

monthly investment overview.

December 2008

The Economy

US Real Gross Domestic Product: 2007 +2.0% 3Q'08 -0.5%
Consumer Price Index: Y/Y +1.1% Nov. 2008 -1/7%

News flow on the U.S. economy remains negative. Preliminary estimates on 4th Quarter Real U.S. GDP are now in the negative 5%-6% range. Deflation and excess capacity are key near term concerns, evidenced by CPI growth slowing to +1.1% yr/yr in November compared to +5.6% yr/yr at the end of July'08. Despite help from lower gasoline prices, the U.S. consumer continues to abruptly pull-back on discretionary spending. 2008 will mark one of the worst holiday seasons since the 1970s, with the average retailer (excl. Wal-Mart) likely to see December same-store sales fall as much as 8% yr/yr. Unemployment moving up to 6.7% in November and non-farm payroll declining by 533,000 will further pressure consumer spending. The industrial side of the economy is seeing increased downward pressure as well. A reading on the ISM index of 32.4 in December is well into recession territory. Government actions to combat the ongoing financial crisis and subsequent severe economic slowdown have moved to historic proportions. Bloomberg estimates that the government's total announced rescue efforts are now close to \$8 trillion, with the implementation of these programs set to continue into 2009. President-elect Obama announced in early December his preliminary plans for a fiscal stimulus package estimated in excess of \$800 billion over two years. In addition, a \$17.4 billion bailout of the U.S. automakers was aimed at preventing further economic weakness and will provide temporary relief until March 31st 2009 as these companies work to restructure. In response to the weakening economic outlook, the Federal Reserve at its December 16th meeting established a target range for the federal funds rate of 0 to 1/4 percent. Finally, the U.S. dollar exchange rate weakened in December, coming off of "flight to quality" strength that was driven by foreign central banks cutting interest rates in response to their own severe economic weakness.

The Stock Market

Dow Jones Industrial Average YTD Total Return: -31.88%
Standard & Poor's 500 Index YTD Total Return: -37.00%

Stocks rallied off their lows of late November as the market ignored an overabundance of negative news and instead focused on government intervention to prop-up the economy. Stocks that were the strongest in the recent rally included those in the construction and basic materials industries (beneficiaries of Obama's infrastructure plan) and various early-cycle consumer industries. Gold stocks in particular posted a strong advance due to oversold conditions and expectations of eventual inflation pressure. Stocks in certain areas of technology and financials lagged.

The Bond Market

Federal Funds Rate: Target 0% - 25bpts
10-Yr US Treasury Yield: 2.20%
Barclays Intermediate-Term US Gov't Bond Index: YTD +10.43%

Treasuries extended their very strong rally into December as investor flight to safety pushed the 10-year Treasury yield down to 2.2% and the 90-day Treasury bill remained close to 0%. Yield spreads continue to reflect high risk premiums as evidenced by the all-time highs of just over 20% on the Merrill Lynch Junk Bond index. Government efforts to unlock credit markets, however, appear to be working. Three month US\$ LIBOR declined to 1.5% in December from a peak of over 4.5% in October. In addition, a decline in 30-year fixed mortgage rates from 6.2% in November to 5.1% at the end of December has driven a huge spike in mortgage refinancing activity. A government plan to complete \$500 billion of agency MBS purchases by the end of 2Q'09 could provide further relief.