mason, SunTrust and Wachovia money funds receiving bailouts. Legg Mason had to add \$100 million to one money fund and extend \$238 million in credit to two others another. Money market funds have been one of the largest purchasers of SPV and SIV commercial paper. As they have gotten into trouble they have stopped paying back some of the commercial paper leading to losses in money funds that are supposed to be extremely safe.

General Electric and its Asset Management money market fund illustrated that point. In Barron's⁵, also on November 14, GE announced it was going to allow the money fund to decline to \$0.96. The article cites losses in mortgage and asset backed securities. But the big question is why GE would allow its fund to devalue, essentially a kiss of death to the fund? Perhaps GE



knows the scale of losses is just beginning and is trying to come clean now?

If small investors fear for the safety of their ultra-safe money markets the cascade of redemptions would look like another bank run. Already shaken by the September liquidity crisis money fund problems would only add to the panic. Perhaps that explains the lack of coverage. It seems like very few investors know of the trouble boiling just below the surface. Again, perhaps the “powers that be” are trying desperately to

hold off judgment in the hope that things will get better.

A panic in money market funds would make the last liquidity crisis look small. The resulting commercial paper market decline would create another liquidity crisis in the banking system resulting in another run on bank deposits, creating another bank crisis. This time the Fed may not be able to save everyone and some institutions could fail, the exact scenario we envisioned in August (Part 5, Page 14).

Part 4 Is this 1979?

Trouble in money funds would reverberate into every market around the globe. The markets are already in the process of reevaluating risk and risk premiums. The lack of liquidity and panic may send interest rates soaring to levels we have not seen since the beginning of this millennium.

Rising interest rates, weakening consumers, a true lack of liquidity, and bank insolvencies, not exactly the ingredients for economic optimism. We argued in August that a recession would result from the credit derivative crisis. We now have a much clearer picture into the mechanism for contraction. At this point in time we cannot see how to avoid a recession. The Fed will be torn between its two conflicting purposes (more on that in a moment) and even if it were to lower interest rates to near zero that will not stoke economic growth in the context of the banking crisis. Lowering short-term interest rates in the hope of increasing growth can only work if banks are functioning normally.

But banks are busy managing risks in loans they have already made, packaged and sold, and are now forced to take back. New loans

to consumers and businesses are forced to the back burner regardless of the interest rate environment. The only interest rates banks will be paying attention to are the commercial paper rates they depend on to fund their day-to-day operations.

The Fed’s ability to save us may be terminally compromised. The mini bank run in September gave us a sobering glimpse into the fragility of investor confidence in the overall credit markets. Developments since that time have done nothing to shore up that confidence and new developments may be sowing the seeds of the next panic. Investors are awaiting an all-clear signal from Wall Street that this crisis has passed. But the sheer magnitude of the problem, and the fact that the dependent variables are still deteriorating, mean that the crisis is only deepening.

Stagflation may be the most likely scenario. Slowing economic growth coupled with rising inflation. The case for slowing economic growth has been made. Rising inflation means lower purchasing power for the dollar. The falling exchange rate of the dollar has contributed to inflation in imports.



On a GDP basis that helps the current economy (increased exports vs. decreasing imports on an inflation adjusted basis), but it may be short-term gains at the expense of long-term health.

Inflation in oil, for instance, gets passed through to consumers in all sorts of products, from gas to plastics. At the same time food prices have been increasing, partially due to alternative energy speculation that came from higher oil, and partially due to importing food components. In the FOMC minutes from September 18, 2007, where the 50bp rate cut was decided, was this statement on inflation:

“However, a sustained moderation in inflation pressures had yet to be convincingly demonstrated. Moreover, the high level of resource utilization had the potential to

sustain these pressures. Although the downside risks to growth had increased somewhat, the Committee repeated that its predominant policy concern remained the risk that inflation would fail to moderate as expected.”⁶

And therein lies the conflict. By lowering interest rates in response to the panic, plus injecting some \$150 billion in liquidity since August, the Fed has abandoned inflation-fighting at a time when inflation fighting is needed. Injecting liquidity is a fancy way of saying printing money. More dollars in circulation lower the purchasing power of existing dollars. And that tradeoff between keeping inflation low and propping up the banking system (followed by stimulating growth) may put the Fed in a no-win situation, the same situation that it faced in 1979.

Part 5 Conclusions

The Fed in 1979 faced double-digit inflation and near-zero economic growth. Its solution was to raise interest rates to nullify inflation, then worry about economic growth. The result was a two and a half year period where real economic growth averaged – 0.1%, including a 10% contraction in real economic growth from October 1981 thru March 1982 – the worst economic conditions since the Great Depression. Although inflation was brought under control by early 1982, it was an awfully painful process – unemployment reached 11% by the end of 1982.

That is the direction we are headed. The question of “if there will be a recession” is being replaced by “how bad will it get”. At this point in time there is no good indicator of the depth and breadth of the problems. Goldman Sachs issued a statement that they

will not have to record any losses from credit derivatives in the fourth quarter. Some analysts familiar with Goldman have speculated that they are simply offsetting losses with gains from shorting the mortgage market. That’s not exactly a vote of confidence.

For the stock market – the Dow and S&P are down 8.1% from their October 9th highs. The sell-off has been broadly based, with only three of the twelve sectors⁷ up in the last month. Leading the decline is the media sector (-7.98%), the financial services sector (no surprise there, -5.33%), the energy sector (-4.47%) and the consumer services sector (-4.43%). The media sector’s decline is coming from losses in cable and broadcasting stocks while energy stocks are down due to oil’s pullback from \$100 per barrel. Consumer services are down mostly



from weakness in retailers, hotels, and home builders.

The sectors posting gains were utilities (+2.75%), consumer goods (+1.84%) and telecom (+1.34%). The strength in utilities comes from investors seeking the protection of dividends. In the consumer goods sector, strength is coming from consumer staples names like Unilever, Imperial Tobacco, Procter & Gamble and Coca Cola, while weakness has hit the luxury items like Guess, Coach and Tiffany. Also weak are durable goods manufacturers like GM, Ford and Whirlpool, and domestic food producers such as Tyson, Constellation Brands, and Wrigley. In the telecommunications sector strength is coming from foreign names while domestic companies are in the negative.

The stock seems to be coming to terms with a slower economy. Utilities and consumer staples companies are defensive stocks, while strength in foreign stocks indicates a market view of slowing US growth vs. the

rest of the world. And the market's view of the inflation picture remains troublesome as US food producers struggle while foreign food companies are favored. The most telling sector is consumer products – big ticket and luxury items are the first to go when consumer spending falters. Right now the market appears to have that kind of outlook.

While the market changes its mind quite frequently, as evidenced by its strength from August to early October, it does appear to be settling in for a rough ride. Some corporate managers seem to believe that – they miss their earnings numbers and immediately announce a huge buyback policy (see Target, Lowes). The prudent policy looks to be selling into any strength in the near future, as the next panic may be right around the corner – perhaps as too many money market funds admit losses that can no longer be ignored. For the foreseeable future we will be monitoring the market to purchase stocks at bargain prices.

Endnotes

¹ The Financial Services Compensation Scheme. The Financial Services and Markets Act of 2000, United Kingdom. http://www.fscs.org.uk/consumer/FAQs/Deposit_claims_FAQs/

² All Banking, Interest Rate and Money Supply figures are from Federal Reserve Statistics. <http://www.federalreserve.gov/Releases/>

³ All GDP and National Income figures are from the Bureau of Economic Analysis. <http://www.bea.gov/>

⁴ “Investor Safe Haven Becomes a Concern”, The New York Times, Online Edition. November 14, 2007. http://www.nytimes.com/2007/11/14/business/14fund.html?_r=2&ref=business&oref=slogin&oref=slogin

⁵ “Mortgage Woes Damage a GE Bond Fund”, Barrons Online. November 14, 2007. <http://online.barrons.com/article/SB119499399633791914.html>

⁶ “Minutes of the Federal Open Market Committee”, The Federal Reserve. September 18, 2007. <http://www.federalreserve.gov/fomc/minutes/20070918.htm>

⁷ Sector and Stock Performance figures are from Morningstar, as of November 22, 2007. <http://news.morningstar.com/stockReturns/CapWtdSectorReturns.html>

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ATLANTIC CAPITAL MANAGEMENT

560 VILLAGE BLVD, SUITE 260

WEST PALM BEACH, FL 33409

(561) 686-6844

www.client-centered.net