THE DANA VIEWPOINT

TWO AND DONE

November 8, 2007
Dow: 13,137

As expected, last week the Fed cut the federal funds rate by one quarter point to 4.5%. This move is obviously in response to the current credit crunch involving sub-prime mortgages. Psychology does matter, and these latest moves by the Fed are an attempt to assure investors that the Fed stands ready to provide whatever help is needed to avert a financial panic. Citigroup is estimating that they may have to write off more than $21 billion (yes, billion) in losses due to investments in sub-prime mortgages. Other financial institutions are facing write-offs also, and no one knows how much is left out there. Fortunately, the rest of the economy remains strong so it is unlikely the credit crisis will bring down the economy as a whole. Inflation is still tame at this point (core inflation is running less than 2% on an annual basis) so the Fed is not forced to raise rates. On the other hand, they are not likely to cut rates further. As we have stated in the past, interest rates are low by historical standards and money is plentiful.

The biggest obstacle the Fed faces is the declining value of the dollar, and lowering interest rates further will only help push the dollar lower. Many will say (especially in Congress) that a cheaper dollar is good as it lowers the cost of our goods overseas and reduces our trade deficit. Cheapening the dollar is the same as imposing a tariff, and tariffs have never worked in the past and are less likely to work now with spreading globalization. In fact, the cheaper dollar (tariff) is counter productive. Competition sets prices (domestically and internationally) not currency changes. A depreciating currency can eventually lead to inflation or even hyperinflation (Germany in the 1920s) and possibly economic collapse. Deficits are driven by the business cycle. Exports traditionally outgrow imports as the economy slows, and when imports grow faster than exports, the dollar tends to deteriorate. Exports have actually been higher than imports for over a year which would indicate that the decline in the dollar is almost over as there is about a one year lag time. Add to that the fact that many in Congress and elsewhere are at least trying to talk the dollar down or wanting to pass legislation to “protect” the dollar, and you have the recipe for the dollar doing the opposite (strengthening).

The fact that many countries are reducing their holdings of dollars is not necessarily an indictment of the US in general. Low interest rates are making other US assets more attractive, namely stocks and direct investments in US corporations. We went through this in the 1980s when Japan was buying out

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America. Now other countries (notably China) are flush with cash and see better investment opportunities here than in our Treasury bills and bonds. The rest of the world recognizes that the US is still the strongest economy and has the most stable political environment in the world. Why wouldn't they want to invest here?

The bad news bears. There certainly is no dearth of bad news out there, and the media seems to delight in focusing on it. The credit crisis of course is real, but it is being addressed both by the Fed and by those financial institutions that are directly involved. The market will correct all the excesses like it has for all financial panics in the past. What we don't need is heavy handed government interference which will only make it worse. Oil is approaching $100 a barrel but is not having the same negative impact on the economy as it would have in the past. The price of oil is being driven by the burgeoning economies around the globe which can be viewed positively. General Motors just reported one of the largest losses ever for a US company ($38.9 billion). However, they just settled with the UAW on a contract that should make them more competitive with foreign car makers.

Thanksgiving. The holiday season is once again upon us, and we have much to be thankful for as a country. Economically there are many bright spots. The economy grew by a 3.9% annual rate in the third quarter up from 3.8% in the second quarter. Employment has expanded for fifty consecutive months, and we have created 8.5 million jobs during this period. Gross Domestic Product (GDP) has grown $1.5 trillion over this period, and the budget deficit is down to $163 billion or 1.2% of GDP, the lowest percentage in five years.

Of course, we should most of all be thankful that we live in a country with so many freedoms. One does not have to look far to see how many people are living under tyranny and have none of the basic necessities of life that we tend to take for granted. ***Happy Thanksgiving everyone.***

Random thought for November : According to former Secretary of Education, Richard Riley: The top ten projected in-demand jobs in 2010 did not exist in 2004, and we are currently preparing students for jobs that do not now exist.

Michael L. Dana
Chairman of the Board

James W. Ivey
President

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15800 W. BLUEMOUND RD • SUITE 250 • ZIP 53005-6026 • P.O. BOX 1067 • BROOKFIELD, WI • 53008-1067 • 262.782.3631 • FAX 262-782-0581
365 ERICKSEN AVENUE.N.E. • SUITE 312 • SEATTLE, WA • 98110-1888 • 206.855.8781 • FAX 800.560.6227
E-Mail: dia@danainvestment.com
Web Site: www.danainvestment.com