

MARKET UPDATE & OUTLOOK

October 31, 2008

Economic Backdrop

In 2007, defaults on mortgage loans rose significantly, particularly for subprime borrowers. Many of these loans had been packaged into structured securities, which suffered downgrades and loss of value. While much of the exposure to the sector was distributed across global markets, many financial institutions retained extensive investments in the sector. Often this investment was highly leveraged. By late 2007, banks were forced to raise capital to offset the write-downs. The Federal Reserve cut rates and took a number of other steps to assure system liquidity, and events appeared to be playing out in typical, cyclical fashion.

In 2008, the housing downturn grew more severe, exceeding our earlier expectations. Some economists feared the US was in recession, and investors became apprehensive about loans of all types, not just mortgage-related. Concern for the strength of financial institutions increased. Disclosure from these institutions is notoriously murky, which made it difficult for investors to gauge exposures and potential losses. With losses mounting and financial institutions intertwined in an opaque web of credit default swaps (CDS) contracts and other exposures, uncertainty reigned. Banks grew leery about counterparty risk and pulled back from lending to one another, never mind consumers, businesses and municipalities.

As the third quarter hit, a crisis of confidence was picking up steam. Fears over financial institutions hit a new high, reaching as far as *Fannie Mae* and *Freddie Mac*, despite their close ties and importance to the federal government. In September, it came to a head. A rapid series of events unfolded, with each seeming to have a more destabilizing effect on the markets than the last. First, the government sponsored enterprises (GSEs) were placed into conservatorship, and their dividends were suspended, creating chaos in the preferred market and wiping out an important source of capital for the banks. Next, *Lehman Brothers* went bankrupt, and *Merrill Lynch*, fearing it was next, opted to be acquired by *Bank of America*. Money market funds with holdings in *Lehman* commercial paper were stung by losses severe enough to cause massive redemptions and the close of the country's oldest money market fund. The CDS market was in disarray as institutions were hit by collateral calls they had a tough time meeting. This helped take down *AIG*, one of the largest insurers in the world. In rapid succession, *Goldman Sachs* and *Morgan Stanley* decided to transform themselves into commercial banks, while *Washington Mutual* and *Wachovia* were each acquired by stronger banks. Through all of this, the Fed and the Treasury were aggressively pumping liquidity into the markets and negotiating deals. This culminated with the so-called "bailout bill" at month-end.

The impact on the fixed income markets has been to drive down the value of bonds issued by financial institutions to unprecedented levels. Additionally, the transformation of the investment banking world has reduced market liquidity. Lower liquidity and higher uncertainty have caused the prices of most other credit-related debt securities to come under severe pressure. In bond terms, yield spreads have risen to historically wide levels. We did not anticipate the crisis of confidence that exploded across the markets in September.

Where is the market today? What do we think?

We expect policy makers to continue taking action to stem the credit crisis, but that action will likely be insufficient to alleviate the stresses in the broader economy. We also expect returns on higher risk investments will improve, but not immediately. Investors need to see evidence that banks are making progress in healing their balance sheets and that future home price declines won't cause more severe problems.

Between the Federal Reserve and Treasury, massive sums have been brought to bear to keep the financial system alive, including an alphabet soup of borrowing programs. Still, economic risks have grown, as there could be many headwinds ahead, not the least of which is a tight credit environment. Other concerns are the loss of wealth from home and stock prices, plus the risk that a cold winter will bring an expensive heating season. Home prices are expected to fall through 2009.

Real GDP growth in the US declined by 0.3% in the third quarter of 2008. We may see further declines in economic growth, along the lines of 4.0% in fourth quarter and another 2.0% drop in the first quarter of 2009. The global economy has been slowing, too. The US is not the only country with a financial crisis on its hands. Looking ahead, we see more consolidation, more regulation and tighter lending standards. There will be less credit available in coming quarters than we have been used to.

We believe we are making progress in addressing the crisis, but there is still much to do. Home prices will continue to decline, but as we work down the excess inventory, those declines will decelerate. Our economist believes housing starts are bottoming and the worst of the construction crisis is almost behind us. The financial and market crisis will likely ease when the right mix of policy responses finally unfolds. The economy could start to turn up by mid-year 2009, though it may take longer—and we're not suggesting it will be robust.

Experience with past market cycles shows us that once confidence and optimism are restored, markets can turn up quickly as investors recognize that good companies are selling on the cheap. We're working hard to ensure our investments are in a prime position to capture potential upside.

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