



Financial Markets Review and Outlook

January 2009

Unless you have been cut off from all communication, you are well aware that 2008 was among the most tumultuous and disastrous of years for global financial markets and economies since the 1930s. Even a summary listing the significant events would occupy multiple pages. Very briefly, the buildup over many years of poor risk analysis, bad government policy decisions, poor regulatory oversight, a significant decline in the pricing of and aversion to risk, a reduction in residential mortgage underwriting standards, reliance on egregiously misguided rating agencies, the explosive growth and misuse of credit default insurance, irresponsible corporate compensation structures and a cultural shift toward increasingly shortened time horizons for assessing corporate and financial performance, all combined to lead toward a massive, global, systemic abuse of leverage (borrowing). Often, excesses such as these have resulted in asset specific or geographically limited bubbles and busts, but this time the domino run started by the collapsing U.S. housing market spread pretty much everywhere.

The most relevant questions now are: How might this play out? And, how should investors position their portfolios to survive and/or prosper in the environment?

A summary of our conclusions and recommendations are as follows:

- For investors with a long-term horizon, we believe potential investment returns from stocks and corporate bonds are quite attractive. We believe capitalism is intact, and investors will be able to look back at this period as an opportunity to buy stocks and bonds of great companies at very attractive prices. For diversification and consistent return potential, investors should consider including alternative investment strategies as a strategic allocation.
- Over the next year, there are two basic scenarios that could play out: (1) The severe recession responds to the massive stimulus currently being applied and begins to recover by late 2009; or (2) The severe recession develops into secular deflation, resulting in an extended recession with a muted recovery thereafter.
- Starting with their respective long-term strategic allocations, we recommend that investors: (1) initially underweight stocks, and tilt their stock portfolios toward high quality, cash flow positive companies; and (2) overweight investment grade corporate bonds and/or high quality municipal bonds, while avoiding treasury bonds and including a small slice of high yield bonds.

For a more detailed review and outlook, please read on.

Economy

It is clear that we are in the midst of a synchronized global recession. There had been hopes that the globalization and expansion of emerging markets would foster a decoupling of global economies. However, it is unrealistic to expect that a severe credit, liquidity and solvency crisis in the world's largest economy wouldn't affect the rest of the world. While the large emerging economies, such as Brazil, Russia, India and China (the "BRIC" countries) may have been progressing toward self-sustaining economies, they are not completely insulated. India and China have benefitted directly and indirectly from the steady growth in U.S. consumer spending, while Brazil, Russia and many other emerging markets remain heavily dependent upon exporting their natural resources. Thus, the sharp drop in export demand and commodities prices in the latter half of 2008 derailed many of these countries. It is important to note that while some foreign economies have become less dependent upon the United States, the U.S. economy has become more, not less, closely linked to foreign economies as it is increasingly dependent upon foreign sources for investment, labor and natural resources, and it increasingly needs to compete with the world for these factors. The global breadth of holders of U.S. residential mortgage-backed securities is one clear example of this. More importantly, China and Japan are significant investors in U.S. treasury securities.

In the U.S., we have seen a severe pullback in both consumer spending and capital investment which has led to an acceleration of job losses unprecedented since the Great Depression. Some analysts have noted that the freezing of short-term credit markets hastened companies to eliminate planned capital expenditures and slash employment roles because of a lack of funding. The U.S. unemployment rate jumped from below 5% in early 2008 to 7.2% by the end of the year. In December 2008, the NBER (National Bureau of Economic Research) concluded that the U.S. economy had been in recession since December 2007, making it already longer than the average post-war recession. Because of the important global linkages, virtually no country has gone unscathed. The most optimistic economists are forecasting that massive monetary and fiscal stimulus will unlock the credit markets, encourage investment and spending, stem job destruction and succeed in turning the economy by mid-2009. Opinions are mixed about which countries or regions will lead any recovery. Alternatively, the pessimistic view is that no amount of stimulus can quickly solve problems created over the course of two decades and we are therefore in for a deep and extended global recession and a muted recovery thereafter.

Inflation/Deflation

As has been well documented over the last two decades, we have generally been blessed with moderately positive inflation, which is universally considered to be optimal. This has been facilitated by advances in technology, which enhances productivity, and globalization which has enabled companies the flexibility to shift production, seeking the most cost-effective labor pool. These forces enabled the U.S. Federal Reserve (the Fed) to be extremely stimulative after the internet stock bubble burst in 2000. Headline

inflation remained moderate because of the globalization of labor, but hard asset prices, such as for real estate and eventually commodities, soared because the cost of capital for speculators approached zero.

It is clear that in the current environment, with residential real estate prices still falling, key commodities prices having fully corrected, unemployment rates rising, and consumer and capital spending quickly declining, that inflation is not imminent. In fact there is a high likelihood that we are in at least a brief period of deflation, and a risk that we are in for an extended period of deflation. Anything more than a brief period of deflation is generally thought to be the worst case scenario. In a deflationary environment, along with the obvious quantitative reduction in prices and cost of living (which doesn't seem so bad) comes a change in psychology which can suck the life out of the economy. When prices are consistently falling, consumers and businesses alike put off any purchase or investment as long as possible. When in doubt, wait. The economy grinds slower and slower. Concerns about the prospects for deflation are exactly why U.S. treasury bonds are at their lowest yields in our lifetimes, and why the premium for fixed rate treasuries over inflation indexed treasuries ("TIPS") is so slim.

We do not have much recent experience with deflation, but it is said to be among the hardest of cycles to break. Hence, the Fed, and reserve banks across the globe are adding unprecedented monetary stimulus. This appears to be absolutely necessary to unfreeze the credit system and counteract the massive and rapid deleveraging that the global economy has been experiencing. These institutions are determined to reflate the economy. When the economy begins to turn, it will be very difficult for Fed officials to tighten policy quickly enough to keep inflation moderate. Too much money chasing after too few things spells inflation. Furthermore, inflation will be instrumental in helping to pay down the large deficit that the U.S. government is now creating, whereas deflation would be devastating. Hence, if the stimulus works, there is a significant chance we will see heightened inflation in the years to come. The inflation/deflation status will likely be closely linked to the state of the economy.

Currency

An interesting thing happened in 2008. As the U.S. economy was quickly weakening and the U.S. Government was creating and spending hundreds of billions of dollars, the U.S. dollar actually strengthened versus most major currencies, reversing a six-year weakening trend. This likely occurred because other developed economies were similarly distressed, foreign central banks were also flooding their systems with money, and importantly, the U.S. dollar is still used as a reserve currency; hence, a haven of safety.

Cash

As has been well documented, the normally docile and highly liquid ultra-short term lending markets (money markets) froze during 2008, severely limiting the ability of businesses to obtain short-term loans and manage their cash flow. This problem

worsened in September and October when investors lost faith in all corporate credits and rushed toward the safety of short-term treasury bills. The Fed's actions to backstop money market securities has relieved some pressure, but there is still an exorbitant demand for U.S. treasury bills which has led them to drop in yield to virtually nothing.

There is currently far more money invested in money market mutual funds than at any time in the past, more than \$3.8 trillion, which, for reference, is almost half of the total capitalization of the S&P 500. So much of it has migrated to U.S. treasury-only money market funds that many of those funds have closed to additional investments. The problem that these funds face is that the yields on the securities in the portfolios are so low that they may not even pay for the expenses of running the funds.

Bonds

The credit crisis brought an extreme bifurcation of the debt market in 2008. The yield on U.S. treasury securities dropped while all other yields rose. Investors have shunned everything but U.S. treasuries so that the yield premium offered by investment grade corporate bonds, high yield bonds and municipal bonds are at extremes. Long-term treasury bonds were by far the best performing traditional asset; the Citi 10-year Treasury Index returned 20.3% for 2008. Although corporate bonds did not lose as much value as stocks in 2008, they performed far worse relative to normal expectations and history. For example, the BarCap (formerly Lehman) U.S. Corporate High Yield Index lost 26.2% in 2008, which is almost three times worse than any other year on record. The credit markets became dysfunctional. Because of their own financial stress and need to reduce leverage, broker dealers, who had for years been willing to make active markets (buy and sell) in bonds, stopped doing so. The result was that bonds other than treasury bonds became practically illiquid, an additional factor that served to drive prevailing prices lower (yields higher). Prices improved modestly at the end of the year, but at this writing the current yield on investment grade corporate bonds (BarCap Corp Bond Index) is 7.3%, while the yield on 10-year treasury bonds is 2.6%. From an historical perspective, this is an extraordinary yield premium. High yield bonds are trading at yields averaging 18%, and 10-year A-rated municipal bonds have an average yield of 4.5% (federal income tax-free).

10-year TIPS (Treasury Inflation Protected Securities) are selling at a yield of 1.9%, which, when compared to 10-year treasury bonds, implies that the market is roughly expecting an average annual inflation rate of 0.7% for the next 10 years.

Stocks

Stocks of all sectors, capitalizations and geographic regions dropped precipitously in 2008. Domestic stocks (S&P 500) lost 37%, developed foreign stocks (MSCI EAFE) lost 45%, and emerging markets stocks (MSCI EM) lost 54% during the year. Very simply, this was due to a combination of rapid reduction in risk appetite, forced deleveraging, and significant fundamental deterioration of company balance sheets and earnings. As has been well reported, several prominent companies went bankrupt, a

few others were taken over by the government, and many others are in the process of receiving significant government loans.

Because of the rapid decline in fundamentals, the valuation ratios of stock indices are relatively unchanged from a year earlier. For example, the price to trailing earnings ratio (P/E) for the S&P 500 remained at about 20 at year-end, the same as it was at year-end 2007, slightly higher than its 18 times earnings level at the end of 2006 and higher than its post war average of 17.3. Hence, in nominal terms, average valuations are not especially compelling. However, it is important to note that a large portion of the earnings deterioration was centered on the financial sector, so within certain sectors there are plenty of historically cheap stocks. One traditional measure of value, the average earnings yield (E/P) of the S&P 500 relative to U.S. treasuries is historically very high. Similarly, with an average dividend yield of 3.3%, the S&P 500 has a rare dividend yield premium to U.S. treasuries.

Virtually everyone on the planet is aware of the economic malaise, and has factored in significantly weaker expectations for the economy and corporate earnings in 2009. But just how stable are corporate dividends and what is the earnings power of companies? Wall Street estimates for the earnings of the S&P 500 for 2009 seem to be ranging between \$53 and \$70 per unit, with the consensus on the high end. At a current price of 850, that puts the P/E ratio on expected earnings anywhere from 12 to 16. History suggests that consensus estimates are typically over-optimistic, especially during recessions. In other words, the consensus eventually gets the recovery right but usually underestimates the depth and/or length of the earnings drought.

Real Estate

Residential real estate prices and transaction volume have been in a steep decline for more than two years. Since this is one of the root causes of the financial crisis, a commonly held belief is that a stabilization of housing prices will be a necessary precursor to economic recovery. While we believe there is truth to this, we also believe that attempts to prevent the market from reaching a natural equilibrium will merely lengthen the pain. This is, among other things, an inventory problem. The inventory must be worked off. As with other industries, the quickest way to work off inventory is to reduce production and offer the product at significantly reduced prices. This is happening currently and should not be constrained. We expect that before there is a stabilization or rebound in prices there needs to be a rebound in the unit volume of transactions. We have begun to see the first step, which is a stabilization of transaction volume in existing homes. Another good sign would be a significant increase in mortgage restructurings, which is conceptually a resale of a property by the mortgage company to the current mortgagee at a reduced price.

After years of price appreciation and stable rents, commercial real estate also faltered in 2008. Real Estate Investment Trusts ("REITs") were particularly challenged. Because REITs are required to pay out almost all income on an annual basis, they cannot maintain a large cash cushion and are thus more dependent upon the short-term funding markets. Even well managed, otherwise healthy REITs were challenged when

the short-term credit markets froze. With the current and expected declines in consumer and business spending, significant cutbacks in employment and the failure and consolidation of businesses in the financial and retail industries, the immediate fundamental outlook for commercial real estate is not attractive. However, all of these factors are well established so that valuations have been slashed accordingly. While the industry in general may be challenged, the premier operators will survive and prosper over the long-term.

Commodities

The commodities bubble burst in 2008. While prices of food, base metals and energy were surging over the recent years, there was an active debate as to whether this was a result of surging demand from emerging markets such as China, or whether it was driven by speculation and manipulation of the futures markets. It has become clear in hindsight that both were factors, and that leverage and speculation were rampant. In any case, the demand destruction started by exorbitant prices and extended by the economic downturn combined with the removal of levered speculators brought commodity prices back to earth.

Alternatives

Alternative investments provided mixed results in 2008. Strategies that were dependent upon significant borrowing to generate returns fared especially poorly as the cost of borrowing rose, the availability of credit vanished and the increase in volatility caught many by surprise. Widespread and forced selling of all risk assets created higher than expected correlations. However, hedge fund strategies that were not dependent upon borrowing, had the flexibility or mandate to be tactically agile, or were truly hedged had the opportunity to add significant value. In addition, there were a few managers that anticipated the financial disarray and aggressively positioned their portfolios accordingly.

Looking Forward

We believe that the near-term (2009) economy and markets will take one of two basic paths. As noted above, the more optimistic scenario is that the massive monetary and fiscal stimulus would unlock the credit markets, encourage investment and spending, stem job destruction and succeed in turning the economy by late-2009. If this is the case we should expect that stocks would perform well after bottoming in early 2009. Actual earnings would resemble expectations, and forecasts of earnings would begin to improve. Much of the massive amount of cash on the sidelines and in U.S. treasury securities would make its way back into stocks. While high quality stocks would perform well, there might be a rotation back toward risk causing lower quality companies to rebound more. Credit markets would continue to improve, yield spreads for corporate bonds would narrow, and default rates for investment grade and high yield bonds would peak at levels similar to previous recessions. High yield bonds would compete with

stocks as the best performing asset class. High grade corporate bonds would provide strong returns from a combination of their current yields plus some appreciation from spread tightening. Yield spreads for municipal bonds would also probably narrow, and high grade municipals would experience minimal defaults so that the return on municipal bonds would likely be higher than their current yields. The risk in this scenario would be that interest rates rise as demand for capital increases, inflation expectations rise and investors rotate out of the safe haven of U.S. treasury securities. Although rising rates are a detriment to most asset classes, given current valuations and yield spreads we would expect expansion in valuation ratios and spread tightening to more than make up for the rising rates. The worst performing asset in this scenario would likely be long-term U.S. treasury bonds which would return no better than their current yield (2.4%) and possibly much worse.

A considerably less optimistic scenario would be a deep and extended recession with a muted recovery thereafter. In this case, stocks would likely be the worst performing asset class as corporate earnings would come in well below expectations and there would be a continuation of bankruptcies and forced consolidations. Default rates for high yield corporate bonds would exceed expectations but it is still likely that the extremely high carrying yield on these securities would provide a net positive return. It is hard to imagine high grade corporate spreads widening too much more from their crisis levels of 2008, so corporate bonds would also provide positive returns, as would high grade municipal bonds. Interest rates would fall even further, but there is not much room on the short end of the curve, so short-term treasuries would provide meager but positive returns and long-term treasuries would continue to appreciate. The most important thing to note about this scenario is that quality would be king. Stocks of companies with high quality balance sheets, positive cash flow and strong competitive positions would survive while others would weaken and/or perish. Furthermore, bonds, being higher in the capital structure than stocks would hold value better, and given the higher initial yield, provide higher net returns. In most cases, quality, seniority in creditor position and flexibility will be far more important than geographic domicile.

Obviously, there are myriad possibilities between and outside of these two scenarios. We are hopeful that the more optimistic of these scenarios plays out, but believe that we should structure portfolios with both equally in mind. Hence, relative to an investor's long-term strategic allocations we recommend an underweight allocation to stocks coupled with an overweight in bonds. Within the stock portfolio, we would advocate an abundance of positive cash flow businesses with high quality balance sheets and strong competitive positions. There is not necessarily a growth or value tilt, but clearly a quality/stability tilt. Companies such as these are not exclusively domiciled in the U.S. and foreign currency movements are unpredictable. Hence, we continue to advocate global diversification. Within the bond portfolio we would advocate an overweight in corporate bonds, with a slice of high yield bonds to compensate for some of the stock underweight. In both of these cases we believe active bottom up security selection with an eye toward higher quality will be value added. In this environment we believe good active managers are well worth paying for. For taxable investors, municipal bonds offer compelling relative expected returns with the note that high credit quality will be paramount if the environment continues to deteriorate. We expect treasuries to

outperform only in the most dire of situations and would thus advocate little to no exposure. However, if a recovery scenario appears to be playing out, as corporate spreads tighten, we would advocate rebalancing from corporate bonds into TIPS.

Keep in mind that this positioning will not be optimal for either of these scenarios. It will, by definition, be sub-optimal for whatever actually plays out. However, given that we do not know what will transpire, we believe that this is the most prudent positioning for the range of possibilities. Regardless of how the global economy is faring, we expect markets and our portfolios to continue to be quite volatile as investors and speculators react to daily news flow.

Long-Term Strategic Outlook

Over a longer-term (10+years) perspective, we believe strongly in the power and flexibility of capitalism to efficiently allocate capital, generate returns, and improve the standard of living. Hence, despite the various paths that the global economy and markets may take in the meantime, the Samoset Investment Committee has raised its long-term expectations for real (inflation adjusted) returns of developed markets stocks and emerging markets stocks up to 6% and 9%, respectively (if inflation averages 3% per annum, we would expect nominal returns of 9% and 12%, respectively). The Investment Committee found no compelling reason to favor any developed country, currency or region over others; however, the premium return expectation for emerging markets reflects an observation that emerging economies have the momentum and potential to grow GDP faster than developed markets, and given strong balance sheets and trade surpluses, a potential for appreciating currencies. This obviously comes with higher expected political, event and liquidity risk.

The Investment Committee set its long-term real return expectation for debt (bonds) at 3.5%. This combines the very low starting yield for treasuries with higher expected returns for credit, and an inflation expectation of 3%. Given current yields for investment grade credit, high yield credit and even municipal debt, the debt return will be driven by these sectors. As usual, the committee's long-term real return expectation for cash remains near 0%.

Commercial real estate, like distressed debt will provide some attractive opportunities that will require careful, specialized analysis, a lock-up of capital and long-term patience to properly exploit. There will be lots of land mines. The Committee continues to believe that commodities offer no value as a strategic long-term asset class. However, the fundamental and technical volatility of commodities can serve as a profitable opportunity set for active trading strategies. The Investment Committee continues to believe that a properly structured portfolio of alternative strategies will provide value in terms of both real returns and diversification. The recent and ongoing shrinkage of the hedge fund universe and assets under management will benefit the opportunity set going forward.

To summarize, we continue to have confidence in capitalism and believe that the financial markets will provide attractive investment returns over the long-term. However, the global economy is uniquely challenged at this point, and the possible

paths to recovery are unclear. We believe it is most prudent to consider more than one scenario when constructing your portfolio for the near future.

January 23, 2009

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