AR SCHMEIDLER & CO
INVESTMENT ADVISORS
A Hudson Valley Bank Company

The Outlook

December 14, 2007

As of December 14, 2007		
Index	**YTD % Change***	**Market Value**
Dow Jones Industrials	9.35%	13,339.85
S&P 500	5.35%	1,467.95
Nasdaq Composite	9.13%	2,635.74

*YTD % Changes use the index with dividends

The global financial system is operating in uncharted waters; this is an environment the capital markets have never seen before, but this is a unique and dynamic investment climate in which to build capital. **The U.S. Federal Reserve faces a challenge to ensure that the capital markets have adequate liquidity.** Since August, the Federal Reserve has lowered the bellwether federal funds rate, which governs overnight lending between banks and has cut overnight rates, their key economic policy lever, by a full percentage point in an effort to put a floor under an economy increasingly seen at risk of falling into recession. Current policy is also being augmented by a new facility for auctioning short-term discount window credit. In spite of these policies, it remains to be seen if the capital markets will have adequate liquidity. This unusual situation is due to the banks' unwillingness to lend even to one another as a consequence of their heightened risk aversion. **This unwillingness to lend is a consequence of the risks associated with the global proliferation of sub-prime mortgages and derivative financial products.**

Unintended Consequences of Issuing Sub-prime Mortgages

The reduction in credit standards in order to enable people with less than an ideal credit history to have access to home ownership through low-cost variable rate mortgages on the surface appeared to be a noble undertaking. However, the great tragedy of an otherwise admirable plan to increase home ownership, particularly among lower income people, by reducing credit standards, is that now the mortgage industry and global banking system are facing negative consequences as home values have declined and the rate of mortgage defaults has risen. Even though the government and private institutions that initiated the change in credit standards were of good will and not corrupted by the opportunity to make extraordinary profits, this soon changed as the mortgage industry attracted large scale speculation. As matters stand now, more than $500 billion in mortgages will have their interest rates reset in 2008.

Asset-Backed Securities

The sub-prime U.S. mortgage market is only part of a much larger financial mosaic involving an entire array of questionable asset-backed securities, which were marketed on a global scale to banks and countries. For example, liquidity puts, which are insurance contracts the banks sold to buyers of sub-prime mortgage-linked securities, are another financial headache. They were basically money-back guarantees for principal and interest for which the banks have a contractual obligation to make payment. The banking industry is likely to lose substantial amounts of money over the coming months on these contracts. The contracts now represent an estimated $100 billion in losses but originally enabled the banks to earn fee income on each sale. Spreading the risk of asset-backed paper around the world from a Florida investment fund to German banks to the National Bank of Canada, to the Norwegian town of Narvik and many other places, leaves the investment community wondering how much is really out there and who actually has the risk. According to numbers we have seen, the entire derivative market is estimated to be about $11 trillion. Collateralized securities grew 145% from 2006 and are now estimated to total about $720 billion. Credit default swaps expanded 49% over the same period. All in all, derivatives grew rapidly over the last nine years through 6/30/07. It is difficult to see at the end of the day how long this will take to sort out.

The Achilles Heel of the U.S. Economy

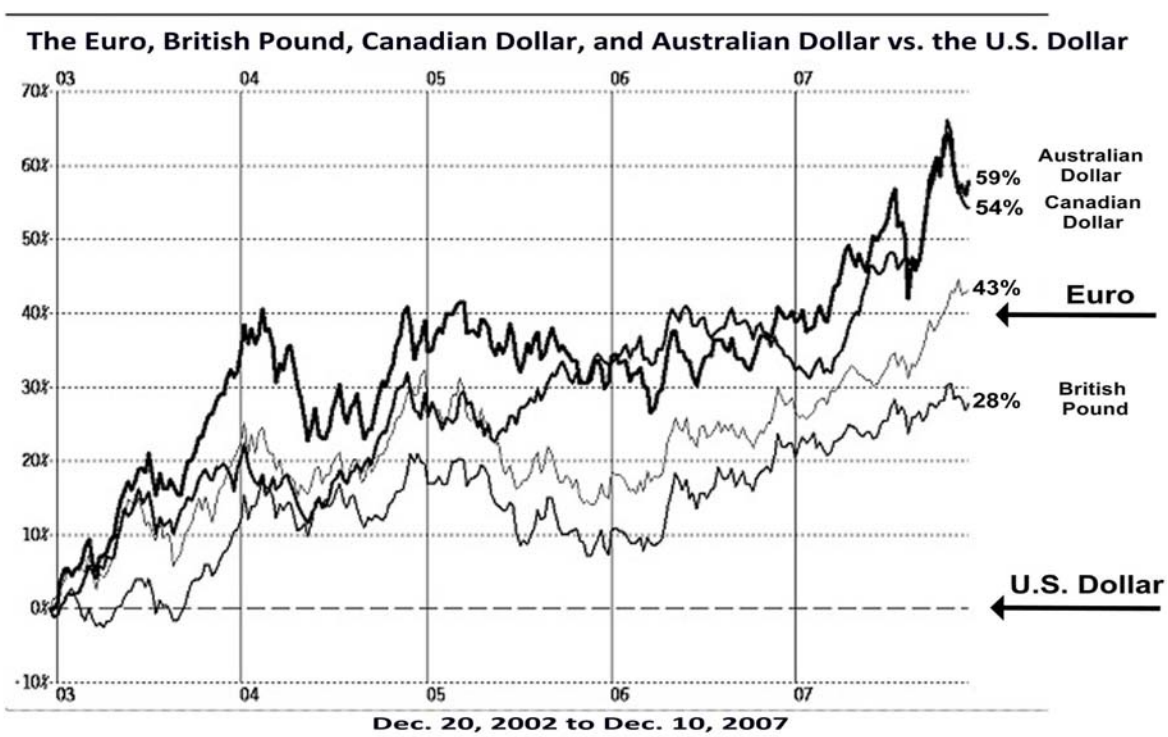
A more difficult period lies beyond the $50 billion already written off by major financial institutions such as Citibank, UBS and Swiss Re. Losses in the mortgage market in the United States could climb to over $300 billion. From our perspective, asset-backed paper and derivative products continue to be at risk, including losses resulting from credit default swaps and other exotic financial vehicles. At this time the Federal Reserve expects U.S. economic growth to range between 1.6% and 2.6%. **We continue to be of the opinion that interest rates will have to be brought down considerably from current levels, and since the Achilles heel of the U.S. economy is the dollar, further declines in U.S. interest rates could lead to an even weaker currency.** This is a challenging environment for the Federal Reserve because a weaker dollar could easily heighten the perception of inflation, which is already beginning to bubble up through rising food and energy costs.

In order to avoid a recession, it is important for us to be able to effectively deal with sub-prime credit problems as well as to deal with an entire array of questionable derivative products. Losses in the banking system are creating considerable strains in the global economy and are restricting banks' ability or desire to lend even to one another. Moreover, the use of high levels of leverage means that as default rates rise, hedge funds and others are forced to sell, transferring risk back to the banking system. As a consequence, bank capital then gets reduced, and banks need to raise additional funds at a high cost. How much ultimately gets put to the banks has much to do with how much further home prices decline. Since this is a global issue, the Federal Reserve and foreign central banks have created a new facility for bank borrowing.

Sovereign Wealth Funds and the U.S. Dollar

In the past, nations with excess U.S. dollars purchased U.S. Treasury debt because it was safe and the interest rate was attractive. Today the interest rate on U.S. Treasury debt is less desirable, and is being issued in a depreciating currency. So foreign governments with excess U.S. dollars, through the creation of Sovereign Wealth Funds, are now making substantial investments in U.S. and foreign companies. The growth of Sovereign Wealth Funds managed by the leading export nations is the result of governments wishing to diversify their currency reserves.

Over the past five years, when compared to the U.S. Dollar, the Euro has appreciated 43%, the Australian Dollar has appreciated 59%, the British Pound has appreciated 28% and the Canadian Dollar has appreciated 54% as seen in the following graph:

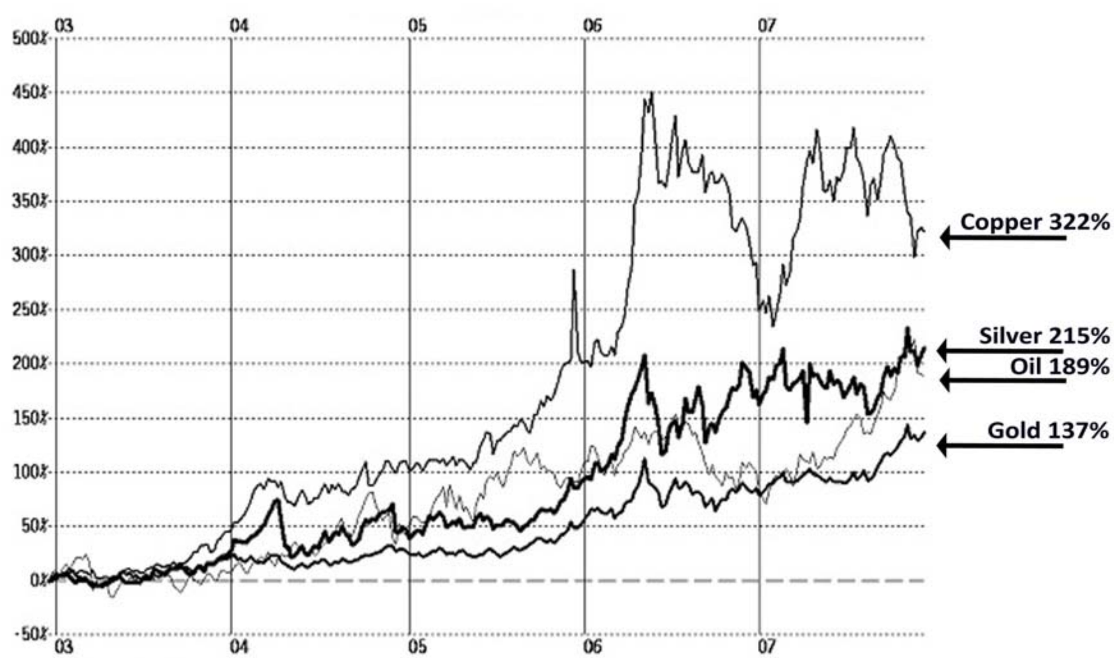


During this time, Sovereign Wealth Funds have grown to $2.5 trillion and are expected to grow to a much larger amount over the coming years. Some of the direct investments recently made by leading exporters include Sony, AMD, and Citibank.

Oil exporters have an estimated $3.8 trillion in foreign-owned assets divided among Sovereign Wealth Funds, central banks and wealthy individuals. Asian foreign exchange reserves are (according to McKinsey Global Institute) estimated at around $3.7 trillion, and if oil prices remain above $70.00 per barrel, nearly $2 billion of new petro-dollars will flow into the global financial system each day. **Given the outlook for further declines of the U.S. dollar, lower U.S. interest rates and the desire of exporting nations to depreciate their currencies against the dollar in order to maintain their export businesses, we expect these large and mounting U.S. dollar reserves to be used to purchase entire corporations and substantial equity interests in U.S. publicly traded companies.**

Depreciation of the dollar, growing global demand for raw materials and continuing global central-bank monetary creation has had the effect over the last five years of increasing commodity prices such as copper, silver, oil and gold as seen in the following graph:

Percentage increase in crude oil, copper, gold and silver prices



December 20, 2002 to December 10, 2007

Worldwide Economic Growth

As the sub-prime mortgage credit problems result in tighter bank-lending standards, it is logical to expect the U.S. economy to slow. However, U.S. economic growth now pales in comparison to expected world-wide global growth. If U.S. economic growth slows or becomes almost zero, our current 3% annual growth assumption, which equates to about $400 billion, can still be absorbed by an expected $1.7 trillion in overall global economic growth. **It is global economic growth that will continue to be the driver of the industrial sector of the U.S. economy. We expect continuing strong exports for the U.S. industrial base.**

Federal Reserve Interest Rate Cut Disappoints Wall Street,

The 30 day Libor (The London Inter-Bank Offering Rate) has recently fluctuated around a multi-year high of approximately 5.25%, a much higher rate than normal compared to three-month treasury bills as a result of banks' reluctance to lend beyond one week. This is a phenomenon that reflects a high stress level in the financial system. Year-end traditional pressures including the need for cash for year-end dividend payouts, tax payments, interest payments and employee bonuses are exacerbating this problem. This increased the pressure on the Federal Reserve to cut its overnight funds rate at their December 11th meeting by 25 basis points to 4.25%. In a related move, the Fed trimmed the discount rate it charges for direct loans to banks by a matching quarter point to 4.75%. While the action was widely expected, some economists had thought the Federal Reserve might offer a bolder half-point reduction in the rates. **The modest quarter-percentage point cut disappointed Wall Street, which had clearly hoped for more aggressive action.** In a coordinated show of international concern, the U.S. Federal Reserve the next day joined other central banks in a plan aimed at encouraging banks to lend more readily at favorable interest rates when world credit markets seize up.

Housing, Financial Institutions and Derivative Products

The U.S. mortgage problem could eventually involve perhaps up to two million homes. These statistics make us believe that the housing industry will take a lot longer to recover than many now expect. We also believe that many homes that would otherwise be up for sale have been temporarily withdrawn from the market. **The financial outlook has been greatly complicated by the proliferation of mortgage asset-backed securities and structured investment vehicles that were distributed on a global basis totaling many hundreds of billions of dollars.** We have never experienced a crisis involving creative financial derivative products on such a large scale. We must assume that an entire line of business which global financial institutions have depended on for many years to generate considerable fee income will no longer be the same profit center that they can count on in the future.

Institutional Benchmarking of Investment Portfolios

Many institutions benchmark their investment portfolios against various market indexes. S&P 500 index has a weighting of about 19% in financial companies down from more than 25%, but this is still a high number considering the unattractiveness of the financial sector. **We believe that portfolios that are replicating the S&P 500 index will continue to experience unsatisfactory returns on a significant portion of their holdings.** On the contrary, representation in areas such as machinery, metals and mining, industrial companies and energy companies that benefit from global growth and infrastructure needs should be well-rewarded over time.

Conclusion

Losses stemming from the sub-prime mortgage debacle could take considerable time to work out, and until the situation is fully understood, markets are likely to remain volatile. Central banks around the world have announced various new programs designed to address the elevated pressures in short-term funding markets caused by sub-prime mortgage-related losses. The crisis may dampen some economic growth, but ultimately it is not likely to significantly interrupt the developments which are taking place around the world. Global growth, particularly in Eastern Europe, Russia, China and India, should continue. We should also not lose sight of the fact that global integration and consolidation is ongoing, and we expect meaningful premiums to be paid for companies benefiting from this outlook. Finally, the equity market is becoming two-tiered, with financial companies exposed to greater uncertainties and industrial companies benefiting from global growth. **This market environment bears similarities to that of the 1970s, when certain sectors and industries did particularly well while the rest of the market did poorly as a result of rising energy and agricultural prices.**

We wish our readers a happy, healthy, peaceful, and prosperous New Year!