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The fourth quarter was one for the history books, and one that investors would probably rather forget. It was shocking to watch as once-prominent financial services companies collapsed and bond markets ceased to function. Companies throughout our economy rely on the capital markets to finance their routine business activities, and individuals depend on banks and other lenders to help them finance spending on cars, homes, appliances, education and a host of other living expenses. Suddenly, access to capital simply disappeared. Economic activity hit a giant pothole, raising concerns for the trajectory of corporate profits and employment.

In one of his classic quotations, Warren Buffett said *"It's only when the tide goes out that you learn who's been swimming naked."* The tide certainly went out in the fourth quarter, revealing firms and households that got too highly leveraged in the recent years of easy credit. In time, historians will likely find that the blame for this mess can be shared widely among borrowers, lenders, politicians, regulators, credit rating agencies and speculators. Cheap money was a boon for consumers but an increasingly difficult factor for investors. As interest rates slipped lower, investors found it harder to meet their performance objectives, which motivated them to entertain a variety of "alternative investment" ideas. Pension plans, endowments, foundations and even wealthy individual investors ramped up their exposure to these strategies, which often relied on leverage to deliver their returns. The hedge fund industry flourished, amassing more than \$2 trillion and a huge appetite for exotic ways to speculate on financial markets. Engineered products that were originally designed to manage risk, such as auction-rate securities and credit default swaps, either did not work as anticipated or ballooned into commitments that swamped issuers' balance sheets.

The credit crisis has been a game-changer. Prior to September, it appeared the markets were working effectively to adjust to the housing downturn and related impact on the overall economy. Financial services firms had acknowledged the impairment of their mortgage holdings by announcing significant write-downs in the value of those assets on their books, and they had shored up their balance sheets by raising additional capital. Economic forecasts called for a relatively brief period of sluggish activity, with conditions expected to improve during the second half of the year. The credit crisis derailed that relatively mild scenario, driving the economy into a deeper and more protracted period of malaise that is now expected to last well into this year. Unemployment, currently running at 6.7 percent, is likely to surge higher in the coming months, and may ultimately peak in the 8 to 10 percent range by the time growth gets back on track. Recovery in the mortgage marketplace has been delayed, which means it will probably take a while longer for home prices to find a firmer footing. We have not yet seen a meaningful improvement in the inventory of homes for sale. Analysts have

substantially reduced their estimates for corporate profits in the after-math of the credit crisis, and worried consumers are likely to delay some purchases until they feel more secure about their jobs and overall direction of the economy.

So many things seemed to take a turn for the worse during 2008 that it may be hard to see anything positive about the current environment. While bond markets have not completely recovered from the credit crisis, they have shown tremendous improvement. Liquidity is returning to the fixed income marketplace. Huge fiscal and monetary stimulus programs are going to make a difference, and the dramatic drop in oil prices serves as an additional boost to discretionary income for consumers. Households, as well as businesses, are tidying up their financial balance sheets. Essentially, debt is being shifted from the private sector to the federal government at a time when the government is enjoying historically low borrowing costs. Interest rates on Treasury securities are at rock bottom levels, which means it is more cost-effective right now for the federal government to borrow money than for businesses and individuals.

We believe the news will be a whole lot more encouraging a year from now. In the meantime, the capital markets will probably show an uncertain pattern of surges and retreats as the economy regains traction. This quarter's corporate profit reports may mark the low point for this cycle, while unemployment will probably peak later in the year. We expect it will be 2010 before home values improve. Confidence will eventually return, which will encourage overall economic activity to get back on a positive path. Our concerns about inflation are postponed until growth returns, so we expect fiscal and monetary policies will remain in stimulation mode throughout the year. Once the economic reports show evidence of solid recovery, we expect those policies will have to pull back quickly to avoid a whipsaw in the inflation picture.

It is a period of mixed messages for investors. Even though the astounding volatility in stock prices seems to have calmed down in recent weeks, we remain in a protective posture. Helping clients remain patient during these rough periods is perhaps our most challenging and important responsibility. Market conditions will improve. Please call if you have any questions or concerns you would like to discuss, and we always welcome the opportunity to get together with you to review your investment program. Our best wishes to you and your family for a healthy, happy and prosperous 2009.

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