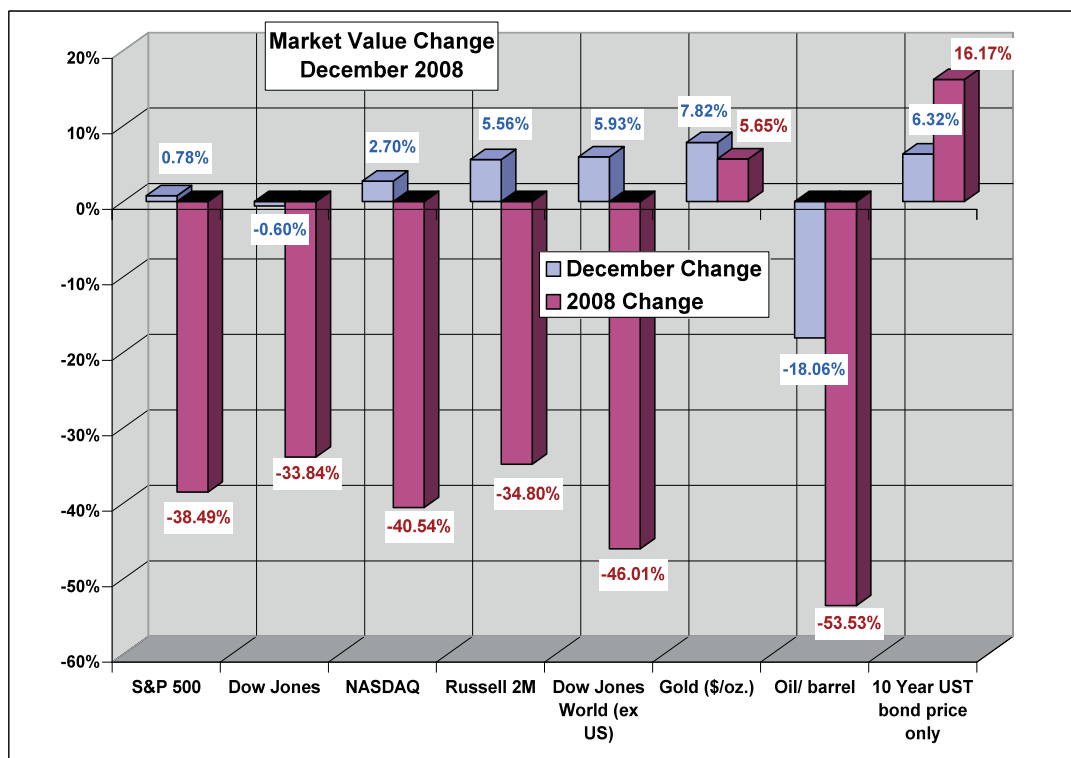


December Markets "Yes Virginia, there is a Santa Claus..."

Santa did bring his yearend rally but this year it was just in time for New Year's Eve. Equity markets wrestled throughout the month with the revelation of a \$50 billion Ponzi scheme, the decision by the Federal Reserve to reduce short-term rates to virtually zero, continued choruses of "bailout blues" from automakers and proof that U.S. consumers have sharply curtailed their consumption.



Stocks fluctuated sharply in December before rallying on the final trading days to bring both the S&P 500 and NASDAQ into the black for the month, leaving the Dow 30 to trail with a small monthly loss. Although the dismal losses for the year marked 2008 as the worst annual equity performance since the 1930s, the sustained rally from their low levels in mid-November sparked some optimism that the worst may be behind us. Whether it remains there is now the question.

Investor fear, coupled with actions by both the Fed and the Treasury, continued the rally in Treasury bonds. The rising prices drove yields to record low levels with the shortest maturities providing only the return of investor money but no return on that money. Treasury securities proved to be the best performing asset class for the year with a 16% gain in price. Bonds that lack the risk-free security of Treasuries fared much worse for the year. Although prices did rise, and yields fell, on many high quality corporate and municipal bonds during December, yearend values are still lower than a year ago, a condition destined to continue until recession fears abate.

Declining global demand for energy continued to pressure oil prices to the benefit of all except those who produce and process it. Oil traded down to the low \$30's/barrel during the month before concerted OPEC action, renewed Mideast tensions and the annual Gasprom/Ukraine pipeline dispute sparked a 14% yearend rally back to the low \$40's. Regardless, oil declined over 50% during 2008 tracing a path followed by most other commodities.

2008 enters the history books as a year of "lessons taught". Whether they are "lessons learned" remains to be seen.

Commentary ***A brave new year...***

2009 may prove to be a pivotal year indeed. Global economic conditions are beyond the experience and models of all policy makers leading to responses that are driven by theory and instinct rather than historic precedence. The Obama administration will bring more change to this dynamic as a new cadre of policy makers and policies come into play.

The events of 2008 provide a blueprint for two policies to be avoided in the future. One, while Lehman Brothers may not have been "too big to fail" it did prove to be "too interconnected to fail". When the brokerage house filed for bankruptcy in mid-September global credit markets ground to a virtual stop. The inability to have access to liquid assets at Lehman put all inter-bank arrangements in question. The loss of confidence cascaded into a complete shutdown of global credit markets, the complete nationalization of banks in Iceland, the partial nationalization of banks in Europe and the U.S., the need to rescue AIG from its own mistakes and the implementation of radical new policy actions by the Fed and Treasury to purchase assets and make direct corporate investments.

To be sure many of these consequences may have been unforeseen and unintended and may have happened under different circumstances as well. But happen they did giving rise to the thought that a more orderly wind down of Lehman may have produced a more graceful outcome.

Second, it would seem that the Fed now has the answer to its long debated question regarding the risk of popping asset bubbles. The Greenspan doctrine of allowing markets to run their course and "cleaning up" after the bubble bursts was tested after the internet-stock bubble burst in 2000. Much of the Fed's subsequent monetary response to the

post-bubble 2000-2001 recession sowed the seeds for the housing bubble and investment yield chasing which we are seeking to “clean up” now. In retrospect most policy makers, corporate executives, investors and consumers would gladly exchange some reduced “exuberance” in housing earlier in this decade for a more stable economy today.

There will be no shortage of regulatory and policy proposals to emerge as remedies to prevent a recurrence of our current situation. Hopefully they will reflect the flawed nature of these two policy failures and result in improved responses in the future.

Although the economic and corporate earnings outlook for 2009 remains unsettled we see a number of factors which may result in positive equity markets. For example:

- The dividend yield on the stocks in the S&P 500 remains higher than the yield on 10 year Treasury notes. Consequently we can expect to see some investor money moving back into equities in order to receive higher income while they wait for the market to recover.
- Presently the amount of cash on the “sidelines” is a record proportion of the total equity market valuation. Once this cash starts to move back into equities one can expect a prolonged rally.
- The traditional relationship between the yield on bonds and the PE valuation for stocks has become highly distorted. In addition to producing the yield anomaly described above it also signals that stocks are undervalued and can be expected to correct to the upside.
- Comparatively low stock prices will induce some corporate merger and acquisition activity, although this time it will be paid for with stock or cash, not proceeds of increased debt. The need for firms to maximize efficiencies and grow market share in a shrinking economy will only provide more impetus here.
- The Darwinian nature of business will benefit the operations and earnings of the survivors which will be reflected in their stock prices. As companies fail their competitors gain market share and pricing power at no cost to themselves. The growing recession will provide ample opportunities for this to play out.
- Last but not least, the mere passage of time will result in favorable earnings comparisons to prior periods. Earnings growth is the basis of all stock valuation, consequently once the comparisons turn consistently positive improved valuations will drive stock prices higher.

While most of these conditions have been present for a while they would seem to become actionable themes in 2009 as we work our way through the recession and into economic recovery.

Outlook and Strategy

“Been down so long it looks like up to me...”

Writing this on New Year’s Day it seems that rarely have so many had such high expectations of results from so few. I’m referring to the seemingly universal concept that the Obama administration will quickly resolve the economic crisis that has been building for decades. The potential for disappointment for some would seem to be high, assuming we accept that failure is not an option. Disappointment generally results in market volatility, as does unintended consequences, both positive and negative; something we should also anticipate as well, while we continue “...to go (economically speaking) where no man has ever gone before...”

Expecting the economic and corporate earnings news to continue to get worse before it gets better our task seems to be where to invest while waiting for the ultimate recovery. For many investors our defensive allocation to cash remains attractive as the security and flexibility of excess liquidity is more important than the meager return it produces. Those seeking a higher return should note that bank deposit products now offer significantly greater yields than Treasury assets with virtually the same risk, assuming insurance limits are complied with. Taxpaying investors can also enjoy a relative benefit from tax-exempt bonds as this asset class has continued to lag the rally in Treasuries.

In previous editions we have noted the attractiveness of high quality corporate bonds. Indeed during the period following the September credit crunch many corporate bonds provided yields at levels generally expected from equities but at a much lower risk. It has seemed to us that this circumstance needs to correct before we could expect a sustained rally in equities.

The good news for equity investors is that we have seen some improvement here as the prices on corporate bonds have risen resulting in more moderate yields. In the meantime these yields remain attractive enough that they continue to provide a meaningful alternative for investors willing to wait out the market recovery. Lastly, the dividend yield available on stocks offer an attractive alternative to cash, as noted earlier.

We have never found it meaningful to seek to predict the outcome for the New Year and won’t change that now. In subsequent issues we will highlight some areas of concern, beyond what’s noted here, so we won’t be surprised if things go “bump in the night”. In the meantime calls and comments are always welcome and best wishes for our New Year.

Dow Jones industrial 30: *9,034.69*
U.S. Treasury Yield: *2.42%*

Mark Fingerlin
January 2, 2009