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WINTHROP Capital Management

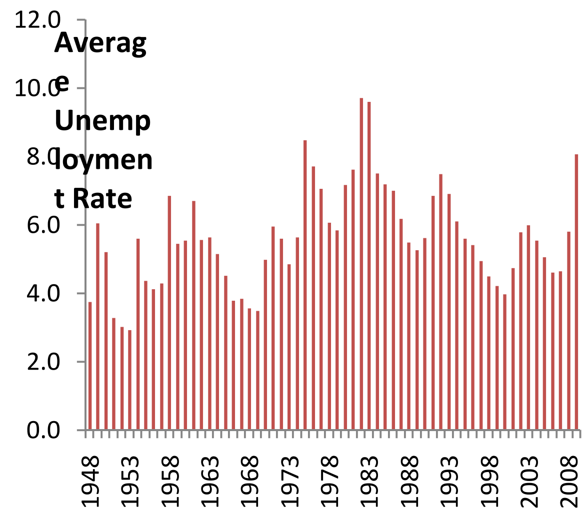
The Economy

Before we can experience sustained economic growth, we need to have confidence and stability in our financial system…

We are moving to a new paradigm in both our economy and our capital markets. Over the past decade, we have built more retail stores, restaurants, factories and distribution centers than could be supported by demand—all with cheap and easy credit. The U.S. economy is now under severe pressure. Fourth quarter 2008 GDP growth was revised to -6.2%, the single largest contraction since 1982. We expect first quarter 2009 growth to come in near -2.3%. The government's response has been quick and right out of text book written by John Maynard Keynes. The U.S. government has injected over $1 trillion of bailout money and support for the U.S. financial system. In addition, president Obama has presented a budget to Congress that includes $1 trillion of economic stimulus. In effect, the government, through its spending programs, is supporting the leverage already in the system and allowing for a more orderly and less disruptive deleveraging of our economy over time.

The consumer sector, which represents the largest portion of the economy, is being hit hard. Consumers are struggling with their levels of debt and as a result, consumption has declined. Over the past few months, most measures of health in the consumer sector remained bleak. Consumers are faced with tight credit, rising unemployment, and falling home prices. Insecure about job stability, consumers are less likely to spend which further mutes economic growth. The unemployment rate jumped from 5.3% this time last year to 8.5% in March, 2009. We expect the rate of unemployment to continue to increase through the second and third quarters of 2009.

The housing market continues to be a trouble spot in the economy. Through January, home prices fell -19% year-over-year in the face of rising foreclosures. With President Obama's recently announced $50 billion initiative to provide foreclosure relief, there is some hope that we are close to the bottom in housing prices. Commercial real estate is also a concern as we expect continued deterioration over the next two quarters particularly in office and retail properties.



Source: Bureau of Labor Statistics

Once the pillar of health in the U.S. economy, the corporate sector continues to reduce costs in the face of uncertain demand. Credit quality continues to decline as the number of downgrades exceeded the number of upgrades by a ratio of 4 to 1 during the quarter. The number of companies that are heading into chapter 11 is accelerating as well. Hollywood Video, the Sharper Image, and Circuit City filed for bankruptcy during the quarter. Waiting in the wings, we expect that General Motors will eventually file bankruptcy.

The inevitable recovery will be slow and gradual. The concern overhanging the capital markets is how we are going to pay for this massive bailout. The proposed budget deficit of $1.75 trillion dollars represents 12% of U.S. GDP. This record deficit will push Treasury financing requirements higher even as demand for U.S. debt is declining. We expect that future off shore demand for U.S. debt will continue to decline, not because of fears of increased risk due to U.S. economic policies, but rather as a result of declining trade surpluses on the heals of a global recession.

…before confidence can return to our capital markets, we need regulatory reform that is meaningful.

The journey investors are currently navigating includes a massive deleveraging of our capital markets and a dislocation in credit that runs the risk of forcing healthy operating companies toward insolvency. Over the past quarter, AIG was forced to restructure its government assisted bailout once again, General Motors moved closer to filing for bankruptcy, the government increased its ownership in Citigroup to 40% and the fear of nationalizing our banking system gripped the capital markets. One of the more important initiatives for investors this past quarter was the announcement of a plan by Treasury Secretary Geithner to enhance regulatory oversight of the U.S. financial system. While details need to be hammered out in Congress, a renewed confidence in our banking and financial system will ultimately be a positive for the performance of financial assets.

The domestic equity markets, measured by the S&P 500, finished the quarter -11.67% after a strong rally in March. The best performing sectors for the quarter included metals, mobile telecom, apparel, and specialty retail. The worst performing sectors for the quarter included life insurance companies, airlines, REITs and paper companies. As you would expect, the banking sector was listed as one of the worst performing sectors for the quarter as well. We estimate that earnings for the S&P 500 will likely decline to $63.00 for 2009. With the S&P 500 trading at 798, that implies a valuation of a 12.67 Price/Earnings ratio.

The investment grade fixed income markets returned 0.12% for the quarter measured by the Barclay's Aggregate Index. Interest rates rose during the quarter as the yield on the ten year Treasury moved from 2.2% at the beginning of the year to 2.7% at the end of the quarter. The improvement in the credit markets during the quarter has been uneven and choppy. The investment grade new issue calendar was very active as issuers took advantage of increased liquidity after the credit freeze in 2008. Yet, credit spreads remain near historic wide levels for most sectors as investors navigate a bifurcated market. However, lower quality companies are still shut out of the markets unless they want to pay interest rates in excess of 12 to 15%. Most financial institutions are still borrowing through the assistance of government sponsored programs and have yet to free themselves from that lifeline.

Merger & acquisition activity picked up a bit in the first quarter, which we see as another positive sign for the capital markets. Two of the largest U.S. deals were in the pharmaceutical sector as Merck announced the acquisition of Schering Plough and Pfizer announced the acquisition of Wyeth. Also, after a rocky courtship, Dow Chemical has agreed to close on its ill-timed purchase of Rohm and Haas.

Investment Strategy for the Second Quarter, 2009

We are seeing enough signs of encouragement in the capital markets for us to increase exposure toward financial assets. While valuations are difficult in the equity market given the volatility in earnings, we are seeing pockets of opportunity. We still like the energy and defense sectors and, as value investors, the pharmaceutical sector continues to keep our attention given its current depressed valuations.

In the fixed income market, utility and high quality industrial issues in the five year part of the yield curve offer excellent risk/reward at current spreads. We are also buyers of currently callable agency debt as the in the money option remains cheap. Near term, we expect ratings pressure on the debt of life insurance companies as the deterioration in the portfolio has eroded their capital base.

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