STRATEGIC FINANCIAL MANAGEMENT GROUP

Investment Strategies & Insights

4th Quarter 2008

Red Sky in the morning…sailors take warning

Just as the seafarers of old used certain conditions as signposts to prepare for the seas ahead, we believe that there are a number of issues that must be navigated before the economy and stock market are in for smooth sailing. After the Tsunami of 2008 with the S&P 500 down 38%, Europe ex-UK down 48%, and Asia ex-Japan down 51%, it seems as if the entire world has experienced the roughest sailing since the Great Depression. In the economy, housing is continuing to face stiff headwinds, as are many companies whose earnings are sinking fairly rapidly, for yet another quarter. So with some obstacles clearly visible, and others like rocks & reefs, just beneath the surface, let's see if we can chart a safe course to our destination and not end up like the S.S. Minnow.

This recession began with the implosion of the housing market and it won't resolve itself until that market regains some semblance of order. It is difficult for us to envision either the financial system or the consumer beginning to stabilize until housing does. We don't need to see a full recovery to feel safe about this segment of the economy, but the double-digit declines need to end.

The credit markets are still challenging, and many companies are struggling with how to pay down, or even roll-over their debt. The traditional lenders (banks) have severely impaired balance sheets and are raising their lending standards, resulting in a reduction in the number and size of loans they are making. When companies are able to secure financing, it is at interest rates comparable to using their corporate credit cards to borrow money (16% to over 20%). Because of this, we expect to see a significant increase in the number of bankruptcy filings throughout 2009. Until lending rates fall convincingly and credit availability increases, we have concerns about a real and sustainable recovery. However, we are beginning to see signs that the international credit markets are improving with interest rate spreads narrowing a meaningful amount.

It appears retailers are hunkered down for a gale force consumer slowdown. The November retail numbers were an absolute disaster, with many stores posting double-digit sales declines compared with last year. Christmas proved to be one of the weakest in over two decades. The perfect storm of rising unemployment, falling home values, and substantial declines in retirement (401-k) and investment assets, have left the consumer unwilling, or unable to spend. If the American consumer is the engine that drives the global economy, then we could be in for a bit of a wait. Coupled with that, the rest of the world is in the midst of a significant deceleration as well. Some countries, such as Germany, the UK, and most of the Eastern Bloc countries, are firmly in the recessionary current. The World Bank and the IMF (International Monetary Fund) are continuing to revise down their estimates of global growth for 2009, almost monthly. We would like to see signs of the US consumer spending more, leading to the rest of the world beginning to show some signs of establishing a degree of stability.

This will represent the sixth consecutive quarter of declining corporate earnings. So far most of the damage has been contained to the financial (banking, brokerage & insurance) and the homebuilding sectors, but it is beginning to ripple out to other areas. Even though the market is a forward-looking creature, it is notoriously bad at factoring in the depth of a downturn. Analysts are also infamous for being shamefully slow to recognize a gathering storm on the economic horizon. We will remain cautious, until earnings begin to find a bottom which will lead to...A Red Sky at night….a sailors delight.

" Policymakers decided it was better to bailout a nation than a sunken ship"

Bill Gross - Bond Manager of the year 2007

SUMMARY:

The 2008 bear market continued in the 4th quarter with the S&P down nearly 22%.

We began to see the international credit market stabilizing and returning to more normal conditions.

Unemployment reached 7.2% and looks to be continuing upward.

President elect Obama is working closely with Congress to push thru a bailout package in excess of 850 billion dollars.

Although economic conditions are currently difficult, the market typically turns up prior to the actual economy.

Some attractive opportunities are just on the immediate horizon.

Investment Strategies & Insights is mailed quarterly to our clients and friends. The intent of this publication is to share some of our most interesting views and research.

So What Is The Economy Really Doing?

Inside The Economy

Inflation and Interest Rates

- Inflation continues to come down at both the consumer and producer price levels. Most commodity prices have fallen substantially, and with rising unemployment, wages and salaries are not increasing to any real extent.
- The Consumer Price Index (CPI) fell 1.7% for November, due primarily to falling food, commodity, and energy prices.
- Producer Price Index (PPI) has fallen for four consecutive months with October & November down over 2.0%, and December expected to fall a similar amount.
- The battle that the Fed is now fighting is not inflation, but rather avoiding deflation.
- The Fed has lowered short term rates to between zero and ¼ of a percent to help reduce borrowing costs and stimulate the economy.

Economic Output and Direction

- Virtually all of the economic indicators remain negative and are not yet showing signs of improvement
- The National Bureau of Economic Research, the arbiter of U.S. recessions, stated that the recession began in December of 2007.
- The Fed Chairman, Ben Bernanke, has suggested that he stands ready to do whatever it takes to avert a deflationary spiral, including buying Treasuries and Mortgage-Backed securities on the open market.
- President-elect Obama has proposed to expand the 3rd bailout program, pushing the total to between 850 billion and one trillion dollars.

Business and Consumer Indicators

- Weakness persists in both the service and manufacturing sectors with a substantial decline in new orders.
- Personal income fell the last two months, and spending has been down the last four months with the largest decline in November (-0.6%). This demonstrates that the consumer is really beginning to reduce expenditures.
- This attitude is reflected in continued declines in consumer confidence, possibly related to recent weakening in the employment data and the drop in the stock market.
- Continued declines in new & existing home sales, as well as prices, prove the real estate market is still taking on water.

Inside The Markets

The Stock Markets

- The Bear market continued in the 4th quarter as every attempted rally eventually failed, with stock prices falling nearly 22%. However, valuations are now beginning to look somewhat attractive.
- The early bounce in the first week of the new year appears to lack conviction, (low trading volume) and will have to overcome weak economic news to be sustainable.
- In addition, earnings for most sectors of the economy appear to be coming in below expectations, and guidance is being revised down almost across the board.
- With so many industries down even more than the broad market, there appear to be a number of opportunities developing that represent attractive values with relatively inviting yields.
- International markets have fallen as well and face a difficult environment going forward. However, long-term global growth, albeit slower in the emerging economies, remains intact.

The Bond Markets

- The yield on Treasuries continued to fall as investors looked for safety.
- As a result, the spread between interest rates on U.S. government securities and lower quality bonds widened, increasing the cost of borrowing for corporations.
- Shorter-term yields have dropped as the Fed has continued cutting the Fed funds rate, with the most recent Treasury Bill auction offered a 0.00% rate.
- Even though the U.S. dollar has fallen a bit lately, it remains quite stable relative to most other currencies, particularly the Euro.
- As a result, the European Central Bank is under increasing pressure to cut interest rates to rescue a stalling European economy.

Commodities / Alternatives

- The Dow Jones Commodities Index suffered a 43% correction in 2008.
- Falling prices have not only been in oil, but grains and materials as well.
- With the magnitude of declines in commodities, volatility should begin to moderate, as the markets have already anticipated a fairly significant and prolonged global recession.

Closing Thoughts

Red Sky at night… sailor's delight

We feel that with the massive fiscal and monetary stimulus created by the three bailouts and a tidal wave of liquidity provided by Captain Bernanke, the economy can avoid sliding into a 1930's like depression. In addition, the stimulus should preclude a 1990's style Japanese deflationary slump. However, we think that the current and impending bailout plans will take some time to take hold and help this Super-Tanker we call the US economy to reverse course. We expect the recovery to be somewhat moderate by historical standards, reflecting a fairly gradual thawing of credit and a slow return to risk taking by both individuals and businesses.

Joseph Schumpeter called what we are currently experiencing "*the perennial gale of creative destruction*", the ongoing evolution from one economic structure to another. He felt that by necessity the excesses of a particular economic system would inescapably result in its own demise, and then lead to another system which would represent an over-compensation for the previous problems. What we have seen is that many of the laws and regulations that were created in reaction to the "Enron's and WorldCom's" of the early 2000's, (i.e. Sarbanes Oxley and Mark-to-Market accounting) have helped to exacerbate our current situation. A dramatic overhaul of the financial industry has occurred, with bankruptcy being replaced by receivership, where firms are no longer allowed to fail, but are simply absorbed in large prearranged "Shot Gun" weddings, with the taxpayer footing some or all of the bill. The fall of Bear Stearns, AIG, Freddie Mac and Fannie Mae, Washington Mutual, Wachovia are all casualties of the new financial order. One can only assume that the inevitable heavy handed approach that the Federal government is likely to take, employing the same kinds of policies that got us into this mess to begin with, will create a new financial landscape, very unlike the one we are just saying goodbye to.

So as the government attempts to right our economic ship, what is our best course of action? Massive dislocations, whether as a result of economic, political, or technological changes, produce opportunities of a scale rarely seen. There is substantial historical precedence for a strong and enduring rally following the magnitude of the market decline that the US and world have just experienced. History is not a guarantee of future performance, but it may offer a potential framework for establishing plausible expectations. Since 1950 there have been eight Bear markets where the S&P 500 has declined a minimum of 20%, not including 2008.

In reviewing the subsequent performance of the market, both one and two years later, we find a number of reasons to be cautiously optimistic. Of those eight periods, all of them were up both 12 and 24 months later. One year after the decline they averaged an increase of 36.5%, and two years following the Bear, they were up on average of 53.8%. Additionally, whenever there has been a significant build-up of cash in money market accounts, as in 1987, 1990 and 2002, what followed proved to be extremely strong rallies. In 1988 the market was up 16.2%, 1991 produced a 30.2% return, and 2003 resulted in a 28.5% gain. Currently, there is even more cash on the sidelines than anytime in last 25 years. With over $8.85 trillion earning virtually zero, that amount of money could potentially provide powerful winds to the sails of the market for 2009.

Many people reacted to 2008 with alarm and fear, and we want to emphasize that panic is not a strategy. However, taking advantage of other's emotional overreaction does represent a sound investment tactic. There are an ever increasing number of industries and sectors, relating to both stocks and bonds, where the valuations have become compelling and we are watching closely for opportune entry points. However, like good sailors we are vigilantly watching the economic and investment horizons for evidence as to whether we patiently anchor, or set sail into that Red Sky.

Best regards,

David White

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