Capital Market Outlook 2009

The year 2008 will no doubt go down in history as one of the worst investment environments for individual and institutional investors. The carnage left in the wake of turbulent capital markets included banks, insurance companies, brokerage firms and hedge funds. The Fed and the Treasury literally were making up new rules on the fly in order to keep the global financial system afloat. By the end of the third quarter, capital markets were seized up, banks had stopped lending, and money market funds were swamped with redemptions. Investors seeking safety drove the yields on US Treasury Bills virtually to zero rather than risk any further loss of principal. To cap off a year of remarkable events, by year end, time had run out for General Motors and Chrysler, which required government assistance to remain solvent.

There has never been more confusion, fear, and uncertainty surrounding the capital markets. Modern Portfolio Theory, which relies on the critical assumptions that investors act rationally and the markets are efficient, has been turned on its head. The most thoughtful investment strategies have underperformed and those that were intended to be well diversified and risk averse, such as investment grade bond funds, were thrown into turmoil.

The capital markets will continue to face challenges in 2009. We are in a three year process of deleveraging which will require a higher savings rate from consumers. The US has an excess of over one million homes which will ensure depressed housing values into next year. Bank lending remains tight and the uncertainty of future losses will keep credit restricted in spite of the government TARP initiatives. All of this will help to fuel uncertainty in financial markets that are crying out for clarity.

Yet, we believe there is opportunity in financial assets for investors in 2009; however, it requires patience and due diligence. While a buy-and-hold strategy may have worked from 2002 to 2007, security valuation metrics require a more conservative discipline and investment horizons require shortening. We believe the investment risk in the capital markets is still high and includes the risks that:

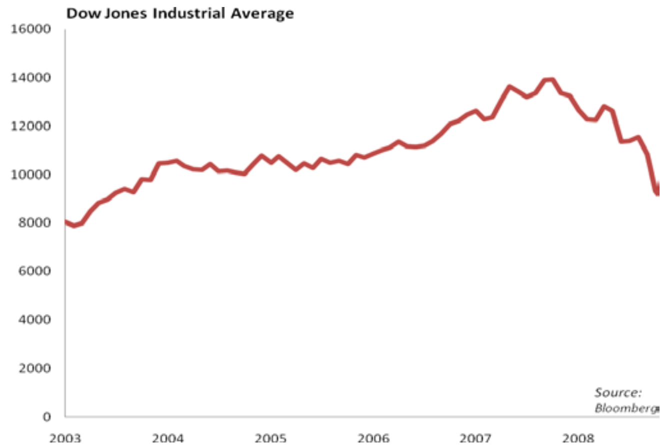
1. Financial Institutions continue to report losses as loan portfolios and assets further deteriorate.
2. The government initiatives to support the financial system don't work.
3. A financial calamity overseas impacts the US financial system.
4. The fiscal position of many state and local governments will deteriorate.
5. A gigantic fiscal stimulus package results in bigger problems in the capital markets down the road.

With the economy already in a deep recession, the capital markets resting on life support and a new form of government supported capitalism; we offer our key investment themes for 2009.

Key Investment Themes

Remain Defensive in Equities

We expect the U.S. equity market will remain under pressure throughout 2009 as corporate earnings are revised lower in the face of deteriorating global demand. Defensive sectors including consumer staples, healthcare, and utilities offer better risk reward. The credit crunch has had a more detrimental effect on smaller companies with fewer alternatives to access capital. As a result, we expect large cap equities to outperform small caps at least through the first half of 2009. As the economy stabilizes and credit becomes more available, we would expect the prospects for small caps to improve. We expect our investment horizon will be shorter and our valuation metrics will be more conservative for most equity investments as we move through a range bound market.



Investors should explore relative value across the entire capital structure

The government's initiatives to deal with the myriad of issues this past year resulted in significant dislocation in the valuation of hybrid capital securities. After Fannie Mae and Freddie Mac were placed in conservatorship, the dividend was eliminated on their outstanding preferred stocks. Shortly after, the failure of Lehman Brothers also resulted in their preferred stock being wiped out. As a result, investors viewed most hybrid securities of financial firms with suspicion. However, the government's investment in preferred stock of many banks along side existing preferred shareholders has helped to shore up capital for most banks, leaving the preferred investors intact. We believe there is value in certain preferred stocks and convertible preferred stocks for investors who can weather some price volatility.

Corporate Bonds offer excellent relative value

With the deterioration in the economy, default rates are expected to increase within the corporate bond sector. The incremental spread that investors currently earn by investing in investment grade corporate bonds is high by historic norms; yet the overall yield is tempered by the historically low levels of US Treasuries. Caution is warranted as the risk to rising interest rates is prevalent as investors redeploy assets into risk sectors.

Municipal Bonds will continue to offer excellent relative value

Several factors contributed to the increase in the yields of municipal bonds during the past year. The downgrades of the municipal bond insurers from AAA to A resulted in forced selling of tax-exempt municipal bonds which led to pressure on prices. Also, as banks posted losses through 2008, their need for tax-advantaged income lessened. Compounded by selling from banks and individuals, yields on municipal bonds increased to levels beyond US Treasuries.

Emerging Markets will be slower to recover

We expect slower growth prospects from the emerging market economies. Seven years of consistent outperformance in emerging markets came to an end in 2008. While emerging market equities currently trade a discount to the global market, we are cautious on valuation. The impact of the global economic downturn will have a lagged effect on emerging markets which means that the sector may stay cheap for awhile. In Europe, our major concern is with the stability of the financial system. If the financial sector in Europe can regenerate capital it may be in a better position for recovery than the United States. The wild card is the significant exposure European Banks have to emerging market countries which will be slow to recover. We expect the dollar to underperform the Euro once the flight-to-quality move to the U.S. dollar unwinds itself.

Economy

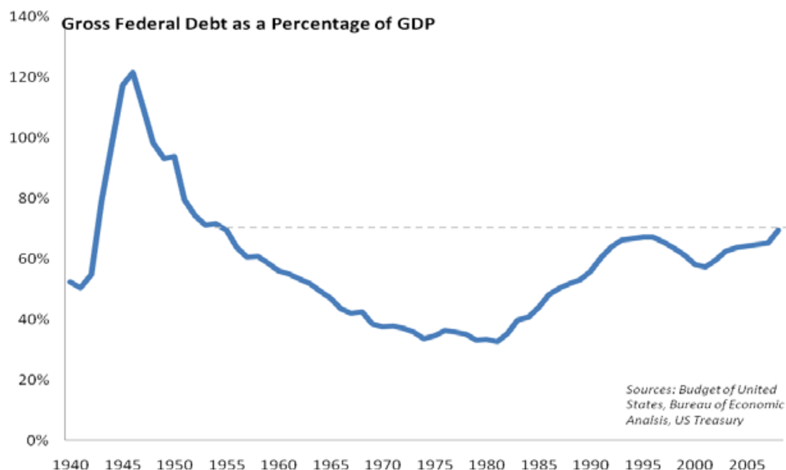
With rising unemployment, retrenchment in global demand, tight credit and a growing budget deficit, we expect a global recession to persist through most of 2009. The recovery will be muted as any gains in consumption are offset by rising taxes to balance the bloated budget deficit.

The economy is facing severe headwinds and will struggle for much of 2009. We expect the economy to continue to contract at least through the first quarter and remain flat for the remainder of 2009. We expect the recovery will be modest by historic standards and not take hold until 2010. The global financial system remains on life support and we still do not know the extent of the damage to the economy as a result of the seizing of the capital markets in September.

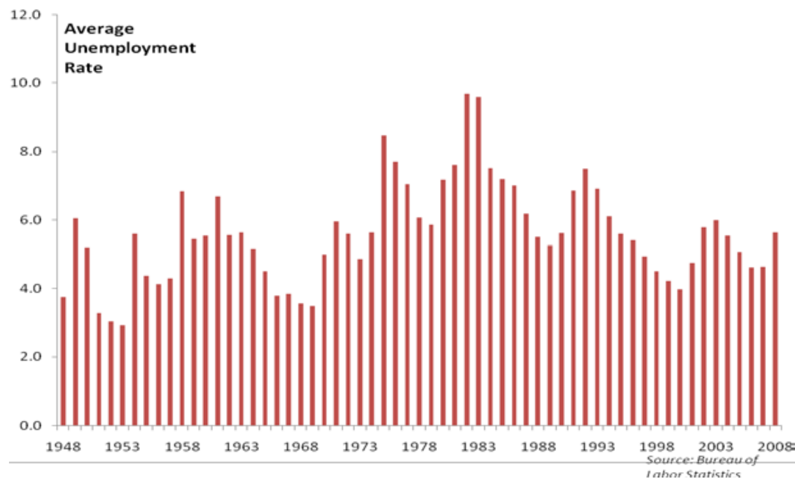
The outlook for the consumer sector, which represents almost 70% of the US economy, is bleak. Consumers are faced with declining home valuations, record levels of credit card debt and increasing layoffs. The necessary discipline required to pay down excessive levels of debt will result in economic pain through depressed consumption growth, which could potentially deepen the recession further.

The government sector eventually will get a lift from President-elect Obama's spending initiatives which are expected to rival the New Deal spending of Roosevelt's era. However, a large Keynesian-style fiscal initiative is wrought with problems. The first problem is that any economic impact will be at least into 2010 and not provide any stimulus next year. By the time his plan is passed through the legislature, programs identified for investment, guidelines initiated, applications submitted, plans made, architects, engineers and contractors hired and ground broken, it would seem to be a nine to twelve month process. Second, we are trading one problem for another problem which may be more dangerous. Deficit spending will help stimulate growth and jobs in the short run, but we will run huge deficits to finance the programs. The result will be deterioration in the dollar and a rise in interest rates to entice investors to finance our growing debt.

The total debt outstanding as a percent of GDP in the US (as well as other countries) has reached levels not seen since the end of World War II. In light of high levels of US household leverage, our abysmal savings rate and growing unemployment picture, it underscores that as a country we are living beyond our means.



The corporate sector will continue to hemorrhage jobs as global demand remains suppressed through the first half of 2009. We expect the unemployment rate to exceed 8.0% by the end of 2009 and excess capacity utilization to decline below 70%. Given the slack resources under this scenario, we believe inflation will not be a problem in 2009.



There is no doubt, in hindsight that an excessively lax monetary policy following the bursting tech bubble in 2000 resulted in two more dangerous market excesses: the housing bubble and the credit bubble. At this point, after aggressive cuts in interest rates this past year, the Fed has been unable to stave off a serious credit crunch. As long as the financial system remains in a fragile state, the Fed will keep interest rates low and money flowing through the system. However, the new administration will likely rollout an aggressive fiscal policy which may prove to be a greater factor in stimulating growth than current monetary policy.

As consumers delever their balance sheets, the government balance sheet has ballooned in size. As a result of the myriad of bail out programs the government has created, the balance sheet of the US government has ballooned from $900 billion in September 2008 to $2.2 trillion by December. Effectively the leverage in the system has been transferred from the private sector to the government sector. Growing fiscal deficits will ultimately lead to an increase in government debt. At some point, more government spending makes it harder for monetary policy to contain inflation. Perhaps the biggest problem policy makers will face is how to attract external financing to support their spending programs and then eventually to wean the country off the government spending spree.

We have crossed over into a new paradigm of increased government influence on the economy, the financial system and the capital markets. Arguably, the United States has moved from a system of capitalism to National Capitalism in which the government invests along side the private sector and provides regulatory oversight. The actions of the government in 2008, including saving Bear Stearns from collapse, taking over Fannie Mae and Freddie Mac, the massive $85 billion in loans to AIG, and loans to General Motors and Chrysler to keep them from bankruptcy represent a new form of government supported capitalism. We expect this National Capitalism to result in significant government influence and regulation over the coming years.

Equity Markets

The deterioration in the economy and deleveraging of the capital markets will likely keep equity valuations range bound until there is better clarity on earnings. We expect to be more opportunistic in the implementation of our investment strategy with shorter investment horizons and more conservative valuation metrics.

In general, we expect corporate earnings to decline in 2009. History shows that stock prices tend to bottom *before* an economic recovery takes hold and the economy reaches peak unemployment. While it is tempting to buy into the weakness, the deterioration in domestic and global demand warrants a cautious approach to our equity allocation. As value oriented investors, we are seeing compelling valuations in many areas of the equity market, but are treading cautiously as event risk remains high. We are focusing on companies that have resilient profits, healthy balance sheets and strong competitive positions. This market will reward fundamental analysis and disciplined valuation. Price/Earnings multiples have contracted significantly and we expect multiples to remain restricted given our outlook for suppressed earnings growth.

We are highlighting three areas for investment focus: Financials, Healthcare and Industrials.

Financials

The banking sector is going through a massive deleveraging process and we expect that will continue well into 2009. Bank loan portfolios will likely suffer further write downs in subprime mortgage loans and will experience further deterioration in consumer, corporate and commercial real estate portfolios. Return on equity (ROE) for banks will drop to single digits as banks navigate sharp increases in loan loss provisions in early 2009. With many banks trading at less than 50% of tangible book value, the market is discounting additional write downs and capital impairment.

Until there is better clarity to real earnings within the bank sector, we see better relative value in the preferred stock and hybrid securities of specific banks rather than investments in common stock. The shares of Wells Fargo and PNC will benefit from the ability to utilize the tax losses of Wachovia and National City as a result of the TARP plan legislation. Long term, we believe this is a strong catalyst for both to outperform their peer group. The preferred stock of Wachovia and National City are attractive at current levels and we would expect price appreciation based on convergence to the respective capital structure once the mergers close.

Healthcare

Through 2008, the healthcare sector posted stronger performance than all sectors but consumer staples, as investors fled financials, cyclical companies, and highly-levered concerns in utilities. Entering 2009, valuations in the healthcare sector demonstrate the current premiums paid for pharmaceuticals and device makers, with trailing earnings multiples 20-30% above the broad market averages.

We anticipate that the new political winds blowing from Washington will lead to more regulation in the form of both stricter FDA approval processes and federally directed health insurance and primary care programs. We see low-margin generic

pharmaceuticals continuing to pressure mature ethical products. The age of the block buster drug is continuing to wane, and we expect that pharmaceutical companies will find it increasingly difficult to support rich dividend payments, which in many cases represent more than 50% of earnings.

Earnings stability and consistency will, we believe, be more readily found among device and equipment manufacturers, niche pharmaceutical producers, and with companies deriving a significant portion of sales from foreign markets, such as Novartis. We believe that certain diversified healthcare companies with sustainable patent protection and geographically diverse market penetration offer superior value during this period of global economic weakness. We see sustainable competitive advantages in Johnson & Johnson and Covidien, each of which hold market leading positions in several diverse product lines.

Industrials

The collective appetite for massive fiscal stimulus in the U.S. is paving the way for President-elect Obama's much anticipated infrastructure spending plans. Aging public utilities and transportation systems are in dire need of repair and municipal governments find themselves without sufficient resources to complete the projects with local funding. While we acknowledge some positive short-term impact on jobs and industrial demand that a massive Keynesian initiative will bring, as noted earlier, we are not expecting an immediate impact on corporate profits.

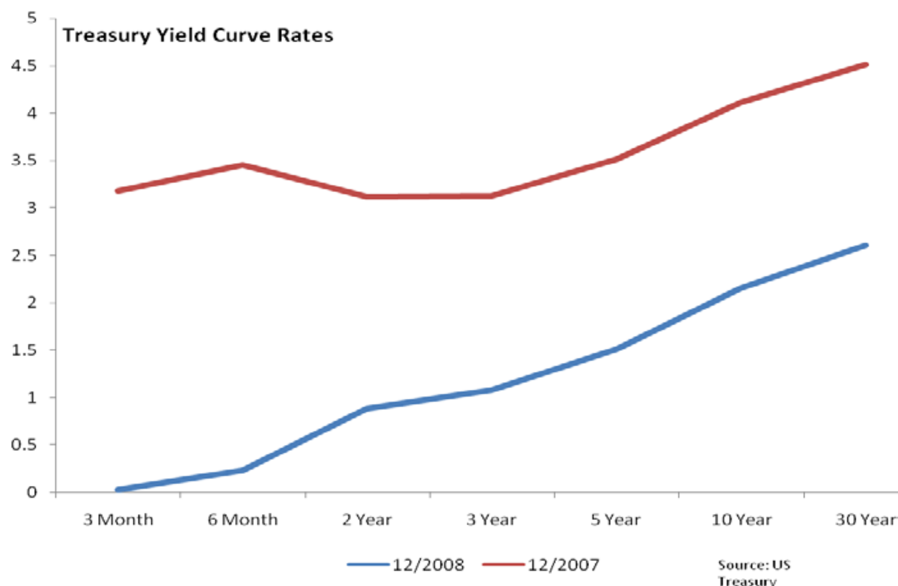
Certain industrial companies are currently trading at valuations not seen in decades, and we see many attractive opportunities for patient investors. We are also convicted that the impact of a prolonged global economic contraction will have a negative impact on highly levered companies, as cash flows are constrained and consumed by debt service. Thematically, we continue to pursue opportunities in companies with infrastructure and defense businesses. We are cautious of General Electric's leverage, but believe that management's recent efforts to shrink GE Capital's balance sheet are a prudent response to the deleveraging in the financial system. Also, we continue to be enthused about GE's strategy to re-allocate assets away from consumer goods in favor of their infrastructure businesses.

While we are cautious about the general speed at which emerging economies will recover, we believe that the current de facto weak Dollar policy will ultimately spur U.S. industrial exports. We note that Cummins, maker of power generation systems and low emission diesel engines, continues to grow distribution in emerging markets, deriving over half of its sales from foreign customers during 2008. And, importantly, the company is well-capitalized to weather the global economic contraction.

Fixed Income Credit Market – Investment Grade

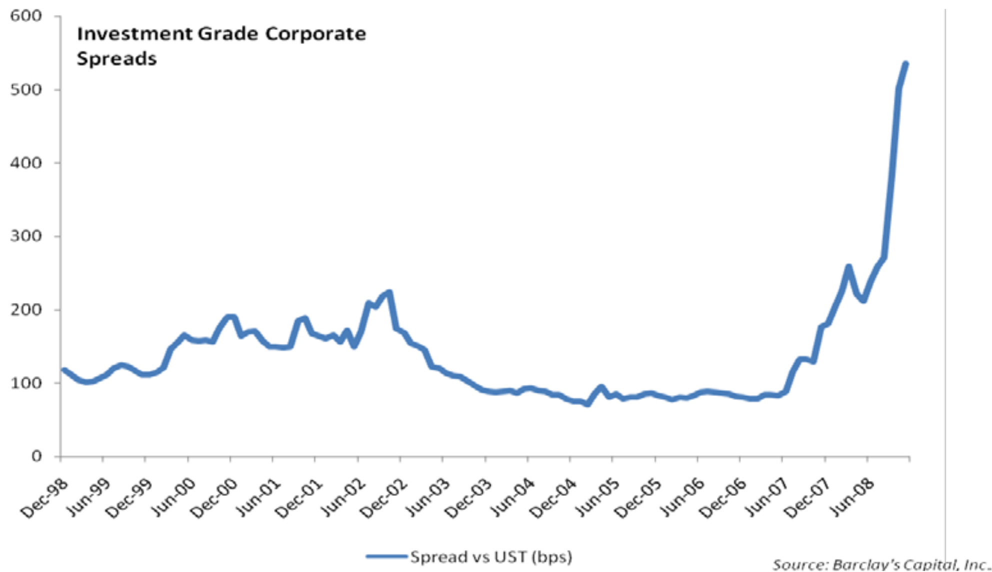
Valuations in US Treasury securities reflect the new world paradigm of lower interest rates the Federal Reserve has created. The wide credit spreads in the corporate bond market offer investors good relative value.

The current financial crisis has resulted in a powerful flight to quality rally in US Treasury securities. US Treasury bonds are trading at their lowest levels ever, while investment grade corporate bonds are trading near their widest spreads. A confluence of factors including a deteriorating economy, heightened risk aversion, government intervention to support the financial system, and gridlock in trading resulted in the worst performance on a total return basis of the corporate bond sector ever. As a result of this turbulence, we believe there is good value in the investment grade credit sector.



Corporate bond yields rose to attractive levels in November; however the dramatic rally in US Treasuries resulted in lower yields across the quality spectrum at the end of the year. Still, we expect patience will be rewarded as new issues access the market and re-price the secondary market. Considering the weaker fundamental outlook relative to the historic wide spreads, we believe the spread widening adequately compensates investors for the risk. Corporate bonds offer attractive investment opportunities in today's market environment, however, it is important to do the fundamental analysis required to understand the inherent risk of each credit. Currently, we emphasize investments in utilities, consumer staples and telecom. Also, while the financial sector is still laden with risk, we see specific opportunities in the banking and insurance sectors.

With the government program to guarantee bank issuance, banks can borrow (for a limited time) at extremely low costs of capital to support operations. This allows for the continued funding of operations and the orderly retirement of short term debt. We believe the short term debt of General Electric, Morgan Stanley, Wachovia, National City and Citibank offers good relative value at current spreads.



Source: Barclay's Capital, Inc.

Insurance companies will continue to grapple with writedowns in their investment portfolios, particularly in areas where there has not been price transparency such as Alt A mortgages, private equity and commercial real estate. We believe there is value in the debt of certain insurance companies given the current trading levels. Within the insurance industry, we see opportunities for investors in the bonds of Allstate, Lincoln National and Hartford Insurance Group.

There is little doubt that the destructive tentacles of the economic downturn will reach into every crevice and sector of the credit markets. We continue to view regulated utilities as a safe haven for investors. Power prices will likely be under pressure as power demand slows in line with GDP. In spite of high leverage ratios, stability in free cash flow and interest coverage should buffer most high quality issuers including Florida Power & Light, Georgia Power and Southern Power from significant fundamental deterioration.

Fixed Income Credit Market – High Yield

We believe there is value in the high yield market in addition to the investment grade credit market. Spreads on the Barclay's High Yield Index reached historic peak levels in November of 2008.

Consistent with the economic downturn, we expect the default rate will increase over the coming year in high yield credit. The recent bankruptcy filings of Mervyn's, Circuit City, and Lehman Brothers are only the beginning of a long term trend higher. General Motors and Chrysler received government assistance at year end in order to stave off bankruptcy. Even adjusting for excessively high default rates, spreads (measured by the Barclay's High Yield Index) are abnormally wide.

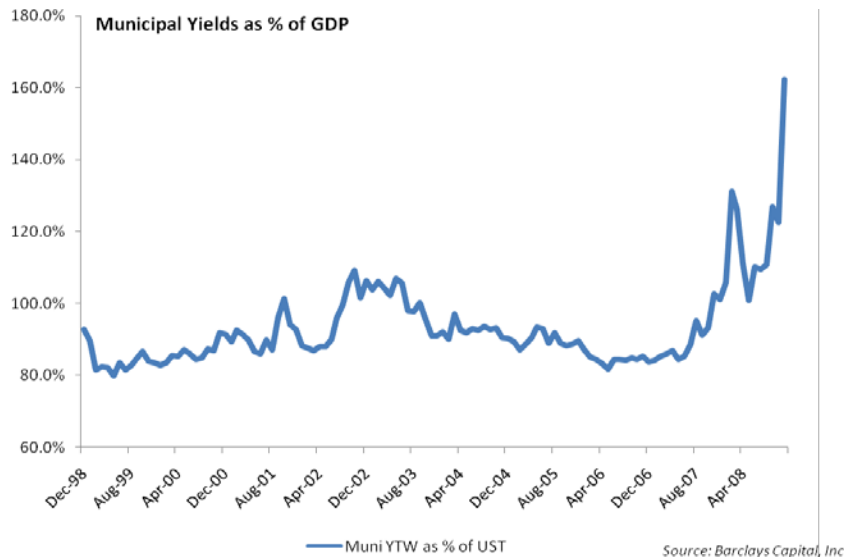
The worst environment for defaults in the high yield market was the five year period immediately following the market crash of 1929. During that time frame, the cumulative default rate, according to a study published by Credit Suisse, was approximately 50%. At this point we are sustaining a five year cumulative default rate of 11.5% which is low due to the easy money policies of the prior five year period. Thus, the current spread levels in the high yield market imply a default environment that will be worse than the default levels we experienced during the Great Depression of the 1930s.

There is a correlation between default experience in the high yield market and reported earnings. In a related study by Credit Suisse, during those periods when the default rates rose above 5%, there was a positive correlation to a decline in earnings. This study indicates that the current wide spread levels in the high yield market are discounting a sharp decline in real earnings, to levels not seen since 1940. While we expect both higher default rates and a continued deterioration in corporate earnings, we believe the current market discount is not merited and, as a result high yield spreads will eventually tighten.

Fixed Income – Municipal Bonds

A confluence of factors has resulted in one of the most significant investment opportunities to ever present itself in the municipal bond market.

A number of factors collided this year resulting in some of the cheapest levels for municipal debt in history. Early in February, the Auction Rate Preferred market seized as Wall Street brokerage firms could not support the reset of the rates for the preferred securities. Investors had their cash tied up in these securities for much of the year as underwriters struggled to refinance the debt outstanding. Then, the municipal insurers lost their AAA ratings resulting in dislocation in the market for municipal bonds. As banks and insurance companies' earnings deteriorated, they no longer needed the tax advantaged income of municipal debt. Large sale programs forced spreads to levels that far exceeded US Treasury yields. Compounding the valuation for municipal bonds is the deteriorating credit outlook for state and local governments.



Historically, municipal bonds have very low default rates, and we expect default rates to remain low in spite of the deteriorating economic environment. There are trouble spots such as California and New York that have much publicized budget gaps. With the trend in government assistance, we would not be surprised to see a federally sponsored program next year that will be accessible to municipalities.

Municipal bond analysis is once again a requirement, since investors no longer can rely on the backing of the municipal bond insurers. We see value in high quality general obligation bonds in areas with diversified business, healthy employment and moderate real estate valuations.

Real Estate

The commercial real estate market moved sharply lower in the second half of 2008 as the economy headed into recession. We expect price erosion to continue through 2009 in all major regions of the country. Lower interest rates will not be enough to counter the tight credit conditions which, along with higher cap rates, will aggravate refinancing conditions

for developers and REITs. In addition, banks and insurance companies will be faced with higher loan loss provisions as current real estate portfolios are marked to market lower.

The collapse of the Collateralized Mortgage Backed Security (CMBS) market in 2008 will compound problems in the Commercial Real Estate Market next year. Loose underwriting, deteriorating collateral values, rising loan to value ratios and a collapse in equity subordination have resulted in significant price declines in CMBS and left the market in a shambles.

With the deterioration in the economy, we see increased downside risk to the retail, office and hotel segments.

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