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~ OUR CHIEF INVESTMENT OFFICER'S COMMENTARY ~

Happy New Year! One year ago we expected that high energy prices and the emerging mortgage crisis would have a dampening effect on the underlying economy. At that time, we felt that the financial companies and industries directly dependent on credit would bear the brunt of this slowdown.

Little did we know, then, the extent of the failure of government agencies, and our elected officials, to supervise the excesses of leverage in the financial system. For years, hedge funds and structured investment vehicles have been allowed to operate beneath a cloak of secrecy. As the year progressed, glimpses of this excess became visible. With the bankruptcy of Lehman Brothers, in mid September, the crisis became one of global proportion, amplified by credit default swaps, securitization and other interconnected obligations. **The September/October financial shock was the catalyst which transformed the mild recession of the first eight months of 2008 into a global recession on a scale to rival the worst of the last half-century.**

As we embark on the new year, the economy is still in decline. Consensus forecasts don't see recovery until late in 2009 and then only a moderate recovery. The financial system in the U.S. is in a fragile state, very vulnerable to continued declines in asset values.

We tend to agree with Credit Suisse, in their Global Strategy forecast, **"The Theme for the year 2009 is likely to be an ongoing contest between the potentially overwhelming force of counterparty distrust and deleveraging and the overwhelming policy responses designed to avert depression, escalating protectionism and widespread political instability."**

Like Credit Suisse, under either scenario, **we expect both the bond and stock markets to improve as the global economy begins to stabilize over the coming months** and we are biased toward an eventual positive resolution. Why do we have this positive bias towards stocks and bonds? A few weeks ago, we wrote a note that pointed out that financial markets are a leading indicator of economic activity. In recent economic cycles, equities have bottomed up to five quarters ahead of a trough in earnings.

Yields on corporate bonds have risen to levels not seen in years, even as U.S. Treasury yields are hovering near zero. **These high yields on corporate bonds reflect what we believe to be unrealistic expectations for default.** At the last market bottom, corporate bond yields led the recovery in stocks; they will need to fall from current levels for equities to rally. Recent trading activity leads us to believe that corporate bonds are poised to rally.

Another catalyst for a stock market recovery in 2009 would be an indication of stability in the U.S. housing market. Looming over the housing and credit markets are resets to Alt-A mortgages. These are loans to borrowers with slightly higher underwriting risk. Many were negative amortization loans with low "teaser" rates which increased the loan balance, even as housing prices declined. Since the reset to these loans will be fully amortizing at market rates, it is imperative that housing prices stabilize so the homeowner has less reason to default. We think **a key factor to housing price stability will be the lower mortgage rates resulting from the Federal government's Term Asset-Backed Securities Loan Facility (TALF) program.** Last week, thirty year conforming fixed rate mortgages declined to 5.1%, the lowest since the survey began in 1971. With the government stepping in to buy $500 billion of mortgage backed securities early next year, we could see the rate go to 4.5%.

While energy prices are notoriously unpredictable, they could function as another form of stimulus since lower prices free up cash flow for non-energy purchases. If the recent price of oil is sustained for the full year, it would effectively reduce our aggregate oil bill by $377 billion, or 2.7% of GDP.

Finally, on top of the generous monetary stimulus, including the unreleased TARP (Troubled Asset Relief Program) and TALF funds, we will have a new administration which has promised unspecified, but large, amounts of fiscal stimulus. There is considerable uncertainty regarding when and how much the policy will affect economic activity, but it should be approved early in the year and have a substantial impact. It is this **unprecedented commitment to fiscal and monetary easing that will help to stabilize expectations for growth and capacity utilization, and restore confidence to the financial system.**

While recession and deleveraging will dominate the headlines early in the year, contributing to near-term deflation, we think that will be short lived. **Historically, when government has contributed more to growth than domestic demand, it tends to be associated with rising prices.** Sooner or later, as the economy starts to recover, we expect the magnitude of this stimulus to manifest itself as inflationary pressure.

During the past four months, financial assets were battered. Corporate bonds and equities were cheap. **The single most important factor, for 2009, is the continuation of the healing process in the financial system.** This is the key requirement for the recovery of both stocks and bonds, and eventually the real economy.

Fixed Income Update

Are Treasury Bonds Safe? So asked a recent article in the financial publication *Barron's.* Yields on U.S. Treasury bonds have been driven to the lowest levels in more than 50 years, as Federal Reserve monetary policy now targets a short-term interest rate of essentially 0%. While it is true that a holder of Treasury securities can expect to be fully repaid when the bonds mature, **prices of such bonds could fall significantly in the near term and stay down for quite awhile if inflation and interest rates move back up.** Locking in yields of less than 2.5% on ten-year Treasury notes, for example, offers little incentive to incur the risk of such a decline.

The current economic news is bleak (which drove many investors into Treasuries in the first place), but highly stimulative fiscal and monetary policy is likely to take hold sooner or later. **The stimulus is so great that higher inflation, a weaker dollar, and rising interest rates likely will follow.**

While Treasury yields have been going down, yields on many other bonds have remained high. The best values today among taxable bonds are in the corporate area. Even with a bit of a drop recently, yields on high quality corporate securities remain at historic levels compared to those of Treasuries. Within investment-grade securities, the best yields are available on bonds issued by financial firms. This is not surprising given all of the difficulties that have plagued these companies over the last year, but the strongest lenders are likely to survive and increase their market share at the expense of weaker competitors. Utility bonds also have relatively high yields, as do those of industrial issuers.

In the continuing difficult economic environment, we are investing in only the highest quality bonds in these sectors, and keeping maturities fairly short to avoid the eventual risk of renewed inflation. In the meantime, three-year financial bonds of good quality yield nearly 5%, for example. As always, it is important to be well-diversified and own securities across multiple sectors, while limiting the size of each holding relative to the total portfolio.

The rates on high-yield, or "junk", bonds are even higher, but in a weak economy the risk of default really does exist for some of the companies that have issued this debt, so we are cautious about buying any but the best quality issuers.

For taxable investors, the yields on tax-exempt municipal bonds also remain high relative to Treasury securities. In fact, **investment-grade munis now yield more than Treasury securities on a pre-tax basis for all maturities.** As with corporate bonds, the weak economy presents a risk to some issuers, as budgets get squeezed by lower tax revenues and higher demand for services. Therefore, we focus on the larger, higher-rated, more liquid issuers rather than stretching for yield from weaker municipal entities.

For those investors who want only the safest securities, there are two exceptions to the advice to avoid federal government bonds. One would be bonds issued by federal agencies that are callable before their maturity date. They typically offer yields that are higher than both Treasury securities and non-callable agencies, in return for some uncertainty as to when the principal of the bond will be repaid. The other exception would be Treasury Inflation Protected Securities (TIPS), whose yields are currently almost as high as regular Treasuries before factoring in any upward principal adjustments occurring as the result of higher inflation. **Again, because of the risk of rising overall interest rates, we would keep maturities in agencies and TIPS fairly short.**

International Market Update

The aftershock of the U.S. financial crisis became a global economic tsunami; all the major country indices sank; most, more than the U.S. market. The diversification benefit, expected from international investing, was non-existent. As we enter the New Year, **we see countries around the world providing aggressive fiscal and monetary stimulus to shore up their economies. As these economies begin to stabilize, we think there will be significant investment opportunity in international stocks.**

Latin America's economies are closely correlated with the U.S., and we see the region improving as the U.S. economy recovers. Also, since Latin America appears to have avoided the excess of credit that plagued the U.S., it should emerge from this global recession in good shape. In addition, since the region's competitive advantage is natural resource based, it should thrive in a recovery driven by global infrastructure development.

We expect Asian economic growth to improve in the coming year, led by the resumption of growth in China. China has greater macro-economic flexibility due to huge foreign exchange reserves, large current account surplus, and a low debt to GDP ratio. Also, unlike the U.S., which has had difficulty getting banks to lend, China has no such difficulty with slippage in implementing its easier monetary policy. China is also a beneficiary from the recent fall in commodity prices. We think the next **investible theme in China will be based on a shift toward increased domestic demand accompanied by the continued growth of a highly educated middle class.**

We are somewhat less optimistic about European investments. Compared with the U.S., **Europe was slow to take action; it is difficult for countries confronting different economic problems to adapt a single coherent monetary and fiscal policy.** In addition, Europe is burdened with an overvalued currency, archaic and diverse labor rules and a shortage of natural resources. On the plus side, they enjoy an advanced transportation and communications infrastructure.

Japan is something of a special situation. With the **strengthening yen making Japanese manufacturing less competitive** and pressuring the country into deeper recession, policy makers have very few tools to reverse this trend in the near term.

Our recent focus has been on companies which allow us to participate in the growth of Latin America and Asia, in general. Specifically, we are seeing interesting investment opportunities in Brazil and China, and we are particularly drawn to companies which directly, or indirectly participate in infrastructure development.