

# EXECUTIVE SUMMARY

- The year 2008 could perhaps be best summarized as “unprecedented.” It was wrought with fear caused by seized credit markets, corporate bankruptcies, bank failures, plummeting real estate indicators, and historically significant government bailouts and mergers, ultimately culminating in a sharp decline in economic activity in the latter half of the year. Investor response to the perfect storm of converging issues resulted in historically high levels of volatility and the most severe bear market since the Great Depression.
- As the National Bureau of Economic Research recently announced, December 2007 officially marked the peak of U.S. economic expansion. As a practical matter, this confirmed the broad view that the U.S. economy had been in a recession, with the only question being the point at which it actually began. Gross domestic product (GDP) slipped into negative territory in the third quarter, led by a decline in consumer consumption of nearly 4%, steepening job losses which magnified as the year drew to a close, and a clearly apparent slowdown in production activity.
- The fixed income markets, which generally perform well when equities struggle, were not exempt from the risk aversion through much of the year. The credit crunch that began in 2007 intensified throughout 2008. The Barclays Aggregate Bond Index returned 5.2% in 2008, while the Barclays 5-Year Muni Index reported a 5.8% return.
- The unusually severe flight to quality resulted in a deep, protracted sell-off in equities. The S&P 500 Index lost 37.0% for the year, lagging marginally behind smaller cap companies. The Russell 2000 Index ended the year down 33.8%. The global capital flow into comparatively safe U.S. Treasuries caused the dollar to surge in October, exacerbating local market losses in equities for U.S.-based investors. The MSCI EAFE fell by 43.4% for the year.
- As the Federal Reserve and U.S. Treasury began to recognize the scope and severity of the crisis, they commenced a broad and unprecedented series of initiatives to stabilize the financial system. The Fed lowered its benchmark funds rate from 3.25% to a range of just 0–0.25%. They worked with Congress to enact the Emergency Economic Stabilization Act of 2008, placing both Fannie Mae and Freddie Mac under conservatorship, and facilitated the bailout of Bear Stearns and the effective nationalization of AIG. Coordinated efforts with central banks worldwide were directed at lowering interest rates and injecting massive amounts of capital to shore up credit markets.

## 2009 – THE ROAD AHEAD

Traditionally, our annual “Road Ahead” commentary represents our written discourse on the outlook for the economy and capital markets for the coming year and beyond. As we prepare these thoughts, both the economy and capital markets are being buffeted by a range of issues that have created an environment characterized by uncertainty and instability. The level of volatility that has been experienced in the past few months is unprecedented in the post-World War II era, and the rapid decline in economic activity suggests that the economy is facing a recession that by measures of amplitude and duration will be worse than any contraction faced by the U.S. economy in at least 26 years.

In our “Road Ahead” commentary last year, we noted that the U.S. economy may have been at an inflection point given the degree of uncertainty and the broad range of opinions about the near-term outlook for the economy. We noted concern about the ability of consumers to maintain what had been a previously unstoppable pace of spending in the face of falling home prices, higher debt service costs, and increasing food and energy costs. We also noted that the possibility existed that the “full effects of the housing pullback, the return to

balance in credit markets, and the re-pricing of risks in the capital markets could play out over an extended period.” That “extended period” started as a multi-month decline that ultimately deteriorated into a market panic.

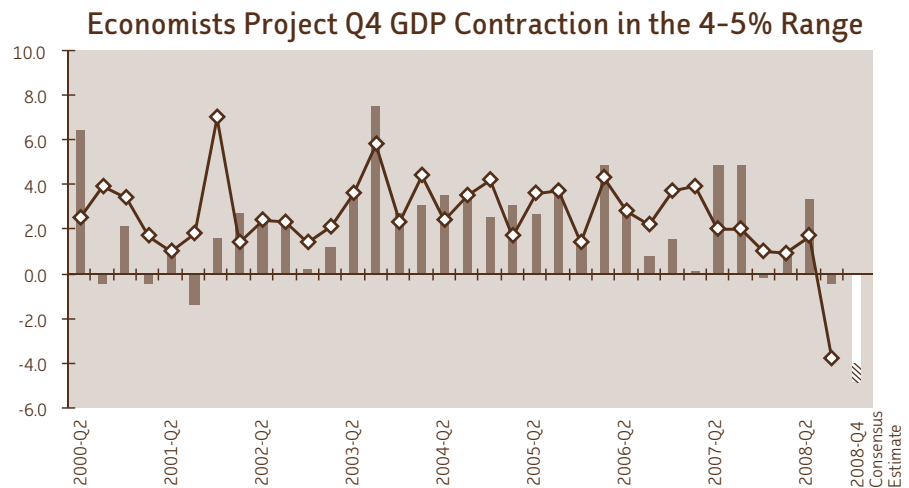
At the time, we believed that the credit markets and economy were likely to struggle in 2008. Like most market observers and economists, however, we did not anticipate the degree of market volatility or the seizing up of the credit markets that subsequently ensued after Lehman Brothers collapsed. Few, if any, could have projected that in the coming months, the Federal Reserve would exercise an increasingly broad range of powers beyond the implementation of monetary policy to directly intervene in the financial markets in unconventional ways. What many believed was a “contained problem” with the subprime housing market ultimately cascaded into the demise of Bear Stearns, Lehman Brothers, Wachovia, Washington Mutual, Fannie Mae, Freddie Mac, and AIG, among others.

Obviously, all of these issues have been previously rehashed by the press, and we have commented on each, as well, in our previous commentaries over the past several months. We raise the issue again here neither to

remind you of the magnitude of the challenges that investors have faced, nor in an effort to defend what we couldn't predict. While we strive to be candid in sharing our outlook for the markets and the economy, we have also consistently noted the difficulties inherent in reliable short-term forecasting, even under relatively stable conditions. We continue to believe that much of this crisis could have been avoided altogether with an appropriate policy response from Washington. However, as has often been the case in other crises, our system seems to prefer to react to crises rather than prevent them, particularly when the potential magnitude is difficult to measure in advance.

The critical message from this discussion is that we continue to be wary of the substantial uncertainties that are hanging over the market and the economy as we look forward today. While significant progress has been made from a policy perspective, we fully anticipate that fourth quarter economic activity will show substantial weakening from the negative third

quarter results. The prevailing view among economists is that the economy could contract by a noteworthy 4-5% annualized for the final quarter of 2008. Moreover, a virtual consensus exists that the economy will remain weak through at least the first half of 2009, perhaps even into 2010.



We see nothing at present that would convince us that view is unnecessarily pessimistic. If anything, economists have been frequently surprised by the degree of weakness in many key economic indicators in recent months. Without question, the possibility exists that the economic downturn could extend beyond that time, particularly if the global deleveraging process continues and material

improvements in the credit markets are not achieved in the intervening period. While we are now seeing significant policy responses to the crisis, we still believe more needs to be done to stabilize home prices and provide sufficiently broad relief to homeowners to stem the tide of delinquencies and defaults. The inherent challenge is that crafting a policy response that is likely to be sufficient and appropriately targeted without absolving many homeowners from poor decision-making (making it perhaps politically unpalatable) has proven daunting. In short, no obvious solution appears forthcoming. In addition, while the recapitalization of the banking system was necessary, also important in the process will be the recognition of additional write-downs to clean up balance sheets further. Only then can a return to “normal” lending activity take place.

We will also approach the next year cautiously given the changes in Washington. From a policy perspective, the Obama administration and Congress will need to hit the ground running. They appear to be on track thus far to do so, and we are generally pleased that a team of very experienced economic advisors has been assembled. Much recent discussion has surrounded the potential for a stimulus package involving some form of tax cuts for the “middle class” and governmental spending targeted at infrastructure investments.

In our view, any assumption regarding the nature, size, or specifics of a stimulus package at this point remains premature. Over the past year, we have all witnessed the evolution of the current crisis and the need for the Federal Reserve, the Federal government, and foreign institutions to remain nimble in order to respond rapidly to changing conditions. We believe that the potential exists for further economic surprises or, from a pragmatic view, the force and direction of shifting political winds to result in a policy response that could still change materially from current proposals.

Conversely, we are somewhat encouraged by the likelihood that the new administration will be able to garner support among its political allies in Congress to quickly pass a stimulus package in some form or fashion. At this point, there is no way to assess the sufficiency or success of a piece of legislation that has not yet been drafted. Some form of tax cut coupled with appropriately targeted spending should provide support for consumers, which we believe is appropriate. Nonetheless, we do not expect that any package is likely to pull the economy out of recession on its own merits, so expectations about its impact must remain tempered.

# THE ECONOMY

Generally, the National Bureau of Economic Research (NBER) flies under the radar as a relatively quiet body which periodically resurfaces during periods of economic unrest. The NBER is responsible for formally evaluating the economic cycle of the United States and determining key turning points such as the beginning and end of economic recessions. Because of the critical nature of this task and the need to evaluate data trends over longer periods, the NBER only announces a formal turning point in the economic growth cycle well after it actually occurred. In early December, the NBER confirmed what most economists had been suggesting for some time: the U.S. economy was in fact in a recession. Additionally, they indicated that the turning point came in December 2007,<sup>1</sup> nearly a full year prior.

As we examine recent data, the economy clearly remains in a contractionary phase that intensified in the final months of 2008. Estimated third quarter GDP indicated that top line economic activity fell during the quarter. Moreover, personal consumption expenditures (representative of most consumer spending and accounting for two-thirds of aggregate activity) fell precipitously during the quarter, slipping nearly 4%. By way of comparison,

during the last U.S. recession in 2001, personal consumption expenditures never slipped into negative territory for a single quarter. Early indications for the near term paint an even less rosy picture; most economists are calling for a steep decline in GDP of perhaps 4-5% annualized for the final quarter.

A second key indicator is the employment market, which had been soft since late 2007, but weakened considerably further in recent months, as new jobless claims reached levels not seen since the early 1970s. The nation's unemployment rate now exceeds 6.7% and has risen over 2 percentage points from its cyclical bottom of just 4.4% in March 2007. At its recent rate, which is widely expected to continue to rise well into 2009, the nation's jobless rate already exceeds its peak of 6.3% in the wake of the previous recession earlier this decade.

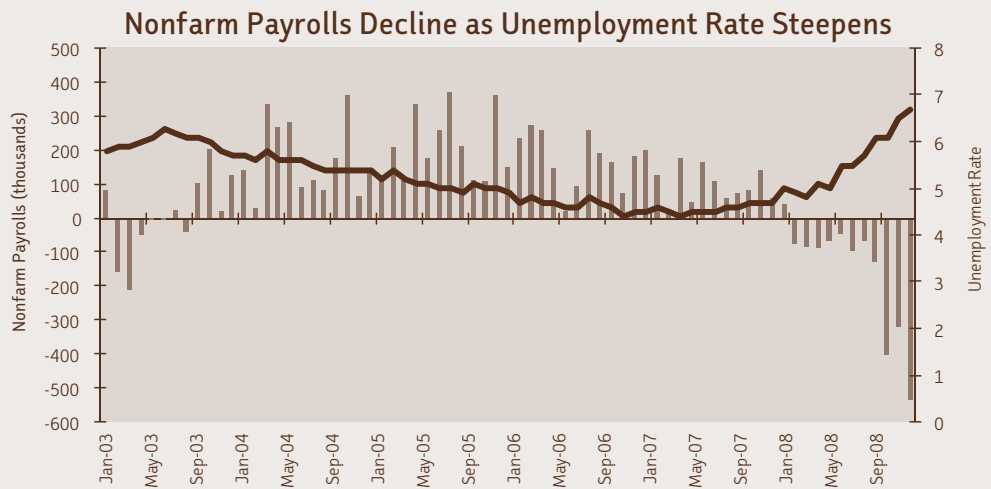
As we look toward 2009, it is difficult to envision a scenario that will lead to a rapid return to economic growth in the United States or abroad. As we have noted in many of our prior communications over the past several months, we believe that U.S. consumers remain in a very precarious financial position. Given the pivotal role of consumers, we expect that the breadth

of problems will not only weigh on consumer spending, but will translate to a more muted recovery in GDP when the economy turns upward. Most assets held on individual "balance sheets," including financial assets and residential real estate, have declined in value. Meanwhile, credit has become tighter, and personal income is softening.

It comes as no surprise that with the convergence of factors pinching their wallets, consumer confidence eroded in December 2008 to its lowest point since the Conference Board's index was introduced in 1967. The result? Consumer spending is faltering, as the broad impact of individual frugality and increased savings result in a substantial drag on GDP. Business spending, construction, and exports are also expected to stumble. While increased government spending could provide some support, it is highly unlikely that any spending by the federal government would be sufficient to completely offset

the sheer impact of the decline in consumer outlays. As such, "recapitalizing" consumer balance sheets may be necessary to stem the current negative tide.

At the point that we are writing this, a substantial fiscal stimulus package in early 2009 appears likely, although it is unclear what form that stimulus will take. If recent indications reach fruition, the size of the package appears likely to easily exceed the bill that passed in early 2008. Given the continued stresses on the residential housing and mortgage markets, jump-starting consumer spending would appear to require some relief directly targeted at stabilizing the negative wealth effect of disappearing home equity and mortgage debt service requirements.



# MONETARY POLICY AND FIXED INCOME

The credit crunch has created massive dislocations within the credit markets and has exacerbated the actions of global central banks. On a relative basis, the markets have been supported by lower short-term interest rates and liquidity infusions to help address the broad economic and financial market issues. Global central banks have been generally reducing interest rates in recent months and likely will continue to do so. In spite of this, interbank lending rate spreads (specifically the Libor minus the T-bill rate), which spiked to historically high levels after the failure of Lehman Brothers, remain high compared to their historical norm. This disconnect is a clear indicator that banks have been extremely fearful of lending to each other even on an overnight basis. The recent gradual easing in Libor rates is a positive sign for the financial markets, as the willingness to lend capital at a reasonable price is critical to the inner workings of the global financial system. The system remains far from a state of normalcy, but signs of improvement from its recent peak period of distress are apparent.

As has been historically the case in times of crisis, U.S. Treasury securities again acted as a safe haven for investors seeking shelter in recent months. Treasury yields have been pushed down across the curve, as many investors have

been predominantly concerned with protecting capital with little regard to return potential. In December, the 10-year Treasury yield dipped to levels below 2.1%, while the 30-year Treasury dropped below 2.6%, both historically low levels since the Treasury began regular sales of each.<sup>2</sup>

The rush to Treasury securities has mostly been concentrated on the short end of the curve, in spite of aggressive global rate cuts. In the midst of a prolonged economic slowdown, the appetite for Treasuries likely will remain healthy. However, the degree of urgency in this flight to quality has shown signs of subsiding, at least temporarily. Given the significant financing burden that the Treasury has recently taken on with recent proposals aimed at shoring up the banking system (like the Troubled Asset Relief Program), Treasury issuance is expected to pick up to a degree unmatched in decades. All else being equal, this should temper yield declines from strong demand. While this increase in fiscal debt may not immediately be inflationary, we anticipate that it may be in the long term. Because of this, it's hard to "pound the table" on low-yielding, nominal Treasury securities as a long-term investment solution, especially in light of the high-quality credit opportunities we see in the marketplace today.

Tightening credit conditions, a declining real estate market, and a flight to quality have caused massive levels of forced selling to occur in global fixed income markets with little regard for investment fundamentals. We believe that this has created some historic opportunities for investors to gain exposure to high-quality fixed income investments, including agency-backed mortgage securities, high-quality municipal bonds, and selective allocations to investment grade credit, albeit subject to implementation at a measured pace. Defaults are a concern in an economic slowdown, but high-quality, active investment managers may be able to mitigate the impact of defaults on investor returns. Relatively robust yields will also help to provide some cushion against these events. Extreme economic pessimism has been priced into the credit markets to a much greater degree than in the equity markets. As such, we anticipate that credit markets may begin to recover earlier than the equity markets. We continue to evaluate many opportunities in the fixed income markets that have experienced seemingly unreasonable price depreciation and may provide returns similar to those historically associated with equities. In time, we will consider adding exposure to those which appear to present an attractive risk/return scenario.

The U.S. dollar has staged a rally in recent months against many major developed and emerging market currencies. This was largely triggered by a flight to quality and the lack of liquidity in the short-term funding markets. While this may last

in the short term, we don't expect that it will be as powerful as we've already seen and may reverse relative to emerging market currencies at some point in the future. We believe that short-term liquidity has improved, which should help keep currency volatility lower than has previously been realized. Also, while monetary policy actions by the Fed have been perceived to be more aggressive than those of their global counterparts, foreign central banks have recently stepped up with very aggressive interest rate cuts as well. These moves may be positive for the U.S. dollar, if the U.S. is viewed as being further down the path to eventual recovery. The playing field is likely to level sooner rather than later, as the economic slowdown is an issue that all countries now have to deal with in equal force. Therefore, it's difficult to pinpoint the results of investing in a single country at this time, which makes diversification even more critical. Some emerging market currencies could continue to be affected negatively for a cyclical time frame given the difficult economic conditions, as they are heavy exporters of commodities. Therefore, credit risk may provide more upside than currency risk in the short run. However, over a secular time frame, we still think there is a possibility that a resumption of emerging market currency appreciation is likely, given that several of these currencies (including Brazil, Russia, and China) have balance sheets and capital reserve trends that are more attractive than those of the United States.

# EQUITIES

Heading into 2009, the typical equity market characteristics that accompany a recession are clearly apparent. As the market is a discounting mechanism, stocks in 2008 declined peak-to-trough by levels that have traditionally indicated a severe recession. We'll continue to look for signs of a rebound in the economy that may present opportunities to reposition our equity exposure to take advantage of the subsequent recovery. Conversely, while we do not anticipate a repeat of the Great Depression, continuing economic weakness could present a challenge to several areas of the market.

Estimates of 2009 earnings for the S&P 500 vary widely. Interestingly, the outlook may be decidedly different depending on one's approach. For example, Standard & Poor's equity sector analysts estimate 27% higher earnings from depressed 2008 levels,<sup>3</sup> while their economists see a 4% earnings decline.<sup>4</sup> While the truth may be somewhere in the middle, continued high volatility due to the uncertain earnings outlook (among other factors) remains a near certainty. Domestic stocks should benefit from what appears to be a slow unfreezing of credit markets and a low inflationary environment, which may help to stabilize borrowing costs. However, the world-

wide economic slowdown will likely restrain growth prospects for stocks, as approximately 45% of S&P 500 revenues come from abroad.<sup>5</sup> The recently stronger dollar could present a headwind to earnings results if risk aversion and the global flight to quality cause its upward trend to remain in place.

Through much of 2008, financials were the worst performing sector. In time, winners will arise from the carnage, particularly those companies with strong balance sheets that have been able to take advantage of weak competitors (via acquisition or organic market share gains). However, we remain cautious on the sector. It's uncertain if government participation/ownership in many large financial institutions will be a long-term benefit. While many companies are now on solid footing after raising capital, the cost could turn out to be quite high. In addition, the deleveraging of financial institutions and expected regulatory tightening could lower their returns and make current estimates of a rapid rebound in the sector's earnings optimistic.

From a capitalization perspective, we have maintained a comparatively defensive position in our domestic equity portfolios. At this

junction, we do not believe the immediate outlook lends itself to ratcheting up risk by increasing our exposure to smaller companies. Typically, these tend to be hit harder by the lack of availability of credit than larger blue chips. Small caps held up comparatively well earlier in 2008 despite higher valuation multiples. As the stock prices of large financial institutions plummeted, the performance of large cap indices was disproportionately hit. More recently, small cap stocks have underperformed to a significant degree. As credit market conditions clear and the economic outlook improves, we anticipate the likelihood of building positions in small cap to participate in the recovery. Until that occurs, however, we prefer to remain comparatively defensive.

The severe correction in equity markets was not limited to the U.S. but extended around the globe. The rally in the dollar in recent months further exacerbated the poor returns for U.S.-based investors. While the strength in the greenback was a negative for international investments, it was a contributing factor to falling commodities prices. For some time, we have expressed an interest in establishing a

strategic position in commodities given its strong diversification benefits and sometimes countercyclical return patterns relative to equities. Despite the very challenging economic conditions in the U.S., we remain convinced that the Fed and U.S. Treasury is further out in front of unfolding events than their counterparts around the globe. Further, we believe that the current economic outlook in developed nations outside the U.S. may result in an earlier recovery in U.S. equities.

Conditions continue to change rapidly, and we expect that there may still be some negative surprises in store for the global economy. Moreover, with investor risk aversion still very high, we expect that the return potential for riskier assets including equities could remain constrained. In time, we fully anticipate that the redeployment of cash that remains on the sidelines will lead to returns that should exceed long-term historical averages. Given the severity of the correction that is underway and the extreme volatility in the market, however, we believe that the potential exists for further losses in the near term.

# POLITICS AND POLICY

The landscape for potential changes in the federal tax law has stabilized somewhat since the November presidential and Congressional elections. However, it remains unclear which tax policies will result in legislation and even less certain when any changes will be effective. General economic conditions will likely also continue to impact the direction of the tax law.

President-elect Obama and the Democratic controlled Congress may advance a number of modifications to the tax law. As of the time of this publication, President-elect Obama has indicated that he would like to increase capital gain and income tax rates for higher-income taxpayers and decrease taxes assessed on low- and middle-income tax payers.

As currently in effect, present capital gain, dividend, and ordinary income tax rates are scheduled to expire at the end of 2010 and will reset to pre-2001/2003 tax rates. An expiration of current tax rates after 2010 would reset the top 35% marginal ordinary income and 15% dividend tax rates to 39.6% and the top 15% capital gain rates to 20%. Obama's administration initially signaled that it plans to reset most top marginal tax rates

for higher-income taxpayers soon after taking office. It now appears possible that tax rate increases under the Obama presidency may be delayed beyond 2009 and possibly allowed to expire naturally in 2011.

The operative word in projecting future tax rates is "uncertainty." It seems clear that tax rates will change in the next several years – the questions of "when" and "how much" remain. It also is possible that a variety of tax measures will be passed during the year to stimulate a struggling economy. We recommend that you consult with your tax advisor to formulate a tax planning strategy in this environment that addresses your specific needs.

# CONCLUSION

In time, we fully expect the economy to recover and a sense of normalcy to return to the financial sector and capital markets. Historically, the equity markets have acted as a leading indicator of the economy, turning six to nine months before economic growth resumes. Consequently, attempting to ramp up one's equity investments when "the economy looks better" will typically result in missing the early upturn, which has historically been rapid and sharp. Will it be the same at the end of this bear market? We will not be so presumptuous to suggest that to be a foregone conclusion, although it remains a distinct possibility.

That is not to suggest that the global and national economies do not have significant obstacles yet to overcome. We believe that the stabilization of housing prices and the employment market are critical elements that will be necessary to right the ship and restore confidence. A return to normalcy in credit markets will also be key to providing consumers with the wherewithal to spend. These two ingredients – confidence and credit conditions – must both improve for consumers to increase their pace of spending and pave the way for economic

activity to expand once again. Legendary economist John Maynard Keynes once wrote, "But whereas the weakening of either (confidence or credit) is enough to cause a collapse, recovery requires the revival of both."<sup>6</sup>

After the economy recovers, we will continue to be concerned about the potential for rising inflation and interest rates, both of which could provide strong headwinds for capital assets such as equities and bonds, particularly U.S. Treasuries. However, if the recovery is tepid, it is also possible that interest rates could stay low for a prolonged period of time. Given the nature of the problems that we collectively face, and the statements made by Fed Chairman Bernanke that they will do "whatever it takes" to avoid prolonged deflation, we believe that inflation protected assets, such as TIPS and commodities, are likely to return to favor as deflation takes hold.

The current environment has presented both incredible challenges and enticing opportunities for investors. As always, we will continue to seek out diversified investment opportunities that we believe will serve our clients well over the next phase of the market cycle.

## SOURCES/FOOTNOTES

- 1 "Determination of the December 2007 Peak in Economic Activity," National Bureau of Economic Research, December 11, 2008.
- 2 "U.S. Treasuries Fall, Trimming Biggest Annual Rally Since 1995," Bloomberg.com, December 31, 2008.
- 3 "Global Equity Insights," Standard & Poor's, December 2008.
- 4 "Operating Earnings for the Sectors in the S&P Composite 1500," Standard & Poor's, December 2, 2008.
- 5 "Global Equity Strategy U.S. Sector Outlooks," Standard & Poor's, November 25, 2008.
- 6 Keynes, John Maynard, *The General Theory of Employment, Interest, and Money*, BN Publishing, 2008.

## DISCLOSURES

Past performance does not guarantee future results. All investments include risk and have the potential for loss as well as gain.

Data sources for peer group comparisons, returns, and standard statistical data are provided by the sources referenced and are based on data obtained from recognized statistical services or other sources believed to be reliable.

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