



Text of 9/15/08 Conference Call

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The bankruptcy of Lehman Brothers coupled with the sale of Merrill Lynch to Bank of America, the troubles at AIG and Washington Mutual have pushed global financial markets to a riot point.

Central banks around the world injected additional liquidity into money markets over the weekend and the Federal Reserve has taken actions to reduce systemic risk by enhancing existing liquidity facilities. In addition to increasing the sizes of the auctions that the Fed conducts, they have increased their frequency to weekly (from every other week) and the Fed has said that it will accept other types of securities, including equities and high yield debt, as collateral for making direct loans to investment banks. Needless to say, Fed efforts to aid liquidity and market function remain ongoing.

On the private sector side a group of banks and broker/dealers including Bank of America, Citigroup, Goldman Sachs and JP Morgan Chase and others are putting up \$70 billion for a borrowing fund aimed at providing liquidity to troubled financial firms.

These are all good steps, but there is not just one silver bullet that is going to restore the markets to a sense of normalcy. The excesses of the financial sector have taken several years to develop and will not be reversed in a quick fashion.

The US equity markets are testing their July lows of 1200 on the S&P, and 11,000 on the DJIA. Even though extreme pessimism and attractive valuations are consistent with a market trough, a sustained advance awaits a notable improvement in credit conditions. We are closely monitoring the credit quality spreads to identify when investors' risk appetite begins to return. It is highly unlikely that any sustainable advance in the equity markets will occur until credit quality spreads begin to tighten.

While mortgage spreads did narrow substantially last week on the nationalization of FNM and FRE, investment grade and high yield bond spreads continue to widen – just another sign that risk appetites are not improving yet.

We need to see global central bankers join in. A coordinated policy response to the crisis should become less of a challenge now that the inflation momentum has downshifted. The collapse in oil and other commodity prices could unleash a deflationary wave across the globe.

Decelerating economic global growth prospects underscore that disinflation could quickly develop into fears of deflation – causing a more aggressive monetary policy response.

Recent monetary policy shifts by a number of global central banks, signal that some bankers are already responding to the slower growth prospects. The People's Republic Bank of China cut rates and lowered the reserve ratio today for the first time in 6 years.

Australia and New Zealand central bankers have also made policy U-turns in the past month in favor of easing. The Bank of England and the Euro Community will be slower to react, however.

Another requirement for a healing in the credit markets is a trough in house price deflation – this is where it all started. Lower mortgage rates and the potential for increased lending by FNM and FRE will help stem the slide in house prices. Nevertheless, the massive overhang of existing homes for sale suggests it will take more time for the market to clear. The weak economic and employment picture are headwinds to the stabilization of the housing sector.

There is a high degree of uncertainty around the exact timing of improved credit conditions, but the good news is that the U.S. policymakers have ratcheted up their commitment to healing the housing market and global policymakers are set to become more pro-growth – now that inflation concerns appear to have been overblown.

Nonetheless, with each round of turmoil and declining asset prices, the financial sector's aggregate capital erodes, adding to systemic vulnerability. Fed rate cuts may have prevented an even greater deterioration of financial conditions, but conditions remain hostile to a sustained restoration of economic growth. This will focus attention on the potential for more comprehensive actions by Treasury - as distinct from the Fed - to improve financial conditions through direct interventions in markets, such as the MBS purchase program announced last week.

Longer term, it appears increasingly likely that a major U.S. government fiscal package aimed at struggling homeowners and/or impaired assets on banks' balance sheets will ultimately be required. Unfortunately such a package would likely require legislative action which will take time.

Domestic demand and the employment market remain under pressure, discretionary consumer spending remains depressed and the drag in housing could persist for at least another few quarters, although the period of peak severity seems to be behind us. Nevertheless, homeowners still face powerful headwinds from the lack of credit availability and the housing market still faces a prolonged workout due to the huge overhanging supply of unsold homes. New home inventories are down sharply, but existing inventories have continued to rise, and foreclosures are still outrunning demand.

The overall liquidity environment remains troubled, and money market conditions still have not improved on a fundamental basis despite unprecedented efforts by the world's major central banks to secure the liquidity base of the financial system.

With bank lending standards as stringent as they have been in the past 20 years, the availability of liquidity is constrained. This affects credit needs in both the household and corporate sectors.

On balance, however, while these are certainly painful events for many, the reduction in capacity in the financial services industry may be one of the components necessary to help solve the ongoing mortgage and credit crisis.

We continue to focus on high quality companies in our diversified portfolios. Fixed income exposure, especially in municipal bonds, is providing a meaningful cushion to the weak performance of equities at this time.

Markets typically discount future events by 6 to 9 months, and therefore, an investor should be careful about becoming too bearish at this particular point in time. This does not preclude a move to new lows by the popular averages, but, at least up to now, the number of stocks making new lows is

substantially less than what occurred at the July bottom – this is a typical occurrence during a major market bottoming process.

It is important to remember that equities and other risk assets tend to perform well when liquidity is expanding rapidly relative to underlying growth conditions. Right now, the Fed is supplying copious amounts of liquidity, but that liquidity is not making its way through the banking system into the economy. Improved liquidity flow into the economy will be evidenced by tightening credit quality spreads.

The volatility in the markets is likely to continue until we see an improvement in leading economic indicators, a tightening of credit quality spreads, and stabilization in the housing market. Until then, a bona fide equity advance will be unlikely.

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