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Perspectives

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The evidence continues to mount that the worst of the recession is over and that the financial markets either have bottomed or are in a bottoming phase. The markets have been particularly encouraged by the unprecedented magnitude of fiscal and monetary policy utilized by the U.S. government to provide stability, liquidity, and an eventual path toward renewed growth. The recession will end, however, only when housing prices stabilize and the flow of credit is restored. While the forward-looking financial markets should begin to recover well before these events transpire, we remain in a tactically defensive posture until such time as the evidence justifies greater risk-taking.

REVIEW

The first quarter of 2009 began with high hopes that the Obama Administration would swiftly lead the financial markets out of their five-quarter slump and that a bottom had been established in November of 2008. Having declined 31.9% in 2008, the Dow Jones Industrial Average began 2009 with a gain of 2.9% on the first day of trading – its best start since 2003 – bringing its gains to about 20% since November.

Within days, however, hope again turned into fear, and the markets began a renewed, vigorous descent. Optimism surrounding the election of Barack Obama gave way to a sense of realism regarding the pace at which the new Administration could engineer a quick end to the turmoil. In a speech delivered by the President-Elect on January 8th, he stated that a recovery "will not come easy or happen overnight, and it is altogether likely that things may get worse before they get better." On January 20th, the Dow dropped 4.0%, the largest drop ever for an Inauguration Day.

On February 10th, the retreat accelerated when a speech by Treasury Secretary Timothy Geithner regarding the Administration's plans for shoring up the banking system failed to meet the expectations of investors. Concerns about the effectiveness of the newly announced $787 billion stimulus plan, the long-term viability of several major financial institutions, and the prospects of bank "nationalization" further exacerbated the selling.

By the beginning of March, the Dow already had fallen 25% for the year, bringing it to 13% *below* the previous low point it had established in November of 2008 and posting a decline of about 54% from its record high close on October 9, 2007. Below 7,000 for the first time since 1997, the Dow recorded its worst periodic performance since the bear market of 1929-1932. February of 2009 was the worst February for the Dow in 76 years.

Investors nonetheless were ready to pounce on any significant good news, which they received when J.P. Morgan, Citigroup, and Bank of America nearly simultaneously reported that they had been profitable during the first two months of the year. The positive tone of these reports was bolstered when the Federal Reserve announced renewed efforts to pump money into the economy, the Treasury provided details of new plans to acquire "toxic debt" from financial institutions, and the Commerce Department released a positive report regarding the housing industry.

As a result of these developments, between March 10th and March 26th, the Dow gained approximately 21%, technically marking the creation of a new bull market and setting the record for the quickest 20% rise from a bear-market low since 1938. The markets finished the quarter slightly less optimistically, however, when the federal government forced the Chief Executive Officer of General Motors to resign and then rejected the requests of GM and Chrysler for an additional $22 billion in funding.

U.S. Equities. The Dow ultimately finished the first quarter of 2009 down 12.5%, and the S&P 500 Index finished the quarter down 11%. The NASDAQ Composite Index fared better due in part to the stronger balance sheets of its technology companies. Posting its best

March returns in history, the NASDAQ produced a gain of 11% for the month and a relatively moderate loss of 2.8% for the quarter.

Despite the gains achieved by all of the major U.S. equity indices in the month of March, the first quarter of 2009 nevertheless marked the sixth consecutive quarter of declines for the equity markets, their longest losing streak in almost 40 years. Volatility remained the norm, albeit less so than in the fourth quarter of 2008. The Dow finished up or down by 2% or more on approximately 33% of the trading days during the quarter. During the prior quarter, it had reached the same level of volatility on approximately 61% of the trading days, while just a year ago volatility of that magnitude occurred on less than 15% of all trading days.

U.S. Fixed Income. Various segments of the credit markets experienced modest improvement during the first quarter. Having regained some level of confidence, investors once again shifted out of risk-free Treasury securities and purchased investment-grade corporate debt. With creditworthy companies selling approximately $212 billion in debt during the quarter, Treasury yields were forced higher, with the yields on 10-year and 30-year Treasuries increasing from 2.2% and 2.7%, respectively, to 2.7% and 3.5%, respectively.

Less creditworthy borrowers continued to confront historically tight credit markets, but even they experienced some modicum of improvement. Aggregate "junk-bond" issuances during the quarter amounted to approximately $10.2 billion – only half of the typical quarterly issuance prior to the credit crisis – but the cost of high-yield borrowing improved, with rates falling about two percentage points to approximately 17 percentage points over comparable Treasury rates. Buoyed by massive government intervention, the short-term debt markets also improved. Short-term corporate borrowing rates (for so-called "commercial paper") fell below 1.0%, and interbank lending rates dropped from about 1.4% to 1.2% during the quarter.

Commodities. Having already suffered losses in excess of 50% during the second half of 2008, the Dow Jones AIG Commodity Index continued its losing ways and was down an additional 13% through March 2nd. Commodities then began a recovery founded upon U.S. fiscal policy, escalating production cuts, and inflation concerns. The index finished the quarter down 6.4%.

Some of last year's worst performers, however, made substantial gains during the quarter. Coming off a 54% loss last year, oil gained 11.3% to close the quarter at $49.66 per barrel. Gasoline gained 39%, and copper rose 32%.

After approaching its record high price of $1,003 per ounce in February, gold finished the quarter at $922.60, up 4.4%. Silver gained 15% for the quarter, recovering some of its losses from last year.

U.S. Dollar. Fueled by a continued flight to perceived safety, the U.S. Dollar continued the rise that it began during the second half of 2008, as investors from around the world sought shelter in the world's reserve currency. While there were various fluctuations in the value of the Dollar over the quarter, in the end, the Dollar gained 9% against the Japanese Yen and 5% against the Euro.

International Markets. Last year, developed-country markets generally outperformed emerging markets, which were among the worst performers for the year. This trend was reversed in the first quarter of 2009, potentially reflecting increased investor optimism about global growth prospects. The Dow Jones World Index, excluding the U.S., was down 11.7% for the quarter (in U.S. Dollars). The MSCI EAFE (Europe, Australasia, and Far East) Index lost 14.6%. Key indices in the developed nations of Germany, France, and the United Kingdom suffered losses of 15.1%, 12.8%, and 11.5%, respectively – in line with or worse than those of the United States. Japan and Canada fared slightly better, losing 8.5% and 3.0%, respectively, for the quarter.

In contrast, the MSCI Emerging Market Index gained 0.5% for the quarter. Benchmark indices in Brazil and Russia rose about 9%. China's Shanghai Composite, which lost approximately 65% last year, gained 30.3% in the first quarter of 2009.

ANALYSIS

In an interview on March 15th, Federal Reserve Chairman Ben Bernanke stated that the "green shoots" of an economic revival are already evident. Indeed, several key economic and financial indicators have become increasingly positive, suggesting that the worst of the recession may be over and that the financial markets may have entered a stabilization phase. Nevertheless, a number of potential obstacles to a complete recovery remain in place, and we therefore remain in a tactically defensive posture until such time as the evidence justifies greater risk-taking.

Housing transactions have shown signs of stabilization, but home prices continue to fall. We repeatedly have said that an economic recovery ultimately must be preceded by a stabilization of home prices. On March 17th, just two days after Chairman Bernanke made his "green shoots" remark, the Commerce Department reported that housing starts had jumped 22.2% to an annual rate of 583,000 units in

February from 477,000 units in January, their largest percentage gain since January, 1990 and their first gain of any magnitude since last April. New building permits also rose – to 547,000 units in February from 531,000 units in January, an increase of 3.0% and again the first rise of its type since last April.

Other positive news for the housing market soon followed. On March 23rd, the National Association of Realtors reported that existing home sales followed a similar trend, rising 5.1% in February to a seasonally adjusted annual rate of 4.72 million units from a rate of 4.49 million units in January. Then, on April 15th, the National Association of Home Builders reported a 50% jump in its Housing Market Index, which is tied to builder sales and sales expectations.

These developments are positive for the fragile housing industry and may very well be an early sign that housing transactions have begun to bottom. The fact that the average 30-year fixed mortgage rate dropped below 5% for the first time since 2003 is also a positive development.

Nevertheless, it is important to note that the reported increases in the above indicators reflect month-over-month improvements from January to February, 2009 only. Year-over-year comparisons from February, 2008 to February, 2009 actually reflect declines in the readings. More significantly, the above indicators do not demonstrate a stabilization of home *prices*, which have continued to fall even in light of the recent improvements in transactional activity. Regardless of the transactional readings, if home prices fall further, they will continue to be an impediment to consumers, lenders, builders, and suppliers, thereby continuing to obstruct a complete economic recovery.

Unemployment continues to rise. As the first quarter came to a close, the Obama Administration warned of the potential for a "planned bankruptcy" of GM and Chrysler. Such bankruptcies probably would have little long-term impact on the financial markets, but they could further delay a full recovery by negatively impacting related industries and consumer confidence. They would also contribute to rising unemployment.

According to the Labor Department, 663,000 jobs were lost in March, bringing the total U.S. unemployment rate to 8.5% for the first time since 1983. Since the recession began in December, 2007, 5.1 million jobs have been lost. The Labor Department also reported that the average work week dropped in March to 33.2 hours, a new record low, indicating that employers increasingly are reducing workers' hours.

We believe that the unemployment rate potentially could rise to as high as 11% given current conditions. Of course, higher unemployment is another potential impediment to a full recovery, as it correlates to lower consumer spending, higher government spending, and lower gross domestic product.

The U.S. government has implemented massive fiscal and monetary policy initiatives and has indicated a willingness to do more if necessary to end the recession. While home prices and unemployment continue to weigh on the economy and financial markets, investors have several reasons to be optimistic. One such reason is recent U.S. fiscal and monetary policy.

We previously have written that all financial panics either exhaust themselves over time or are resolved through significant governmental intervention. The U.S. government has led a massive campaign to end the current crisis, and it has indicated that it will be relentless in taking such further actions as are necessary.

In continuing its mission of improving credit conditions, bolstering the financial sector, creating jobs, and stimulating the economy, the government already has committed trillions of dollars. Last November, the government announced the creation of the Term Asset-Backed Securities Loan Facility, or TALF, in order to revive the securitization market and facilitate new lending by banks and other finance companies. Under this trillion-dollar plan, the government effectively will seek to match buyers and sellers of securities that are backed by student, small-business, auto, credit-card, and other loans. It also will provide attractive financing for the buyers of these securities. We are cautiously optimistic that the TALF will be successful, although we note that the program, which officially was launched in March, is off to a relatively slow start, having made less than $10 billion in loans thus far.

In another trillion-dollar effort to bolster the financial sector and improve the credit markets, the government last month announced its Public-Private Investment Program, or PPIP. The PPIP calls for private investors to partner with the government to purchase troubled loans and securities from financial and other institutions, thereby mitigating the uncertainty surrounding the value of these assets. We are somewhat less optimistic that the PPIP will be successful because financial institutions may be reluctant to part with legacy assets on unfavorable terms, because the mark-to-market rules have been relaxed, and because the PPIP has been so politically unpopular.

In turn, the TALF and the PPIP are intended to complement the American Recovery and Reinvestment Act of 2009, the $787 billion stimulus initiative signed into law by President Obama on February 17th. We expect this stimulus package to begin having a measurable impact later this year.

On top of the nearly $3 trillion in initiatives described above, the Federal Reserve recently launched two massive campaigns to inject additional liquidity into the financial system. In November, the Fed announced a program to purchase agency mortgage-backed securities in order to support the mortgage and housing markets and improve conditions in the financial markets. On March 18th, the Fed publicized the expansion of this program to a total of $1.25 trillion by the end of the year. That same day, the Fed also stated that it would purchase up to $300 billion in U.S. Treasuries in order to reduce borrowing costs and stimulate the economy.

The term "historic" has been used frequently to describe the nature of the current recession and its impact on the financial markets. That same term will long be used to describe the reaction of the U.S. government to the recession. In inflation-adjusted Dollars, spending on any one of the above initiatives vastly exceeds the spending associated with each of the Savings & Loan Crisis, the Marshall Plan, or, for that matter, the Louisiana Purchase which doubled the size of the United States. Government spending eventually will be successful in halting the recession. The only question is how much more, if any, will be necessary.

Inflation is not a current threat, but it is a long-term threat. Headline "inflation" is now negative, at -0.4%, with core inflation at approximately 1.8%. With unemployment rates rising from their current levels, housing prices still declining, and a general oversupply of most goods, near-term price *deflation* is more probable than inflation. Despite the fears that some have expressed, we do not view inflation as a current impediment to an economic recovery; nor do policymakers see it as such. In fact, policymakers will be focused on combating deflation during the shorter term. One asset class that performs well during inflationary and deflationary periods is gold. We have begin adding exposure to gold in our equity and mutual fund portfolios to help hedge against these risks.

Beyond the next two or so years, however, inflation likely will become a concern. The Fed undoubtedly is already preparing for this phenomenon, and we, too, will be watching for signs of inflation, particularly as it relates to our fixed-income clients. The prospects of shorter-term deflation are positive for bonds, but future inflation could be problematic for them (as well as equities).

To be clear, however, harmful rates of future inflation are not yet inevitable. Future spending cuts, interest rate increases, and tax hikes, while politically unpopular, could avert such a scenario; and the Fed could seek to reverse the expansion of its balance sheet once the current crisis has been ended. These are difficult paths to follow, and we will have to monitor events as they unfold.

Earnings have continued to be relatively weak, but they appear to support current valuations and suggest some further upside. Corporate earnings remain under pressure, but valuations relative to those earnings currently are reasonable by historical standards. We project operating earnings of approximately $50-$60 for the S&P 500 for the next four quarters. Utilizing an historical S&P 500 price-to-earnings ratio of approximately 16, we could project an appropriate value for the S&P 500 of between 800 and 960. By these measures, equities have upside potential at their current levels.

Current market conditions favor investments in equities and corporate debt. One of the Fed's goals in purchasing up to $300 billion in U.S. Treasuries is to drive down Treasury yields and force investors into riskier asset classes such as corporate debt and equities. With short-term rates close to zero and 10-year Treasury yields under 2.8%, the opportunity cost of remaining in cash has become increasingly difficult to bear. In effect, with an average dividend yield of approximately 2.75%, equities need only remain at their current prices in order to outperform cash and match the 10-year Treasury yield. Therefore, the environment for holding equities and corporate debt generally has become more favorable, and, conversely, the environment for holding Treasuries and cash has become less favorable.

CONCLUSION

There are compelling reasons to conclude that the worst of the recession has passed and that the financial markets have bottomed or are in a bottoming phase. Current and future U.S. fiscal and monetary policies are likely to provide much needed stability and liquidity and lead the way out of the recession. The recession will end, however, only when housing prices stabilize and the credit markets are successfully reopened. Inflation is not a short-term threat, but it could become a long-term problem if left unchecked.

It is still too early to assume aggressive levels of risk in the financial markets, but we are mindful of the fact that the financial markets are likely to recover before, and in anticipation of, the eventual economic recovery. We will remain defensively postured in our equity portfolios, favoring companies with sustainable competitive advantages that generate positive cash flow (thereby relying less on the credit markets). Tactically, our growth focus remains on companies that are likely to benefit from global stimulus programs. Additionally, we will continue to exploit opportunities in the emerging markets and in investment-grade corporate debt.