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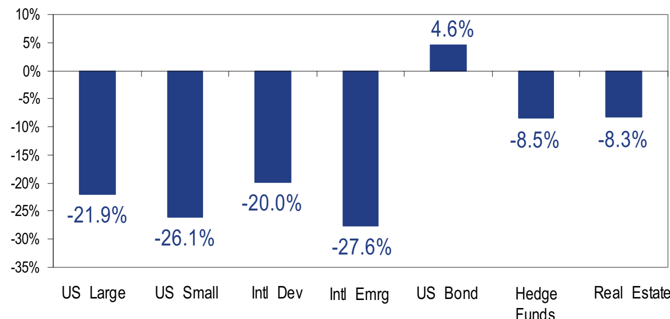
ANOTHER WILD RIDE

The fourth quarter of 2008 was a period of unusual volatility in the financial markets. Investors were still reeling from the wave of single-stock headlines from September including Fannie Mae, Freddie Mac, Lehman Brothers, AIG, and Washington Mutual. Investors were then treated to a new wave of headlines (TARP, Citigroup, AIG, auto makers, etc.), more government intervention, and heightened concern about the health of the economy and the stability of the financial system.

During this period of great uncertainty, investors flocked to Treasury bonds and sold any other kind of risk asset. This led to significant losses across the board (see Figure 1).

Figure 1: Q4 2008 Asset Class Returns



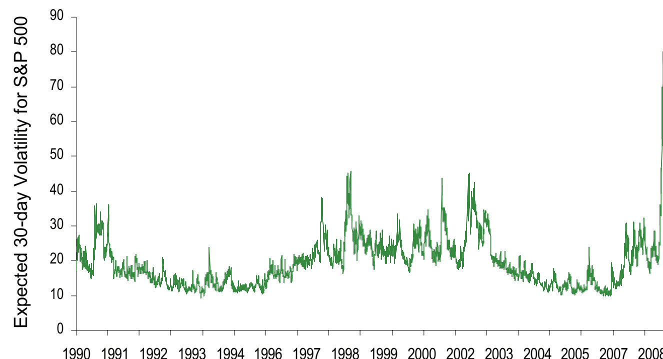
(US Large is represented by the S&P 500. US Small is the Russell 2000. Intl Dev is the MSCI EAFE NR USD. Intl Emg is the MSCI EM NR USD. US Bonds is the Barclays Capital US Aggregate Bond. Hedge Funds is the HFRI Fund of Funds Composite. Real Estate is the NCREIF index.)

Equities were down, as investors worried about financial stocks and the effects of a global recession. The story with bonds was mixed, with Treasury bonds up 8.8%, investment grade corporates up 4.0%, and high yield down 17.9% for the quarter. Hedge funds suffered, too, with funds of hedge funds returning -8.5% on average. Real estate had substantial losses for the quarter, hit by a weakening economy, tight credit conditions, and sharp drops in appraisers' estimates of property values.

The VIX index measures short-term volatility for the equity markets, and it hit record highs during the fourth quarter, surpassing historical levels from past market crises. (The index is produced by the Chicago Board Options Exchange based on options prices for the S&P 500 index.)

As seen in Figure 2, the index was much higher during this past quarter than in 1998, when there was an Asian currency crisis and a significant hedge fund failure (Long-Term Capital Management). The index was also higher this past quarter than during 2000-2003, a period of stress that included the bursting of the technology bubble, the 2001 recession, the September 11, 2001 terrorist attacks, and the Enron/Worldcom corporate scandals.

Figure 2: VIX Volatility Index



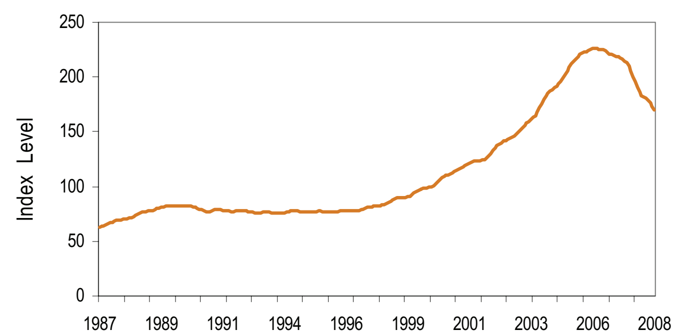
(Source: CBOE)

OUTLOOK

There are a few key indicators that investors and economists are studying to determine the length and severity of this recession.

First, home prices need to stabilize. As seen in Figure 3, home prices have continued to fall and this puts pressure on

Figure 3: Home Prices



(Source: S&P/Case-Shiller U.S. Home Price Index (composite of 10 regions) through 10/31/08)

consumers who are watching their home equity evaporate. Investors in mortgage-backed bonds and businesses also suffer as broader real estate prices decline.

The second concern is unemployment. The unemployment rate is now at 7.2%, which surpasses the high of 6.3% during the last economic downturn in 2003. The Bureau of Labor Services' count of non-farm payrolls dropped every single month in 2008, ending the year with more than 2.5 million jobs lost. Consumer spending accounts for approximately 70% of gross domestic product in the U.S., so housing and payroll declines will continue to weigh on prospects for economic growth.

A third concern is investors' appetite for risk. Treasury bonds did well in 2008 (up 13.7% for the year) because investors did not want to own risky assets and flocked to Treasuries. As long as this money continues to sit on the sidelines, earning yields close to zero, it will be difficult for markets to recover.

GOVERNMENT INTERVENTION

A fourth key issue is how the government is responding to the financial crisis. There were a number of government stimulus programs introduced in the fourth quarter, including:

- The Troubled Asset Relief Program (TARP) was signed into law on October 3.
- The Treasury allocated $250 billion in TARP funds to make investments in healthy banks.
- The Federal Reserve lowered the federal funds rate for interbank lending to a range of 0-0.25%.
- The Federal Reserve and FDIC announced plans to guarantee bank debt, buy commercial paper, support money market funds, and buy mortgage-backed debt.
- The government increased its support package for both AIG and Citigroup.
- The government stepped in to support GM, Chrysler, and GMAC.

There was an initial wave of optimism about these government programs. But, there has also been criticism about how some of the programs were implemented. For example, it is still unclear whether TARP funds will be used to buy troubled assets from banks or to help homeowners modify their mortgages, two of the original goals of the program. This confusion contributes to considerable uncertainty and strains in the market.

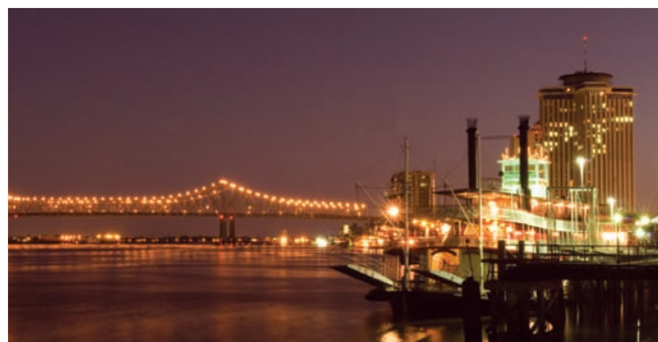
Investors also question whether the stimulus will be sufficient for the problems we are now facing. We are closely watching the Obama team's plans to address the financial crisis, especially their plans for spending the second half of the TARP funds.

SIGNS OF IMPROVEMENT

On the positive side, some markets started to show some improvement at year-end. Major U.S. stock markets hit a low for the quarter on November 20 and enjoyed a nice rebound through the end of the year. (The S&P 500 index rose 20.5% during that six-week period.) The VIX volatility index has also subsided, falling back to around 40 at year-end.

Many bond sectors have also improved, as yields have come down and prices have rebounded. There has been a healthy demand for new issues of investment-grade non-financial corporate bonds so far in 2009—a spillover from the positive effects of the government's guarantee of bank debt. Similarly, the Fed's programs to purchase mortgage-backed debt have pushed down the rate on 30-year fixed-rate mortgages. (Freddie Mac reports that the current rate is hovering around 5%.)

We expect that the economy will continue to be challenged in 2009, but we believe that many of the government's current and planned programs will help dampen the downturn.



2009 Client Conference

Thank you to all who participated in the 2009 Client Conference in New Orleans. We look forward to seeing everyone in San Diego in 2010.