CADINHA&CO

REGISTERED INVESTMENT ADVISERS / INVESTMENT COUNSEL

PIONEER PLAZA, SUITE 1240
900 FORT STREET MALL
HONOLULU, HAWAII 96813
(808)523-9488 *Phone*
(808)526-9725 *Fax*
CADINHA.COM

MORAL HAZARD?

September 26, 2007

Moral Hazard, a notion that dates back more than a century, is centered on the belief that offering insurance encourages people to take risk they otherwise would avoid. So, does the dramatic cut in interest rates engineered by the Federal Reserve Board (Fed) last week constitute a modern-day moral hazard? Was the cut provided to bail out a bunch of greedy speculators and imprudent lenders, or was it prompted by something else, like lower inflation numbers?

If the answer to these questions is that the Fed did indeed "chicken out" and chose to rescue the markets, we can expect the moral hazard effect to be played out. We can expect high-risk, high-leverage investments to return to popularity and to become an even bigger factor in the future. We should also be aware that future corrections are apt to be quicker and nastier, prompting even bigger Fed 'bail-outs". The long run effects are a weaker currency and a lower standard of living for Americans. Foreigners and domestic investors alike will be less willing to hold our debt, resulting in higher interest rates and a softer dollar. The initial market response to Fed Chairman Bernanke's interest rate cut has been a weaker dollar, weak long-term bond prices, and resumed strength in dollar denominated commodities, like gold and oil. In other words, the market believes the "fix is in."

In our most recent communications to you, we suggested that through certain actions the Fed was telling us that they would "resort to any method to stop a financial market correction." (See August 24th and 25th pieces included for your convenience.) Accordingly, we were not surprised by this latest interest rate cut and have increased some exposure to the general market along with a small high quality entrance in the financial industry. Prior to the interest rate cut, we had taken portfolio positions in gold and foreign currencies, while avoiding long-term bonds, in anticipation of this market reaction to an interest rate cut. Consequently, our client portfolios are in good shape. The acceptance of moral hazard risk by the Fed is a very slippery slope, and our portfolio strategy is tilted toward this conclusion.

Coincidently, however, the most recent inflation numbers have been excellent, with the Producer Price Index and the Consumer Price Index both dropping into negative territory. This good news on inflation could be the reason for the aggressive interest rate cut by the Fed. If so, we should expect the Fed to raise interest rates in response to any directional change in inflation to the upside. If this is the answer to our initial question, then the markets have it wrong and the speculators and lenders are likely to be in trouble again. Long-term Treasuries will be good performers again, and the dollar will strengthen. As an anchor to windward, we will probably add a position in longer term Treasuries if the bond markets continue to drop.

The core of our portfolio strategy will be to focus on large, blue chip growth oriented companies with the bulk of earnings coming from foreign markets. These companies are

poised to do extremely well. The other investments are designed to supplement returns and hedge risk in order to protect principal and capital. You can expect us to be very vigilant toward the intensifying political risk as well as the Federal Reserve. After all, we are not yet completely convinced that the "fix is in".

* * *

Harlan J. Cadinha
Chairman and CEO