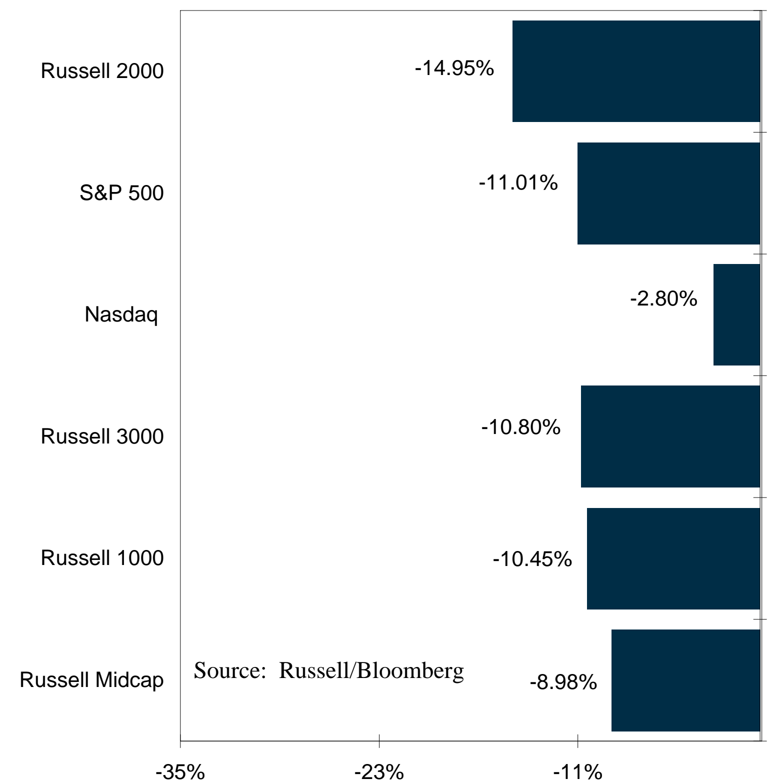
First Quarter 2009 Market Summary

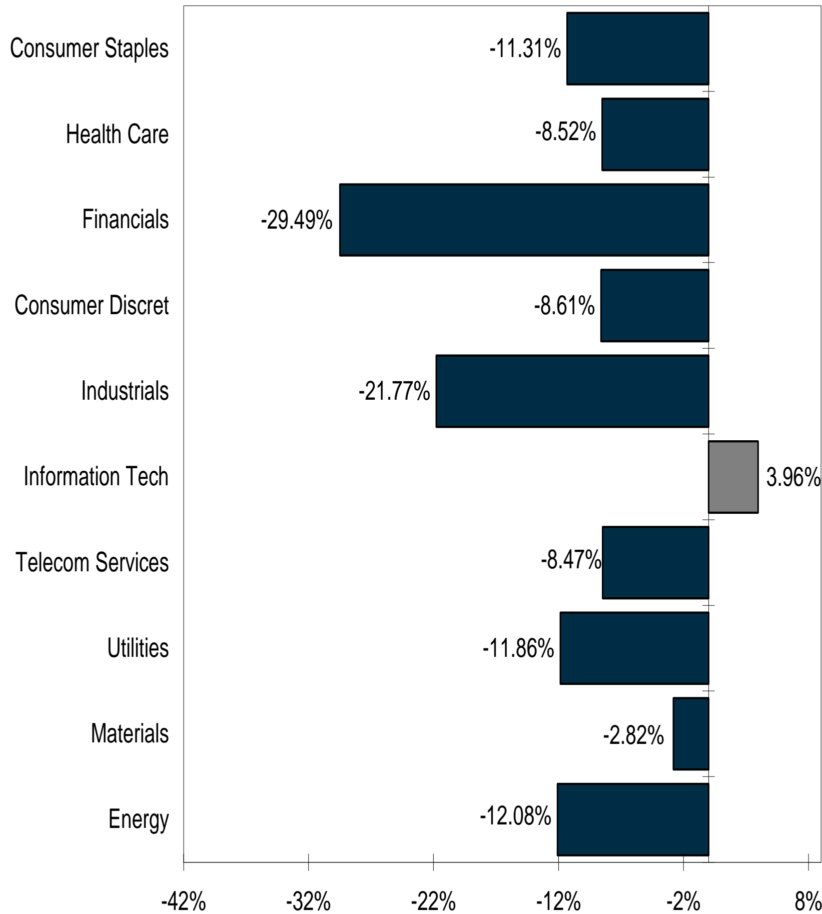
The Economy

The financial crisis continued in widespread nature during the first quarter of 2009, characterized by non-functioning credit markets and solvency problems for financial institutions worldwide. The quarter has once again witnessed unprecedented government initiatives attempting to stabilize financial institutions using a variety of instruments. Central banks across Europe, England, China, Japan and Canada all reduced rates in an effort to boost their economies. Domestically, issues such as bank nationalization, the mounting deficit and legislative uncertainties stood at the forefront of investors' concerns.

There was little question that the economy would continue to show signs of weakness during the first three months of 2009. The fourth quarter GDP number was revised from -3.8% to -6.3%, indicating that the recession was deeper than previously suspected. Throughout the quarter, investors were numbed by the bleak economic data and frequent headlines coming out of Washington.

The housing market remained a prime indicator of our economic troubles as rising foreclosures and falling sales continued to batter home prices. Housing data remained bleak in January with the National Association of Home Builders (NAHB) index continuing to set record lows, falling to eight from nine. Existing home sales dropped an unexpected 5.3% for the month of January.





Nevertheless, housing data did show some resilience towards quarter-end as February existing home sales increased 5.1% month over month, and home prices moved a slight 0.4% higher, reversing the trend from previous months. There was evidence that the continued aggressive policy actions by the Fed and Treasury had started to take hold. Actions taken to facilitate the flow of credit and lower mortgage rates showed some signs of success, as borrowing costs began to fall towards the end of the quarter. The last full week of March had mortgage applications increasing 32.2% (week over week) with a sharp increase in refinancing activity.

There was less cause for celebration concerning the employment situation, which continued to deteriorate throughout the quarter as companies increasingly adjusted payrolls in the face of the economic slump. The quarter began with employment data for December showing a 7.2% unemployment rate, the highest level since 1993. This figure increased to 7.6% for the month of January, registering 2.7% higher than a year ago. This trend would continue through the remainder of the quarter when the February report revealed the unemployment rate rose 8.1%, its highest level since 1983. There is no evidence to suggest this trend should reverse anytime soon as March's unemployment numbers, to be released at the beginning of April, are expected to show the total number of job losses approaching 5 million and an unemployment rate of 8.5%.

January marked both the start of a new year and a new presidential administration. All eyes were on newly inaugurated President Obama and his heavily anticipated economic stimulus package proposal. Following his official entrance to office, financial markets suffered as the S&P 500 closed the week down 2.14%.

The first quarter reinforced the notion that credit problems have spread far beyond the housing market, as many banks have found themselves in precarious situations. Rising unemployment and falling home prices have sent loan defaults soaring. On Tuesday, January 20th, we witnessed Citigroup fall by 20%, Wells Fargo by 24% and Bank of America by 29% on capital adequacy concerns. As the levels of nonperforming loans have risen, and balance sheets have shrunk in the face of eroding capital levels, banks' earning power will face an uphill battle going forward.

The deterioration of credit quality on bank balance sheets positions 2009 to witness the largest number of bank failures since the S&L crisis of the 1990s. There are increasing concerns that the FDIC's deposit insurance fund (DIF), which guarantees customer deposits up to $250,000, could be depleted as more bank failures and seizures continue within the industry. In order to replenish losses to the DIF, the FDIC has considered implementing an "emergency" fee whereby institutions would be charged 20 cents for every $100 of domestic deposits. This has been met by stiff opposition, particularly from smaller institutions, which claim that an extra fee would seriously hinder earning power and even the institutions' ability to survive given the present market environment.

Though far from positive, there were some signs of life in economic data towards quarter-end. Not coincidentally, the improving data comes alongside further clarity from the U.S. government on its plan to remove bad assets from bank balance sheets. Over the past several months, there have been a number of new policy initiatives as well as alterations to previously announced programs. The various economic stimulus initiatives have tended to dominate headlines and nightly news, as the financial crisis took center stage on the floor of Capitol Hill.

Announced last year, the initial Troubled Asset Relief Program (TARP) focused on providing $700 billion for the Treasury to purchase troubled and non-liquid assets from banks and other financial institutions. The TARP program was designed to improve the liquidity of those "toxic" assets and allow the institutions to remove them from their balance sheets and improve their financial condition.

One component of the initial TARP program is known as the Term Asset-Backed Securities Loan Facility (TALF). TALF was announced by the Federal Reserve in November of last year and began execution during the first quarter of 2009. The program is designed to support issuance of asset-backed securities (ABS) which are collateralized by student loans, auto loans and credit card loans. Originally slated at $200 billion, the Fed will now lend up to $1 trillion to holders of certain AAA-rated ABS backed by newly originated consumer and small business loans. The main aim of the program is to aid the American consumer.

On February 10th, Secretary Geithner announced the Financial Stability Plan (FSP). The FSP, serving as a renovation of the Treasury's latest bank-rescue plan, was poorly received by financial markets. The plan was announced with few specifics, and markets initially reacted negatively to the lack of detail as the S&P 500 fell 4.8% by the end of the week. However, specifics would come later on March 23rd when Geithner announced the Public-Private Investment Program (PPIP) as a component of the broader FSP.

The PPIP was designed to spur the purchases of bad loans and real estate securities through a combination of public and private sector funding. The initial intent of the PPIP involves the government taking up to $1 trillion in bad mortgage securities with the help of private investors. Details of the PPIP sent the S&P 500 up 7.1% on the day.

A focal point of President Obama's domestic agenda to fight the recession has been the $780 billion Stimulus Package, more formally titled the "Recovery and Reinvestment Act of 2009." This package was passed by Congress and signed into law on February 17th and provides $780 billion in the form of tax cuts, expansion of unemployment benefits and other social welfare programs, as well as spending in education, healthcare and infrastructure. The package allocates 37% to tax cuts, 18% to state aid (such as Medicare and education), and 45% to federal spending initiatives such as infrastructure.

In an aggressive move on March 18th, the Federal Reserve announced it would purchase $300 billion of longer-term Treasuries over the following six months in hopes of improving credit conditions. The underlying premise was to raise the supply of credit and thus push down longer-term rates paid by families and companies on mortgages and other key loans.

Having already doubled since last September, the Fed's balance sheet will reach the $4 billion mark following the purchase. The Fed announcement sparked a rally in the equity markets while the bond market witnessed the largest one day drop in yields since the crash of 1987. The process of buying Treasuries, also referred to as "quantitative easing," is a direct way to inject liquidity into the system. Mortgage rates followed Treasury yields down, as there was a surge in refinancing for homeowners struggling to make mortgage payments.

One of the major reoccurring headlines concerned outrage over bonuses paid at AIG. The insurance giant had paid out $165 million in bonuses after receiving over $173 billion in U.S. government bailout money over the previous six months. Also grabbing headlines during the final week of the quarter was President Obama's hard stance taken towards struggling automakers General Motors and Chrysler. According to the plan, GM would be given 60 days to come up with a restructuring plan while Chrysler was given 30 days. If the companies fail to prove their viability, the Administration would allow them to file for bankruptcy.

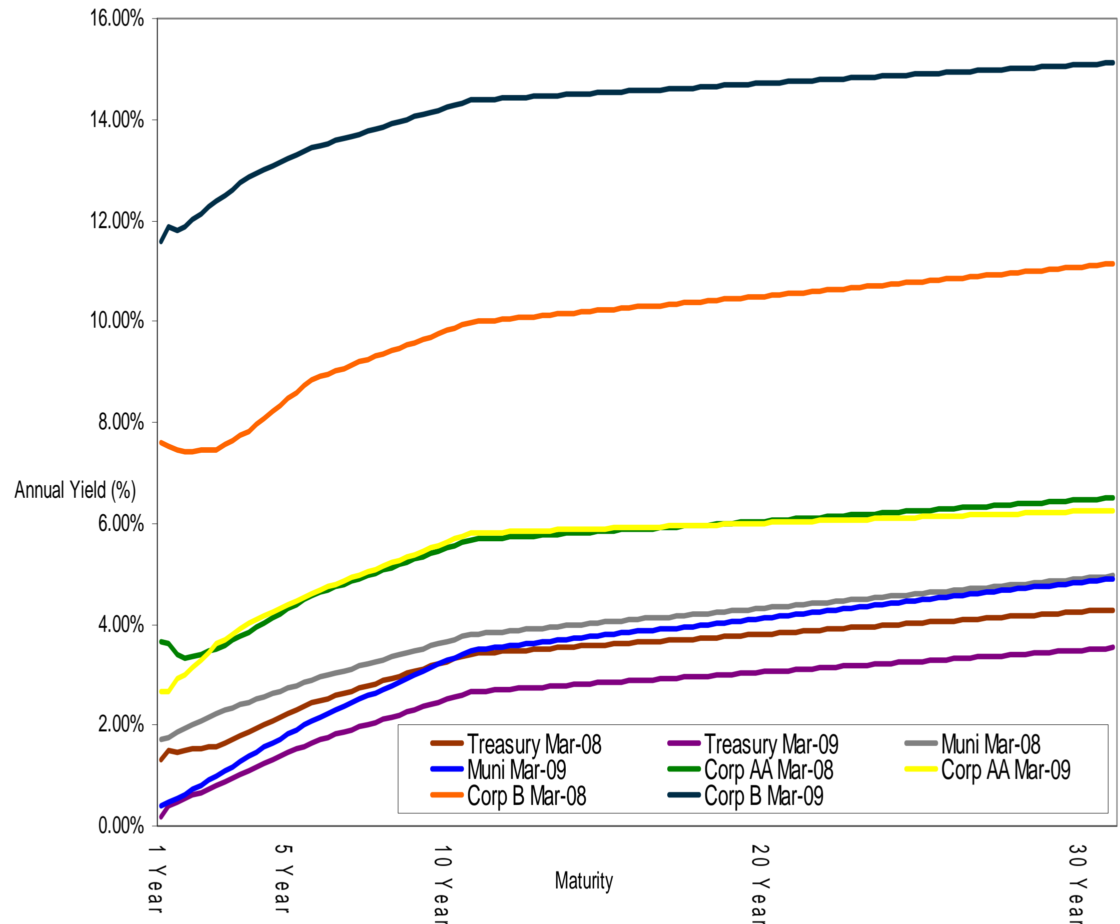
As the quarter drew to a close, it became evident that TARP funds were beginning to run low. This could create a problem; banks may need more capital in light of the upcoming stress tests, while Congress's willingness to permit new TARP spending is close to being exhausted. Treasury Secretary Geithner made a March 29th appearance on *Meet the Press* where he stated that the terms of the $500 billion program to aid banks "cannot change," otherwise investors will lose confidence in the government's plan. Investors will need to believe this statement if the government programs are to attract private capital going forward. The quarter concluded with the ongoing G20 Summit, in which discussions centered on the potential need for additional global fiscal stimulus.

Interest Rates

Much of the focus during the first quarter centered on the funding needs of the Federal Reserve and the Treasury in light of the numerous banking initiatives and recently passed fiscal stimulus package. Worries over the market's appetite for massive debt issuance (and resulting upward pressure on interest rates) was reinforced by a report from the Treasury department that "Foreign purchases of long-term U.S. Treasuries, Fannie Mae bonds, corporate debt and stocks dropped to negative $43 billion in January from positive $34.7 billion in December". With the Fed's announcement on March 18th that it would buy up to $300 billion of longer-term Treasuries over the next six months, the yield on the ten year Treasury bond dropped nearly 50 basis points. Volatility remained high during the quarter as yields moved up from 2.2% at the end of December, briefly topping 3% before falling back to end the first quarter yielding 2.7%. The 3-month T-Bill added 10 basis points for the quarter ending with a yield of 0.2%.

The yield on short-term investment grade corporate bonds dropped noticeably while yields further out on the curve moved slightly lower from a year prior. The yield on the ten year AA-rated Bloomberg Corporate Composite has dropped over 200 basis points from October of last year.

The yields on high yield corporate bonds continued to "improve" during the quarter as yields across the curve fell from December 2008. The ten year B-rated Bloomberg Corporate Composite declined 134 basis points from the end of December. However, high yield corporate yields remained significantly elevated from a year prior when the ten year B-rated Bloomberg Composite was yielding 9.99%.



Source: Bloomberg

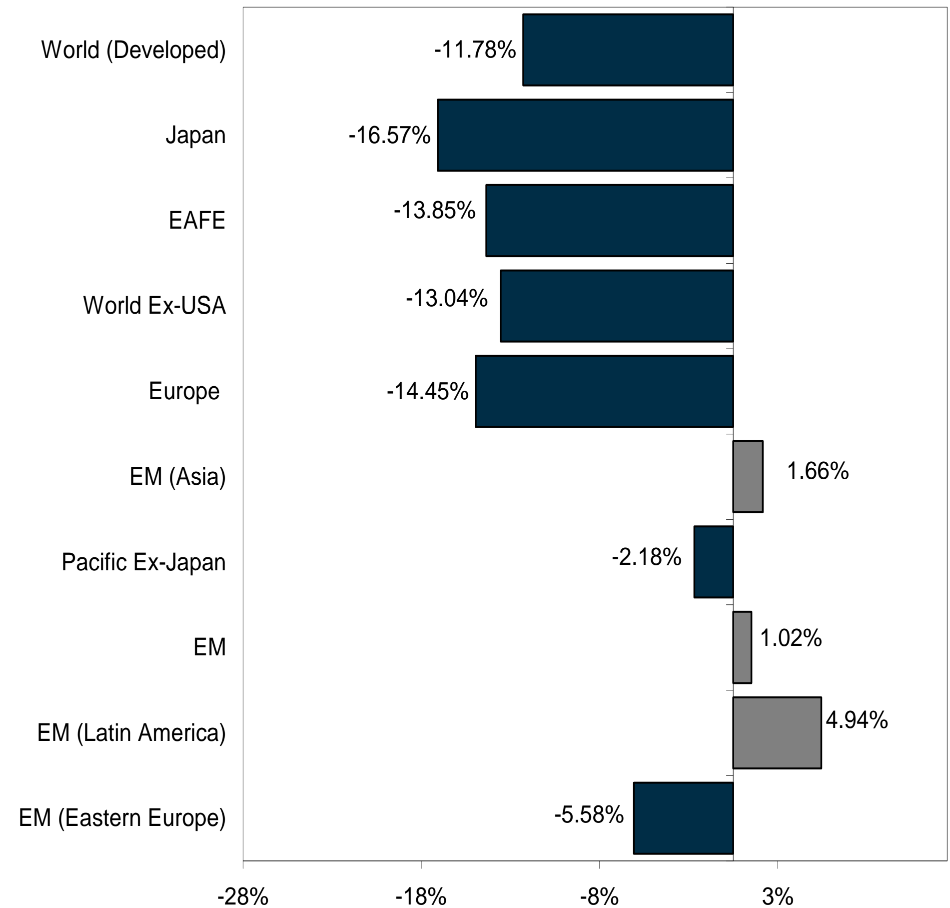
Equity Markets

Equity markets continued their decline during the beginning of 2009, though with less severity than the previous quarter. The S&P fell 11.01% and the NASDAQ closed the quarter down -2.80%. Both indices registered better results than previous quarter losses of 21.9% and 27.1%, respectively.

There were signs of life in emerging markets. The MSCI Emerging Markets Index showed a positive return of 1.02%, a sharp contrast from the previous quarter's loss of -27.56%. Likewise, the MSCI Indices for emerging markets in both Asia and Latin America also registered growth with returns of 1.66% and 4.94%, respectively. However, Europe's emerging markets did not fare as well posting a loss of -5.58%, though this was a significant improvement from the previous quarter's -47.5% decline.

Developed markets showed double digit losses as the MSCI EAFE, a major benchmark of international equity markets, posted a -13.85% loss, up from -19.9% in the previous quarter. Large-cap, mid-cap and small-cap stocks all posted losses for the quarter as the Russell 3000, Russell Mid-Cap, and Russell 2000 Indices posted losses of -10.80%, -8.98%, and -14.95%, respectively.

In terms of S&P 500 sector performance, Financials once again led the way, posting the largest decline of 29.49% while Industrials suffered (-21.77%). The biggest sector improvement could be found in Information Technology, closing the quarter with a positive return of 3.96% compared to a loss of -25.99% in the previous quarter.



Source: MSCI

Outlook

There are potential bumps in the road ahead such as first quarter earnings results, upcoming bank stress tests and the ability to auction “toxic” assets. Investors remain uncertain as to Washington’s ability to help propel us from the current economic mess. Nowhere has this lack of confidence been demonstrated more clearly than in the financial markets.

The losses experienced in the quarter were primarily due to the impact of the ongoing deleveraging cycle. As banks and other financial services firms attempt to stabilize their balance sheets, they are less apt to lend, thereby putting a damper on corporate earnings growth. As earnings expectations decline, so do stock prices. Coupled with fears of a deflationary spiral and falling stock prices, investors have become increasingly nervous and are more prone to liquidate assets at risk.

Heading into 2009, there is some encouragement to be found in the initiative planning coming out of Washington. It is the implementation stage that will be most critical to staging an economic recovery. Valuations have continued to fall in the previous months and uninvested cash remains at historically high levels. Investors must take a “stay tuned” approach as we look for favorable indicators to manifest themselves in the markets. To be sure, there are strong headwinds, but it is possible that the worst may be behind us.

PAST PERFORMANCE IS NOT A GUARANTEE OF FUTURE RESULTS.

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