Financial Markets Review and Outlook

April 2009

Believe it or not, most of what transpired during the 1st quarter of 2009 was not surprising. As expected, the economy continued to deteriorate, the rate of unemployment increased rapidly, housing prices continued to fall, the stock market drove lower, reaching a new bottom in early March, and the U.S. government aggressively searched for new and creative ways to thwart the recession.

There were, however, a few interesting surprises. The big banks announced that they are making money, TIPS outperformed other high quality bonds, and emerging markets stocks rose during the quarter, outperforming all other equity groups.

Now that the market has rallied from another deep trough and the recession seems to be behaving within reasonable expectations, it may seem like the investment community has an increasing grasp on this market cycle, and that it's only a matter of time before the next expansion begins. Be careful. Although we are further down the road, it is still unclear which of the two basic scenarios discussed in our January letter will play out. Either (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.

A summary of our recommendations as are follows:

- We recommend that clients remain well diversified and more liquid than usual. This should include slices of both stocks and bonds for any clients with at least a 5-year time horizon.
- Starting with their respective long-term strategic allocations, we continue to recommend that investors: (1) underweight stocks, and tilt their stock portfolios toward high-quality, cash flow positive companies; (2) overweight investment grade corporate bonds and/or high quality municipal bonds, including a small slice of high yield bonds; and (3) incorporate active tactical allocation strategies into their portfolios.
- Lastly, we recommend that investors create a schedule to gradually move back to long-term strategic target allocations by the end of this year.

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

Economy

As expected, the economy rapidly contracted throughout the 1st quarter of 2009. We are in the heart of a vicious cycle where a lack of available credit and/or the decision to reduce debt has caused consumers and businesses to cut spending and capital investment which has led to an acceleration of job losses and a lowering of prices. This naturally leads to lower employment, lower consumer income rates, lower corporate profits and a weakening of expectations for the near-term future. And the cycle continues. This is worse than usual because the length and ultimate magnitude of the previous virtuous cycle was exceptional, and the current vicious cycle is synchronized across the globe.

The U.S. unemployment rate rose to 8.5% by mid-March, up from 7.2% in December 2008 and 4.9% in December 2007. To put that another way, the U.S. economy lost a record 3.7 million jobs over the past six months. Although employment is one of the most visible and important factors driving the economy, it is important to note that it is typically a lagging economic indicator, so we can expect unemployment to continue to get worse, even if there is an inflection point in the economy.

As expected, the index of leading economic indicators continued to deteriorate during the 1st quarter, but only modestly. This index combines statistics that in combination are generally believed to be a good indicator to the future direction of the economy. Six of the indicators deteriorated, most notably the labor and manufacturing-related statistics, while four improved, including the steepening yield curve and the increasing money supply.

As expected, inflation was non-existent during the 1st quarter. With inventories still being worked down, employment rolls contracting and capacity utilization at extremely low rates, we should not expect inflation to be a near term risk. The caveat to this is the huge increase in money supply, which, by definition is inflationary. However, the purpose of this form of stimulus is to counteract the sudden non-existence of the shadow banking system and the significant slowdown in velocity (the turnover rate) of money.

Cash

An observation we made in October 2008 was that a key symptom of the credit crisis was the freeze up of the commercial paper market and the extraordinarily high level of LIBOR (London Interbank Offered Rate), particularly in comparison to U.S. Treasury rates. This was reflective of institutions' distrust to lend to each other and quite possibly panic. At the height of the crisis, the 3-month LIBOR hit 4.8% which was roughly 4.6 percentage points (460 bps) higher than the comparable Treasury yield. This was not only a symptom but a cause for much of the economic destruction that has followed as businesses and consumers alike found it difficult and/or expensive to obtain loans which forced them to slash spending, cancel projects and lay off staff. The initial drastic measures that the Federal Reserve Bank and U.S. Treasury implemented were focused on alleviating that problem. We are pleased to note that the 3-month LIBOR dropped in December and has hovered around 1.2% throughout most of the 1st quarter, which has generally been about 1 percentage point (100 bps) higher than the 3-month Treasury

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yield. While most credit experts would not characterize this as completely back to normal, it is close to normal and emblematic that the credit markets are not in crisis.

Bonds

As expected, Treasury bonds performed poorly as the flight to quality subsided and investors carefully waded back toward riskier assets. Not only were treasury yields too low to provide reasonable carry, but investors began to consider the huge cost of the many government actions, which will provide an increased supply of Treasury issues for years to come. Treasury bonds might have performed even worse had the Federal Reserve Bank not announced a program of quantitative easing, in which the Federal Reserve Bank would actively purchase Treasury securities in order to keep interest rates low. Surprisingly, TIPs did perform well, as they corrected from a severely discounted price at year-end and possibly began to price in expectations of inflation down the road. The 10-year Treasury bond lost 2.68% during the 1st quarter while the 30-year bond dropped 13.45%.

Mortgage backed securities (MBS) and asset backed securities (ABS) were among the best performing debt securities during the quarter, which may seem counterintuitive given the state of the housing market and employment trends, but these issues also benefitted from increasing U.S. government support. This highlights the fact that financial analysis and forecasting has become even more challenging as U.S. government programs involving hundreds of billions of dollars are being announced and revised on a daily basis. The Citigroup Mortgage Index returned 2.26% during the 1st quarter.

Investment grade corporate bonds provided disappointing returns on the whole, but there were bright spots. The financial sector suffered, particularly in the middle of the quarter as fears arose that some of the large banks might be nationalized. The industrial sector performed adequately and the lower credit quality portions (BBB) did better than higher quality groups. Importantly, there was increased new issuance in the investment grade space, which found strong demand due to attractive spreads. These spreads remain reasonably attractive. The BarCap U.S. Aggregate Bond Index returned 0.12% for the 1st quarter.

Along these same lines, junk (non-investment grade) bonds performed extremely well, not only due to their exceedingly high yield, but also to spread tightening (price appreciation). The timing of this is a bit surprising given default rates are now increasing and should be expected to increase further. There were 35 defaults in March alone, almost as many as in January and February combined. However, these default rates were well anticipated, and investors' willingness to move into higher risk assets is encouraging. The BarCap U.S. Corporate High Yield Index returned 5.98% during the 1st quarter.

Global bonds performed about the same as U.S. bonds in local currency, but the U.S. dollar's strength hurt non-dollar denominated bond returns for U.S. investors. Lower credit quality and emerging market debt outperformed higher quality issues. The BarCap Global Aggregate Bond Index returned -3.25% during the 1st quarter.

Municipal bonds provided ample returns, as their starting yields were quite attractive and the large stimulus packages helped to abate concerns over credit quality. The BarCap Municipal Bond Index returned 4.23% for the 1st quarter.

Stocks

Stocks dropped about 10% from the start of the year to President Obama's inauguration and then paused for a few weeks awaiting the new administration's policy initiatives. The honeymoon was very brief and Treasury Secretary Tim Geithner's bank rescue plans were met with skepticism and confusion, sending stocks sharply lower into early March. The financial sector suffered the most as banks such as Citigroup, and Bank of America teetered on the precipice of worthlessness while investors and politicians debated whether they should be restructured by the U.S. government. All major stock indices dropped to lows not seen since the mid-1990s. From its peak above 14,000 in October 2007, the Dow Jones Industrial Average fell more than 50% to 6,547 on March 9, 2009. The S&P 500 was down almost 25% for the year to date, before rallying to finish the quarter down "only" 11%.

Interestingly, it was the banks themselves that provided a catalyst when they announced in mid-March that they were producing positive operating earnings during the 1st quarter. (Since that bottom and as we write this review, financials are rallying in anticipation of their 1st quarter earnings results.)

While virtually all sectors lost ground in the 1st quarter, the technology sector was the lone exception, rising about 4% within the S&P 500, on the strength of Apple, IBM and Google. Extremely weak financials and a relatively strong technology sector go a long way toward explaining the vast difference in performance between growth and value style benchmarks. Growth indices outperformed their value counterparts by about ten percentage points (1000 bps) across all capitalization ranges. Small-cap stocks generally trailed large-cap benchmarks, and developed international markets provided similar returns in local currencies but lagged by about 3% as the U.S. dollar strengthened. Most surprising was the performance of the emerging markets which never dropped more than11% into mid-March and rallied to a slight gain for the quarter. There doesn't seem to be any fundamental rationale for this move relative to developed markets stocks. We believe this is technically-driven, and is indicative of the types of stocks that will rally the most as soon as investors see light at the end of the tunnel.

Real Estate

As expected, residential real estate prices continued to decline, but there are signs that the transaction volume is picking up. Commercial real estate has serious challenges at this time, and it is not surprising that REITs and REOC securities performed dreadfully during the quarter. Given the current glut of supply and expectations of continued job cuts and business consolidation, the near term outlook for commercial real estate remains unattractive.

Alternative Strategies

Alternative strategies provided mixed returns. The CS Tremont Investable Hedge Fund Index lost -0.48% for the quarter. The best returns were generated by multi-strategy and global macro hedge funds, which rose 3.65% and 2.58%, respectively.

Looking Forward

Reflecting upon the events of the 1st quarter, it is comforting to note that there were actually a few pleasant or neutral surprises, and importantly, there were no significant negative surprises. Now that we have rallied off of two deep troughs (November and March) it may feel like we are in a stabilizing trading range. As the recession and markets this past quarter have behaved within reasonable expectations, it may seem like the investment community has an increasing grasp on this recession and market cycle, and that its only a matter of time now to wade through this recession and get on with the next expansion. We are further down the road, but it is still unclear which of the two basic scenarios discussed in our January letter will play out. The added challenge is that the economy and markets are now more than ever being impacted by government programs, policies, and regulations that are being developed on the fly. It is difficult enough to interpret the possible implications of programs that have already been announced, but clearly impossible to forecast implications of policies yet to be developed. This is a necessary complication because we believe that aggressive stimulus and government support is absolutely necessary to prevent a complete collapse and severe depression. Without aggressive action the outcome would be much easier to forecast, but all bad.

The fact is that the U.S. government is in fire-fighting mode, trying desperately to save the building before it collapses. It is difficult to keep current, but we estimate that the U.S. government alone has earmarked more than $5 trillion dollars for various forms of stimuli, bailouts, backstops and investments. In the aftermath of the carnage created by the failure of Lehman Brothers, the TARP (Troubled Asset Relief Program) was budgeted to make $700 billion in “investments” (cash injections) into banks, insurance companies and the auto companies in order to forestall or prevent their bankruptcies. The CPFF (Commercial Paper Funding Facility) has used more than $250 billion to backstop the commercial paper markets. Given that marginal liquidity and trading has returned to these markets, and the interest rate at which they trade has dropped significantly, one could only conclude this to be successful so far. The TALF (Term Asset-backed Loan Facility) has been earmarked with $1 trillion to help re-establish the asset securitization business. Some people have referred to this as the shadow banking system, which for better or worse had become a significant source of lending across the global economy. The PPIP (Public Private Investment Partnership) was designed with the dual goals of helping banks unload their distressed loans and mortgage securities, and finding a rational market mechanism to help put an accurate value to them. The Obama administration has also passed an $800 billion dollar stimulus bill which can be implemented in the form of government spending or tax cuts. The Federal Reserve Bank has begun a program of quantitative easing where it may purchase up to $1 trillion in treasury securities, mortgage-backed and asset-backed securities. Other forms of stimulus and policy changes that do not have a quantifiable cost include a Fed Funds target rate of 0%, and the Financial Accounting Standards Board (FASB) statement 157 rule change allowing companies some flexibility on marking their securities to market prices. There have been others and there will undoubtedly be more programs to follow.

Whether or not these programs will work is a difficult question and all you need to do is read the paper or watch TV to note that opinions vary widely. That raises another point which is that the prevailing psychology will be an important ingredient to how well we muddle through this ordeal. This harkens back to President Roosevelt's famous quote, "We have nothing to fear, but fear itself", which addressed how the nation's morale had become part of the problem. We believe that the employment picture will have the most profound effect on the prevailing psychology along with its significant effect on fundamentals. We understand that the goal of most of the U.S. government programs is to ultimately save and create jobs. Lagging indicator or not, we will closely monitor various employment statistics to search for inflection points.

Similarly, housing prices have profound effects on the fundamental value of mortgage securities, but just as importantly they have significant influence on consumers' and investors' confidence. We have previously noted that transaction volume would need to rise before we should expect housing prices to stabilize. The good news is that there seems to be stabilization and possibly an increase in sales volume for existing houses, particularly in the hardest hit areas. If this is sustainable and broadens across the country it will help prices to stabilize soon. On the other hand, we do not expect housing prices to rebound in any significant way. The silver lining to this is that the combination of price drops and low interest rates has made housing more affordable than it has been in years. As long as consumers evolve back to viewing their houses as places to live and cost centers as opposed to ever appreciating investments, low and stable housing prices will be a good thing. Similar to low oil prices, low interest rates, and low taxes, low and stable house prices should be economically stimulative.

The market is in the mood now to be searching and hoping for light at the end of the tunnel. History and logic assures us that the stock and credit markets will anticipate an economic turn by a few months, but this knowledge is not useful because we do not know when the economy will recover. If it turns out that the massive government programs are already taking effect, some by virtue of merely being announced, that the big banks are indeed on sustainable footing with no need for further significant write-downs of bad loans and securities, that housing price declines are abating, that unemployment gets no worse than 10% and that the big three auto makers have found a way to survive, then we have indeed already seen the bottom and stocks should continue to rise from here. There is a lot of cash on the sidelines, and as soon as the market perceives that the risk of severe depression is gone, stocks will rise quickly, and probably overshoot. Hence, there is a fair amount of upside potential at this time.

It is not certain, however, that the government's firefighting activities are appropriate or enough to put out the fire. Nouriel Roubini, the NYU professor of Economics who has become well known for having forecast this crisis, recently estimated that there is still a 15% to 20% chance of a severe depression. Staying with the firefighting analogy for a moment, we may also ask how bad the water damage will be. Or worse yet, are we trying to put out a grease fire with water? While we understand the thesis and motive behind each of the relief programs, it is disconcerting to note that our officials are trying to remedy problems that were ultimately created by the availability of massive amounts of cheap leverage by creating massive amounts of cheap leverage. It suffices to say that there remains a fair amount of downside risk as well.

So what is an investor to do? Diversify. Given the heightened risk, and the breadth of the possible outcomes we believe investors should be more diversified than usual, and maintain ample liquidity. While hiding in cash provides plenty of liquidity, it is not well diversified and will perform poorly in a few possible scenarios. Relative to your long-term strategic allocations, we continue to recommend that investors underweight stocks and tilt their stock portfolios toward high quality, cash flow positive companies. Concurrently we recommend that investors overweight investment grade corporate bonds and/or high quality municipal bonds, while avoiding treasury bonds and including a small slice of high yield bonds. We also advocate allocating a portion of your portfolio to active tactical allocation managers, which can implemented either in traditional long-only strategies or within a group of alternative strategies.

Particularly for clients that are, for some reason, far from their strategic target allocations, we believe it is prudent to create a schedule to gradually move toward your long-term targets by about year-end.

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