WEALTH MANAGEMENT RESEARCH

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2009 Capital Market Outlook: January 23, 2009

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A new year, a continuing evolution

As we turn the page from one of the most challenging years for investors in modern history, the new year—as well as the new White House administration—brings with it hope for a return to better days for financial markets. The changing of the calendar also elicits the annual onslaught of predictions and prognostications from market analysts who endeavor to forecast—accurately, we presume—what the markets will do in the coming year. But like trying to predict the temperature 12 months from now, such forecasts are of dubious value for investment decision-making. They also bear little relevance in an environment that is undergoing a structural, evolutionary change.

We believe the global economic landscape is experiencing just such a change at present, and while we believe continued positive progress will be made toward reinforcing and reshaping the financial system in 2009, it will likely disappoint anyone anticipating a quick fix. While the economy may continue to languish, however, we believe stock and bond markets will be, as they have historically been, anticipatory animals—potentially rebounding in advance of positive economic trends. We also expect any rebound to come in fits and starts—quite probably in bouts of two steps forward and one step back—before we reach a new equilibrium from which a more sustainable and healthy new cycle of economic growth can begin.

The cracks in banking and financial institutions that appeared, undetected by most, in early 2007 were at first limited to minor leakage from mortgage-backed portfolios, particularly those related to subprime or other higher-risk borrowers. In August 2007, those initial weak spots came together to form wider, more noticeable gaps, highlighted by the closure of several large investment funds invested mainly in mortgage-backed securities. The losses quickly accelerated, and the effects spilled over into credit markets, where the key tenet that money loaned was likely to be repaid seemingly lost validity in a flash—and banks and financial institutions began curtailing their lending to each other and to consumers.

Despite attempts by policymakers to repair each individual trouble spot, the network of cracks continued to propagate, causing more rapid and severe damage to the global economy than some had initially thought possible. The culminating moment, so far at least, appears to have been in September 2008, when credit markets froze in the aftermath of Lehman Brothers' bankruptcy, and the structural integrity of the global financial system as a whole seemed at risk. In the months since, policymakers have become increasingly more creative and assertive and have focused on wider-scale solutions to help us recover from the current economic malaise. At the same time, economic data has been increasingly worrisome, credit conditions remain tight, and weakness has spread unrelentingly from the financial economy to the broader economy. In short, the dam partially collapsed in September 2008, and damaging flood waters are now racing through the global economy. Therefore, it is likely that we'll see continued bad economic news as we move through 2009. And yet, against that unsettling backdrop, it is important to note that a potentially wider catastrophe was averted through the actions that were taken, and plans are actively being implemented to provide immediate relief, as well as to restore and rebuild both the system and participants' confidence in it.

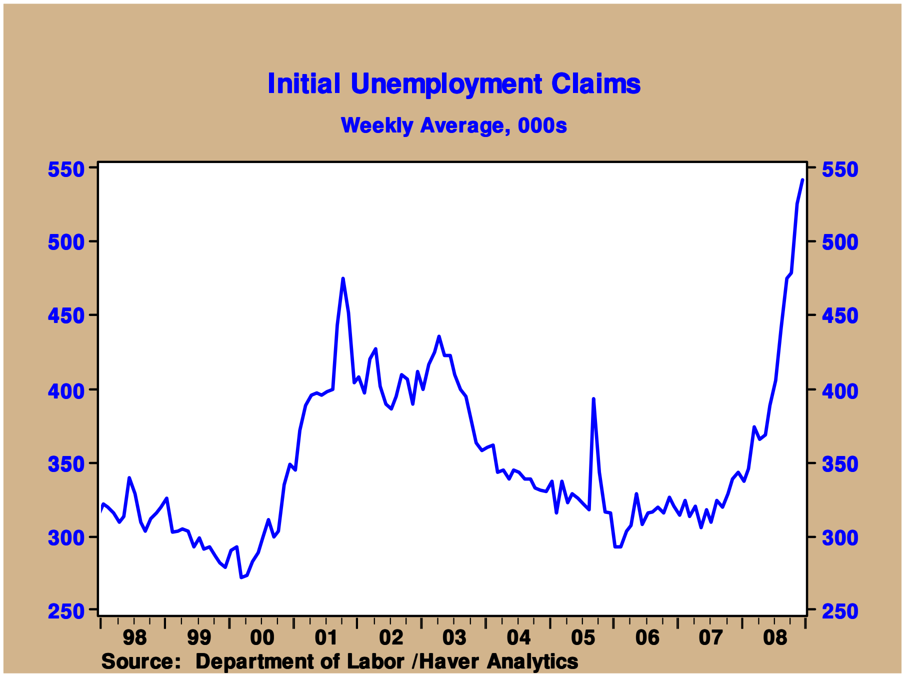
We believe the continuing evolution of several key, and interrelated, dynamics will drive financial market performance in 2009, including residential housing, credit, consumer spending, unemployment, and—by far the biggest wildcard—government policies and spending programs. Leverage, a key cog in the economic expansion that we experienced following the 2001 recession, is unlikely to help fuel the rebound this time around, as businesses, consumers, and financial institutions alike have collectively been stung by the harmful, sometimes catastrophic, effects of excess borrowing in the face of a slowing economy. Leverage, dispassionately magnifying both gains and losses as it does, quickly morphed from ally to grim reaper for many individuals and business—including some of the best-known firms on Wall Street—when the economic winds shifted in 2008.

In the broadest terms, the severe slowdown in consumer-spending that we experienced in the latter months of 2008—which we had forecast in our August commentary—has depressed the demand for goods and services on a global basis. This, in turn, has caused businesses to retrench by cutting back production, reducing staff, and rethinking planned investments. On the other side of the ledger, the government is actively engaged in trying to offset this demand destruction through some combination of tax relief, increased spending, and incentives for businesses to invest and hire additional workers. Government (the public sector) will endeavor to support aggregate demand at a time when consumers and businesses (the private sector) are unable or reluctant to do so. At the same time, government cannot assume that role indefinitely and must set the stage for the private sector to regain its footing—all the while carefully managing the risk of creating unintended, and unwanted, consequences through its chosen course of action. We believe that will be the dominant theme through 2009 and will set the economic stage for years to come.

Economic backdrop

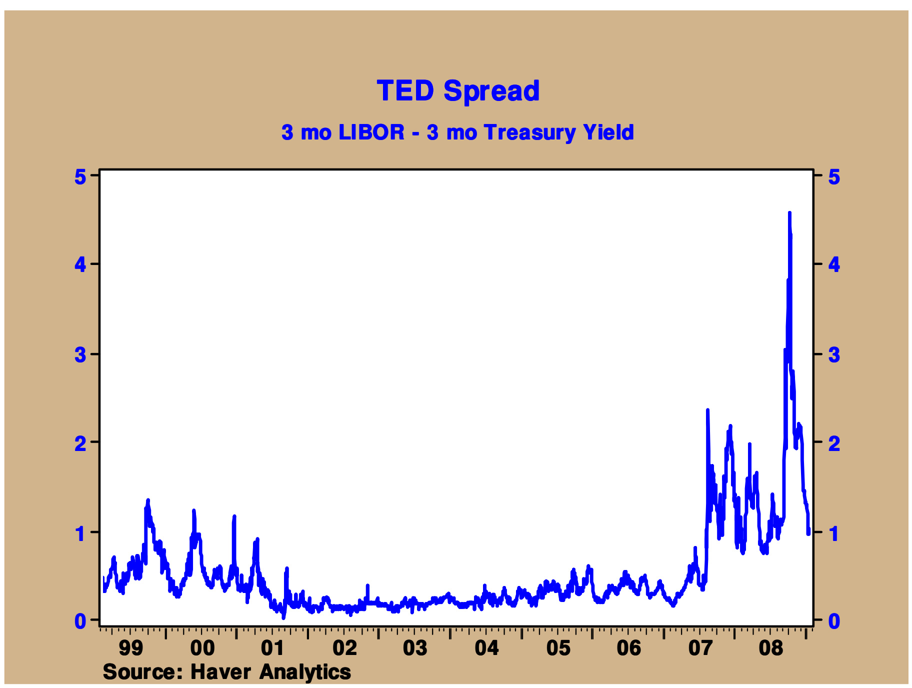
The Fed's "beige book," a compilation of business activity from around the country, has highlighted rapidly deteriorating economic conditions across all Federal Reserve districts in recent months. The most recent release in early January showed that conditions have weakened even further in the first weeks of the new year. Housing sales activity remains slow, while prices continue to fall in many regions. Retail sales are off sharply—holiday sales were down 2.8 percent, according the National Federation of Retailers—and have now fallen for six consecutive months, according to Commerce Department statistics, the longest consecutive stretch of monthly declines in at least four decades.

Domestic automakers, who seemed on the verge of bankruptcy in December, avoided that fate when ex-President Bush orchestrated a last-minute loan package, but they still face unyielding competitive pressures. General Motors, Ford, and Chrysler each saw its sales fall by more than 20 percent in 2008, as compared with the prior year. In response to sluggish demand, businesses in many industries have scaled back production, resulting in lower factory utilization and layoffs or reduced hours for many workers.

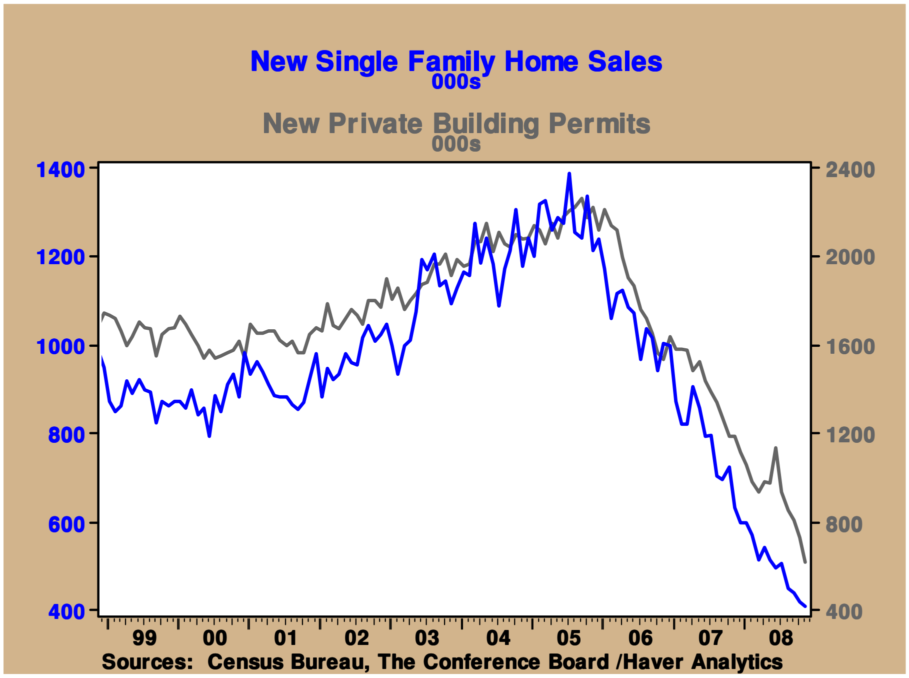


Correspondingly, new unemployment claims have spiked above the highest rates seen in the 2001 recession, and the unemployment rate has climbed to 7.2 percent. We expect job losses to continue to mount in the coming months. Employment, however, tends to be a lagging indicator, meaning that an economic rebound will likely be underway before improvement is reflected in employment statistics.

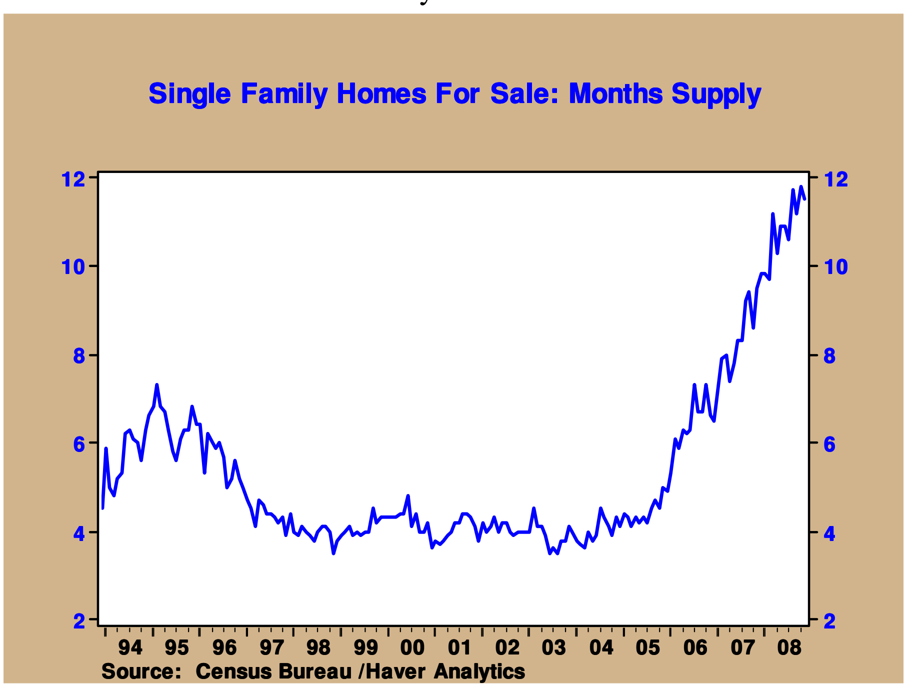
Credit markets, an important pillar to an efficient and healthy economy, also remain under stress at present. The TED Spread measures the yield premium banks demand for lending to other banks, as opposed to simply investing at U.S. Treasury yields. Generally used as a gauge of the perceived level of counterparty risk among lending institutions, the TED Spread remains elevated, indicating that there is still some fear of insolvency among commercial banks. On a positive note, however, it has come down significantly from its all-time peak reached in October 2008, at least partly as a result of significant efforts on the part of the Fed and other central banks to provide liquidity and stabilize the credit markets.



The residential housing market, the epicenter of the excesses that precipitated the current recession, continues to pose systemic risk in our opinion. As we have articulated in prior commentaries, it is difficult to envision a sustained economic recovery beginning until some equilibrium is reached in housing. To date, it appears that more time—and possibly direct government intervention—will be needed to reach that equilibrium. Despite the flurry of programs and activity to inject capital into ailing financial institutions, purchase commercial paper and other securities in the open market, and manage the interest rate environment, little has been done to directly alleviate the stresses present in the housing and mortgage markets. And those stresses are indeed still evident.



Despite home prices that have fallen more than 20 percent from their peak, sales activity has been insufficient to clear the current supply of homes for sale. Issuance of new building permits has plummeted since 2005, though with a slight lag, as builders adjust their plans to coincide with the current economic reality of reduced demand for new homes. Supply imbalances remain in part because attractive mortgage financing is available only to well-qualified borrowers—and because of a wait-and-see approach by interested buyers, who chose to sit out the recent housing stampede and are now contently waiting for an attractive entry point.



While the obvious glut of foreclosures and at-risk mortgages due to inadequate lending standards garners much attention, a secondary problem facing the housing market is the magnitude of price declines. As prices fall by more than 20 percent, even well-qualified buyers—those who used conventional financing and therefore put down 20 percent (or more) of their original purchase price—could find themselves owing more on their mortgage than the home is worth, thereby giving them less incentive to pay the mortgage in full. The possibility for such a downward spiral—whereby foreclosures result in falling prices, which leads to more foreclosures and further price declines—is a worst-case scenario, but it cannot be completely dismissed in the current context.

That said, mortgage rates have already dropped in response to the general decline in interest rates, as well as the Fed's program to directly purchase obligations of government-sponsored enterprises (GSEs) and GSE-originated mortgage-backed paper. Ultimately, this action should help to increase the availability of and decrease the cost of mortgage financing, thereby helping to stabilize prices in the housing market. Yet with nearly 12 months worth of housing inventory currently for sale (at current sales rates)—a number that remains near all-time highs—any improvement will likely take months to materialize, which may simply be too long to wait. Direct governmental intervention is the likely counter-policy to prevent the worst-case scenario from gaining a foothold.

Stimulus package unveiled

With President Obama now officially seated, the blueprint of his proposed stimulus package is taking shape. The plan calls for a two-year, $825 billion stimulus package—$550 billion in new spending and $275 billion in tax relief—focused on creating business incentives to spur job creation; tax relief for individuals; and direct government spending on infrastructure projects, alternative energy, and various social programs and services. The proposed spending—roughly 3 percent of gross domestic product (GDP) over two years—would represent one of the largest government outlays in U.S. history.

Questions linger, however, as to how quick and effective the president's proposed program would be at helping to jolt the economy from its vulnerable state. For one, the program provides less of a direct infusion of spendable income than many had hoped. The intended infrastructure and energy-related expenditures, while certainly likely to provide benefit in the years and decades to come, are longer-term in nature and provide little immediate relief. Second, assistance for at-risk homeowners is conspicuously absent from this proposal—although it has been frequently mentioned by the president and his economic team—meaning that adjustments to this plan, or a separate and distinct mortgage initiative, should be expected. The president, however, has articulated that he believes any program that provides only an immediate burst of disposable income is too short-sighted—failing to address what have become chronic shortfalls in our nation's competitiveness. After the U.S. economy shed 2.6 million jobs in 2008, and with early indications that 2009 is off to an equally uninspiring start, the need for significant fiscal stimulus seems readily apparent.

Additionally, Congress began the new year by releasing the remaining $350 billion from the previously approved $700 billion Troubled Asset Relief Program (TARP), the first half of which went largely to inject capital into ailing banks and financial institutions. But as the banking system continues to unwind leverage and absorb losses on loan portfolios of all types—

residential mortgage, credit card, auto, commercial, and others—we believe additional funds will yet be needed before that final chapter can be written.

Investment implications for 2009

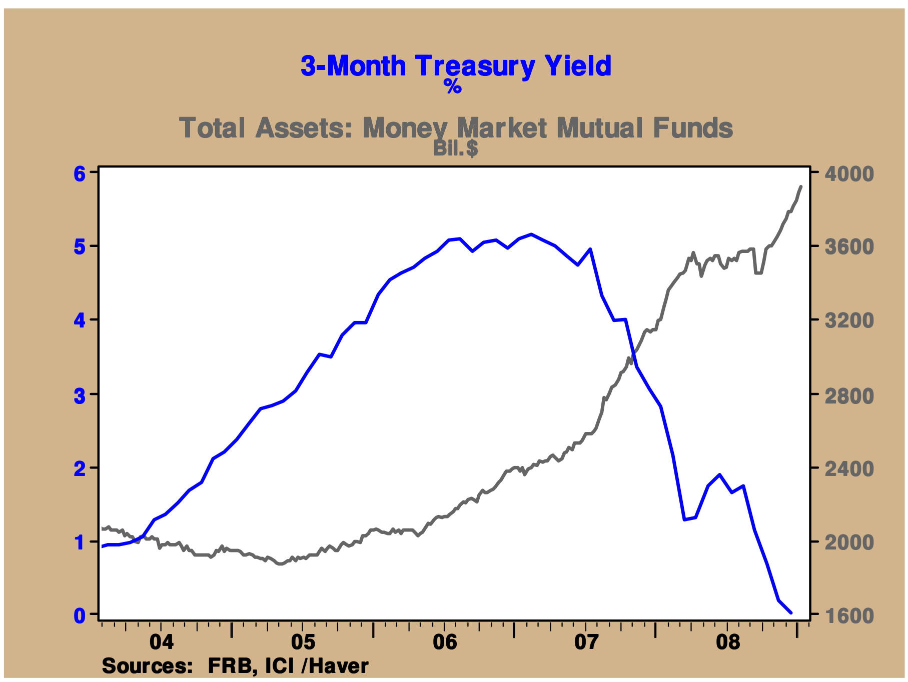
Last year reminded investors that financial markets are unpredictable, and risk does indeed mean that returns on all kinds of investments will, at times, be negative as well as positive. The investment themes we espoused in our 2008 Outlook one year ago included:

- Bias toward a defensive posture; favor high quality and lower risk
- Assess true risk tolerance in expectation of heightened volatility
- Favor large, blue-chip companies
- Favor Treasuries and high-quality corporate bonds
- Exercise caution in taking on duration and/or credit risk
- Underweight high-yield bonds

Many of those themes served investors well last year, yet in hindsight we wish we had been even more forceful in our recommendations.

We expect the structural changes and policy responses that began last year to continue into 2009, and quite probably beyond. Important themes in 2008—reductions in consumer spending, deleveraging by both consumers and financial institutions, disruptions in credit markets, and heightened governmental responses—will continue to evolve until a new equilibrium is reached. Unusual volatility, so prevalent last year, as markets shot higher on hopes of a quick recovery, only to plunge in the following days as a new piece of disappointing economic data was released, will likely continue as well.

In 2008, tried and true principles of asset allocation and diversification came under fire, and were abandoned by some, as shell-shocked investors fled to U.S. Treasuries as the only perceived safe haven. Investments in money market mutual funds soared late in the year, even as the yields on those investments dropped to miniscule levels. And yet while last year's downturn shook the confidence of investors both large and small, history suggests to us that markets will eventually recover. Our feeling is that those who compare the current environment to the 1930s underestimate some unfortunate policy decisions that exacerbated



and prolonged that downturn, and they fail to appreciate the drastically different policy responses that have been implemented today. There is no guarantee, of course, that today's chosen course of action will prove successful. But expecting conditions to deteriorate drastically from here is to believe that all efforts to stimulate demand and re-inflate the economy will fall short—making a Great Depression-type fate feasible. We assign only a very small chance of that extreme view coming to pass.

Our expectation for 2009 is that economic data will remain sluggish—and will quite possibly worsen—in the coming months while government spending programs gain traction, losses on mortgage-backed portfolios continue to work their way through the system, and credit conditions slowly thaw. Consumer spending may well continue to weaken a bit from current levels—establishing a new "normal," absent the excesses fueled by the unsustainable borrowing of the past—but it will not precipitate the doomsday scenarios that some have predicted.

Despite the popular consensus, we don't necessarily envision a sudden, drastic transformation from bad economic conditions to good in the second half of the year. But we do think that, slowly, conditions will indeed improve, bumpy though the journey may be. Along the way, volatility will continue to be felt, and long-term investors should avoid the temptation to try to call market tops and bottoms. In volatile markets, dollar-cost averaging can be a very effective strategy for deploying new assets, as well as moving assets back into the market that had been pulled to the sidelines. We believe a consistent and disciplined approach should be favored over those that rely on market timing.

Stocks

The S&P 500 fell by 37 percent in 2008, a stunning drop and its worst annual showing since 1937. The steepness and magnitude of stock market declines were a reflection of forced selling by leveraged investors, a recognition that corporate earnings were likely to be lower than previous expectations, and accelerating investor pessimism.

As of January 21, the 47-percent plunge in the S&P 500 from its October 2007 peak certainly reflects reduced expectations relative to the recent past. Deleveraging, which we believe peaked in September/October of last year, is likely to continue, but at a less frenetic pace—mitigating one element of downward pressure on stock prices. It is certainly possible, if conditions in the real economy continue to deteriorate from here and corporate earnings fall precipitously, that stock markets could fall further in the coming months and either retest or fall below the November 2008 lows. It is more likely, in our opinion, that 750–800 on the S&P 500 (or roughly 7,500–8,000 on the Dow Jones Industrial Average) represents something close to a bottom in the current market cycle and offers a potentially rewarding investment opportunity for long-term investors.

Our themes for the coming year revolve around a basic premise that corporations around the world will continue to battle the headwind of slower consumer spending—as both suppliers and recipients of credit take a more risk-averse stance, and wage-earners push the national savings rate above the near-zero level of recent years. U.S. policymakers, while far from flawless in their execution, have been ahead of the curve in addressing the current economic challenges and have implemented policies designed to re-inflate the economy and prevent a deflationary spiral from taking shape.

Decoupling—the idea that emerging economies are now more independent and better insulated from economic upset in the U.S.—is a concept that we certainly believe will play out in the decades to come but will offer little benefit to investors in the current context. As such, our expectation is that the U.S. will lead any global recovery—which will also benefit emerging economies that are dependent on the U.S.—while economies in developed Europe are expected to lag.

Our themes for 2009 include:

- Expect heightened volatility to continue; dollar-cost-averaging an attractive option
- Favor large-cap, blue-chip companies
- Overweight U.S. relative to strategic targets
- Slight bias toward emerging markets in foreign allocations
- Focus on well-capitalized, dividend-paying companies to help cushion downside risk
- Consider hedged equity, long/short, or merger/arbitrage strategies for a portion of overall equity exposure

Fixed income

Last year brought unprecedented volatility and pricing anomalies to fixed income markets, as fear, mistrust, and deleveraging all combined to drive credit spreads near all-time highs on many types of bonds. Treasuries were by far the most popular port in the storm, as investors flocked to the low-risk, low-return option. Although spreads have tightened somewhat in recent months, municipals, investment-grade corporates, high-yield, and mortgage-backed bonds still offer significant yield premiums over Treasuries of comparable maturity.

There is a widespread fear that the current Fed policies of ultra-low interest rates and increases in money supply are sure to cause inflationary pressures down the road. While that may well be the case longer term, we think the likelihood of such a scenario in the next 12 months is low. Commodity prices have staged a U-turn in recent months—falling precipitously in the face of weaker demand after spiking in mid-2008. Generally weak economic conditions and a financial system that is likely to continue to delever make the Fed's primary policy goal in the current environment to prevent deflation. The Fed believes it has the tools and knowledge to combat unacceptable inflation if and when it occurs, but trying to navigate out of a deflationary spiral has a far less predictable outcome.

Our themes for 2009 in this space include:

- Treasuries unlikely to repeat 2008 outperformance; underweight
- Investment-grade corporate and municipal bonds offer attractive yield spreads for level of risk; overweight
- High-yield appears cheap, spreads at all-time highs, but default rates expected to rise; advise caution and underweight

- Interest rates at historically low levels, inflation also a longer-term concern; favor short-intermediate portion of the curve
- Distressed debt likely offers significant opportunities for skilled managers

Commodities/natural resources
After leading the pack higher for much of the recent bull market, commodity, natural resources, and precious metal investments proved equally capable of leading the retreat in 2008. For 2009, we do not expect a sharp rally. Rather, we expect that the generally depressed global demand picture will help to keep a lid on the price of most commodities, the supply of which is constrained in the short term, but whose demand is highly elastic to changing economic conditions. When demand falls, as it did in 2008, prices react quickly and drastically. Note that commodities should equally respond to any sudden surge in demand, which we believe is unlikely in the coming quarters. These investments—often included in portfolios to provide a long-term hedge against inflation—may well deserve a place in long-term, strategically allocated portfolio. From a tactical standpoint, however, we see muted opportunities in 2009.

The more things change, the more they stay the same
The above saying should ring true as we march ahead into this new year as well. The themes that began in 2008, or even before, will continue to evolve. Economic conditions are likely to be subdued, governmental efforts to restore the health of the private sector and consumers will continue unabashed, and the environment will pose unmatched opportunities for some and insurmountable challenges for others. But while those themes remain the same, we expect the investment environment to be entirely less menacing than it was last year. While a sharp, quick rebound may not be in store, we believe that the more gruesome of economic prognostications will also not come to pass.

One thing is guaranteed about any economic or investment forecast—some of it will be proven correct, while other parts will not. As we move ahead into 2009, we will continue to monitor conditions and provide commentary that we hope you find insightful and helpful.