

2008 Review and 2009 Outlook

Introduction

The most challenging year in recent history for the markets was 2008. A crisis that began in a relatively small pocket of Wall Street in mid-2007 overtook the global markets in 2008. The wealth destruction has been substantial and the ramifications for the future are significant. Now, the Wall Street story is becoming a Main Street story. The fall-out from the credit contraction and the near-term loss of confidence in the markets is working its way through the real economy with sharp job losses, declines in production and spending, and continued housing turmoil.

In the pages that follow we will cover three general topics – the year in review, a current economic snapshot, and our outlook for the near future. We have also written a 30-page document which further analyzes this article's topics, summarizes the lessons we learned from 2008, and describes the state of the fixed-income and hedge-fund markets. Please contact your advisor if you would like a copy of this longer document. While we hope you find our written communication informative and useful, please remember that we always welcome your comments and questions.

Year in Review

A quick look at the year-end statistics shows the magnitude and the breadth of the stock market losses. As shown in the table below, the Dow Jones Industrial Average posted the best results of any major stock market index and it fell by 32%. The performance of mutual funds further illustrates investors' widespread challenges, as ninety-five percent of equity mutual funds declined by over 27% in 2008.

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<i>S&P 500</i>	-21.9%	-37.0%
<i>Dow Jones Industrials</i>	-18.4%	-31.9%
<i>Russell 2000 (U.S. Small Company)</i>	-26.1%	-33.8%
<i>MSCI EAFE (International)</i>	-20.0%	-43.4%
<i>Dow Jones - AIG Commodity Index</i>	-30.0%	-35.7%
<i>BarCap U.S. Aggregate (Taxable Bond)</i>	4.6%	5.2%
<i>BarCap 5 Year Muni (Tax-Free Bonds)</i>	3.9%	5.8%

The banking and brokerage community was overhauled last year after being hit by a “once in a lifetime credit tsunami,” according to former Federal Reserve Chairman Alan Greenspan. The most dramatic changes began in September as AIG was forced into the government's arms, Bank of America absorbed Merrill Lynch, and long-admired financial institutions such as Lehman Brothers, Bear Stearns and Wachovia disappeared. We believe Lehman Brothers' failure was the single biggest event of 2008. On September 15th, Lehman Brothers filed for bankruptcy “in order to protect its assets and maximize value,” according to a company statement. Before filing for bankruptcy, Lehman Brothers was the fourth-largest US investment bank. During the 21 days after Lehman's collapse, credit markets deteriorated rapidly and the market fell by 33%, which represents 71% of the total loss for 2008.

When Lehman Brothers failed, systemic risks unfolded that the Federal Reserve feared when it prevented a disorderly collapse by Bear Stearns. With Bear Stearns, the Federal Reserve essentially quarantined the bad assets via a risk-sharing mechanism with JP Morgan – tilted heavily toward the Federal Reserve bearing the risk. When Lehman was on the precipice of failure, no buyers were willing to step up for a similar transaction and neither the Federal Reserve nor the U.S. Treasury Department felt they had the authority or capability to stop its collapse.

Central banks and world governments are using dramatic tactics to address the issues of the current economic crisis – loss of confidence and the shocking nature of the de-levering underway. The U.S. Congress seems poised to pass the largest peacetime government spending program since the Great Depression as it seeks to create jobs, maintain production, and offset the general decline in private sector activity. In addition, the Federal Reserve has:

- *Worked directly with institutions to prevent their failure.* A week after Lehman's bankruptcy, the Federal Reserve helped Goldman Sachs and Morgan Stanley become bank holding companies.
- *Dropped rates to zero.* At their December meeting, the Federal Reserve went to the historic point of reducing the rate on inter-bank lending to zero, or near-zero.
- *Flooded the system with capital.* The money supply has grown at rates approaching 20% over the last three months, and the monetary base has grown an astounding 188.2% over the last six months according to Ned Davis Research.¹
- *Announced asset purchase programs through various government-sponsored programs.* The most aggressive may be one that is expected to come out in February 2009, called the Term Asset Backed Securities Loan Facility ("TALF").

Economic Snapshot

The markets – especially credit markets – improved toward the end of 2008, potentially indicating that healing is beginning from the damage caused by rapid de-levering. One such indicator is the high-yield bond market, which enjoyed a sustained rally during December – its first in over eight months.

Most economists project growth in 2009 to be flat to down 2%. This would come in the form of a negative first half followed by mild growth/recovery in the second half. Given the dramatic nature of the events of 2008 and the massive stimulus by the government, it is important to realize that the confidence in any predictions is particularly low for the coming year. The economy is in a "tug-of-war" between the negative impacts of credit tightening and massive government stimulus.

The employment outlook remains bleak as we move into 2009, partly because of the lagging nature of this indicator. Job losses are mounting with as many as 2.6 million losses occurring during 2008. We believe it will likely be 2010 before job gains start occurring on a regular basis throughout the economy.

One of the positives from the last six months has been the savings to the consumer on a range of commodities – most significantly fuel. The outlook for inflation is muted for 2009 with little concern for high inflation in light of the massive demand destruction and slack in the global system – both production capacity and labor markets.

¹Ned Davis Research, Institutional Hotline, December 30, 2008.

Any even-handed analysis of today's markets must ask about "unknown" future events that could adversely impact the markets and the economy. Governmental responses to the events of the past year will surely have unintended consequences as we move forward. Additional significant "unknowns" going forward are described below.

- *Economic or Military Conflict between Nations (including Protectionism)* – Conflicts from the shifting landscape can be seen in the Russia-Ukraine energy dispute, increased social unrest in China, issues throughout the Middle East, and the increasing tension between India and Pakistan. We will be very sensitive to the path of globalization over the coming year as many big deadlines loom on the trade and climate change front in 2009.
- *Debt Default by Sovereign Nations* – We have concerns that countries will have a hard time issuing debt and maintaining fiscal discipline in 2009. High on the worry list are Russia, Ireland, Greece, and many countries in Eastern Europe, plus the Middle East should oil remain relatively cheap.
- *Currency Turbulence with a Flight from the Dollar* – The possibility of a sustained loss of confidence in the U.S. economy, and thus the dollar, remains one of the biggest risks to the system.
- *Economic and Social Stress in China* – China is specifically highlighted as a risk to the global economy since it is a significant financier of the U.S. budget deficit.
- *Rapidly Accelerating Inflation* – We expect continued disinflation in the overall economy for the near term. However, inflationary forces resulting from the current government interventions and longer-term budget deficits present longer-term risks.

Looking Ahead

Given the pain that investors endured during 2008, we find it understandable that they are reluctant to increase risk tolerance or even maintain the level of risk they had in their portfolio 12 months ago. With markets down the most since the 1930's in 2008 and with a lost decade for savers, the individual investor is asking if they will ever make money again. The irony of this situation can not be ignored, however. Many risky assets are trading at levels not seen in at least a generation and the reward for "safety" via treasuries or cash is as poor as it has been in fifty years.

At the end of the day, most client goals rely on a long-term return expectation of 7-9%. The odds are as good as they have been in 25 years that these goals are attainable over the long-run, even if the near-term horizon is hazy. It is a truism in investing that opportunity corresponds with discomfort and bad news. When the news is sunny again, the prices of assets will be much higher and a large portion of the future returns will already be realized by those investors able to hang on or buy in the face of today's current confusion. As Mark Twain proclaimed, "I was seldom able to see an opportunity until it had ceased to be one."

Investors can categorize their major decision broadly into two camps – taking risk or preserving capital. The latter seems the most logical in light of the economic data, but ignores the fact that value and risk are two sides of the same coin. Alternatively, the former, as uncomfortable as it feels, it is the only way forward for most investors dependent on their assets for future spending. With asset prices depressed and trading at very attractive valuations, the future risk may actually be much lower than a year ago. At current prices, we expect the odds of risky assets underperforming treasuries and cash for the next

decade to be extremely low. We are acutely aware that negative scenarios are possible and we are working diligently to identify factors which may indicate conditions are deteriorating below current levels.

Going forward, we believe the following investment opportunities warrant strong consideration and you may see related activity within the portfolio in early 2009:

- *High-Quality Large Capitalization Stocks and Dividend-Paying Equities* – Within the domestic-equity portion of the portfolio, we expect to continue our overweight to large capitalization stocks and high-quality companies. We have accomplished this through both index-oriented and active manager funds in the past, and we will continue to utilize both, though we think this is a year when active management may produce above-average results.
- *Asian Markets* – Within the international portfolio, we will likely continue our move toward emerging markets, and specifically Asia. This theme was recently funded by decreasing our allocation to Western Europe. Within Asia, China has certainly been impacted by the global slowdown and a sharp drop-off in export activity; however, we believe China remains one of the brighter spots in a difficult global economy.
- *Fixed-Income Markets* – Opportunities exist across the entire fixed-income spectrum, including mortgage-backed securities, high-quality corporate bonds, and leveraged loans. In addition, bank loans and convertible securities are very attractive. In a recent newsletter, famed fixed-income commentator Jim Grant stated that “[W]e are going to venture that [no market] is so cheap – nor so disorganized nor demoralized – as the one in convertible bonds.”²
- *Commodities* – China became the largest buyer of many commodities over the last decade and its growth is more important to the pricing of commodities than growth in the U.S. Moreover, the supply chain issues in commodities are real. Basic material industries were underinvested for more than two decades, and investment was just coming back to the space when the credit crisis hit.

Summary

In conclusion, 2008 was a year of historical significance. We recognize the concern, fear, and pain that our clients have experienced and are working very hard to communicate our beliefs and our actions during this time. As a firm, we also want to reiterate that one of the keys at a time like this is to reorient your focus to the things that you control – namely your long-term goals and the plan to achieve them.

Above all else, we want to thank you for your continued support and business. We will work as hard as ever in 2009 to align our efforts with your goals and to communicate with you. As always, please feel free to contact us at O’Sullivan Creel Wealth Advisors with any questions.

² Grant’s Interest Rate Observer, November 28, 2008, page 5