



## **ECONOMIC AND INVESTMENT FORECAST**

### **January 2009**

2008 was a miserable year for both the U.S. economy and the U.S. financial markets. Although most people were aware that the U.S. consumer was overextended and the economy was slowing, partially due to rapidly increasing energy costs, few, if any, experts forecast the severe impact on the financial system. The highly leveraged consumer, struggling under a mix of heavy debt, meager inflationary income growth, and a budget largely consumed by health care, gasoline, and other rising costs, finally reduced spending. The collapse of home prices together with the failure of complex derivatives of sub-prime mortgages held by financial institutions around the world became the catalysts for a severe recession. Inflationary concerns turned to deflationary worries as our financial system began the painful process of de-leveraging. As fear replaced greed, financial institutions, burdened with now unmarketable sub-prime mortgage derivatives on their balance sheets, greatly restricted credit. This resulted in further slowing the U.S. economy despite the Federal Reserve's increase in liquidity and the Bush administration's huge stimulus package (TARP). Wall Street financial institutions Bear Stearns, Lehman Bros., and Merrill Lynch filed for bankruptcy or were merged away by year end. It wasn't until late 2008 that we learned that, according to the National Bureau of Economic Research, the U.S. economy had been in recession since December 2007. Unemployment continued to rise as corporations reduced costs fearing lower revenue. Consumers held onto their money fearing job losses and home foreclosures. This downward trend could continue for at least several more months. Unemployment could reach 8-9%, and the GDP could decline by up to 5% for the first half of 2009 before stabilizing.

However, many economists now predict that the positive effects of massive international stimulus, low energy costs, lower mortgage rates, and new stimulus programs initiated by the Obama administration should gradually turn the U.S. economy back to positive growth in the second half of this year. As with the beginning of the recession, the end of the downturn in the economy will not be confirmed until well after the actual event. It is expected that the U.S. economy, which led the world into this slowdown, will begin recovery well ahead of most developed countries.

This past year was the worst for stocks since the 1930s, and the financial markets experienced unprecedented volatility. The low for the stock market in 2008 was on November 21<sup>st</sup>, with the Dow down 51.9% from its high just over a year earlier. The S&P 500 Index ended 2008 down 38.5% and the MSCI EAFE (foreign) was down 45.1%. There was no place to hide as virtually all equity categories worldwide were affected. Although stocks staged a rally in December, continued economic weakness eliminated most of that gain and stocks may test the previous lows before rebounding. Historically, the U.S. stock market has begun to advance approximately six months prior to the end of a recession, and following every recession but one since World War II, stocks have recorded strong gains in the following year. Whether or not any of these scenarios occur this time, there are currently many large U.S. companies (or mutual funds that hold them), with attractive dividends and potential for strong gains in the next several years. Stocks in emerging economies and basic commodities also have excellent potential when the worldwide economies begin to recover.

Investment grade U.S. corporate bonds, international bonds, and U.S. treasury inflation protected securities (yes, we believe that inflation will return within 1-2 years) are also attractive. The massive cash hoards now on the sidelines (the highest level since 1990) will likely begin to move in a series of waves back into the financial markets over the next several months.