



December 22, 2008

Weekly Market Commentary

Both the S&P 500 Index and NASDAQ Composite Index finished slightly up, while the Dow Jones Industrial Average Index dipped slightly. The transportation, health care, financial, and retail sectors led advances.

It was another week where bad news didn't carry the same weight it once did. Industrial production declined 0.6% in November; housing starts declined 18.9%, marking the largest decline since March 1984; building permits hit a record low, and weekly initial jobless claims held near a 26-year high. Goldman Sachs reported its first loss as a publicly traded company, and yet its stock traded higher after the news. While observing that the consumer is in retrenchment mode, Best Buy beat earnings estimates for its third quarter, and gained 15% last week.

The bigger news, history in fact, was made in the credit markets when the Federal Open Market Committee (FOMC) cut the Federal Funds Target Rate, the key interbank lending rate, from 1.00% to its lowest range ever of 0.00% to 0.25%. The central bank also reduced the discount rate by 75 basis points to 0.50%, the lowest rate since April 1946.

	Key Market Data		
	Week ending		
	12/19/08	12/12/08	Change
Dow Jones Industrial Average Index	8579.11	8,629.68	-0.59%
S&P 500 Index	887.88	879.73	+0.93%
NASDAQ Composite Index	1564.32	1540.72	+1.53%
10-Year Treasury Note Rate	2.12%	2.58%	-0.46%
NYMEX Crude Future (Barrel)	\$33.87	\$46.28	-\$12.41
Euro/U.S. Dollar	\$1.3918	\$1.3360	+\$0.0558

The FOMC announced that the Fed stands ready to stimulate the credit market and the economy, including possibly buying a lot of long-term Treasury securities. On the news, the yield on 10-Year Treasury Note fell 46 basis points to 2.12% by week's end.

OPEC, meanwhile, said it is going to cut oil production. Designed to stimulate demand, the production cut announcement had the opposite affect, pushing oil prices lower for the week. The drop in oil prices was all the more striking given that the dollar had a tough week as concerns grew over the U.S. government's increasing debt obligations.

In terms of government spending, the big news came Friday with the Bush administration agreeing to lend \$17.4 billion in Troubled Asset Relief Program (TARP) funds to the automakers. The loans are being made on the contingency that the

automakers have a viable plan by March 31 to become profitable.

The broader view

With the S&P 500 Index up almost 18% since its low in November; the 10-Year Treasury Note Rate down almost 95 basis points; and oil at a four-year low, we believe we are seeing a number of emerging “good news/bad news” scenarios.

First, the good news: There is a lot of liquidity in the domestic financial system. In the past 13 weeks M1 grew 50.2%, while M2 soared \$73.9 billion last week alone. M1 contains cash and assets that can quickly be converted to currency. M2, which economists use to quantify the amount of money in circulation, is a broader classification of money than M1. Additionally, the Federal Reserve's balance sheet is up to almost \$2.5 trillion. Altogether, the domestic monetary base is up over 100% year-to-year. Now at a record low, if mortgage rates fall below 5%, we could see a massive wave of refinancing. With oil prices declining, the four month Consumer Price Index dropped to -14.1% – an annual rate of decline larger than during the 1930s.

More good news: The Fed revamped its \$200 billion program, which is focused on extending credit to consumers and small businesses by stretching the term of loans from one year to three years. Additionally, Treasury Secretary Henry Paulson pressed Congress to free-up the remaining half of the \$700 billion TARP after the government depleted \$350 billion in less than three months.

The bad news: Above, we touched on the never-ending stream of negative economic releases. Following the lead of a poor December Eurozone Purchasing Manager

Index (PMI) report, an indicator of health in the manufacturing sector, the U.S. PMI is likely to decline to around 34% in December – helping to explain the weakness in commodity prices.

Additionally, both state and local governments are being negatively impacted by the recession. In contrast to the corporate bond market, which is showing signs of a revival, deteriorating fundamentals at state and local levels are pushing municipal bond yields higher, relative to benchmark Treasuries. Investors need to be selective about their municipal bond holdings (including tax-exempt mutual funds) and should focus on higher-quality general obligation bonds; pre-refunded bonds; and, to a lesser extent, essential-service revenue bonds.

When looking at stocks, it is uncertain as to whether they have moved past the bottoming-out process they began in October. Equity valuations may be reasonable-to-attractive; but, not until investor pessimism has peaked, should investors expect a sustainable rally. In the near term, this could mean oscillating between sharp market rallies and sell-offs. After all, the markets are only 10 weeks into their present foundation-building; and such activity usually takes between eight weeks and 24 weeks. The stark reality is no one knows with certainty when the markets officially will have bottomed-out. The best course of action for investors is to remain focused and concentrate on maintaining the appropriate asset allocation strategy to meet their long-term financial objectives.

Early in 2009, the Federal Reserve will implement the Term Asset-Backed Securities Loan Facility to provide credit relief for households and small businesses. The size of its balance sheet will continue to

increase to a previous unthinkable high level; which will be a near-term stimulus for the economy. We believe the key message here is to expect aggressive action on the part of the Federal Reserve until a bottom is put back into the economy.

A look ahead

Economic data to be released this week won't add much to holiday cheer. Durable goods orders are expected to have another significant decline as business caution has postponed most capital spending. New home sales may drop to the lowest level since the 1981-82 recession, and consumer spending should drop for the fifth month in a row. The

personal consumption index, the Fed's favorite measure of inflation, should moderate in November, as other measures of inflation have shown sharp declines in recent months. Yet, sales adjusted for the sharp drop in inflation in November may turn out to be higher in December. This could lead to some optimism that consumers have not stopped shopping.

Finally, personal income reports should be flat, given the weakness seen in the November unemployment report.

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All index references and performance calculations are based on information provided through Bloomberg. Bloomberg is a provider of real-time and archived financial and market data, pricing, trading, analytics, and news.

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