Financial Concepts, Inc.

Quarterly Economic News

Fourth Quarter 2008

It seemed as though the year could not end soon enough. In 2008, the credit crisis, which originated in the United States' subprime mortgage market, spread around the world wreaking financial havoc and causing a global recession. US stocks saw their worst performance since the 1930s.

The financial crisis worsened in late summer and early fall 2008 as credit disappeared, stocks sank and confidence eroded. Government bonds became a safe haven, causing yields to drop to historic lows. In the fourth quarter of 2008, the Federal Reserve and Treasury department went to unprecedented lengths to ease the credit crisis and encourage economic growth. The Treasury's $700 billion Troubled Asset Relief Program (TARP) gave banks and other financial institutions capital infusions, while Wall Street underwent historic changes. Despite the continued fall of oil prices, US automakers, stung by high energy prices and the recession, applied for federal relief. The revelation of a $50 billion Ponzi scheme engineered by Bernard Madoff was the culmination for a year of bad financial news.

Stock Market Returns

It is an understatement to say that stock markets had a bad year. The credit crisis appeared to have reached its crescendo in the fourth quarter and stocks felt the impact. The Dow Jones Industrial Average (-31.9%) and the S&P 500 (-37.0%) saw their worst performances since the 1930s and their third worst year in a century. Investors, worried about the safety of stocks and the future of earnings, sold stocks to preserve cash and prevent future declines.

Large cap, small cap and international stocks all had a poor year, and that impacted each sector's long-term returns. Over a ten-year period, the small cap S&P 600 Index is the only equity index to have shown a positive return. International stocks were negatively impacted not only by the recession and the credit crisis, but also by a stronger dollar. The following table shows returns for four major indexes:

Index	4th Qrt	1 Year	5 Year	10 Year
S&P 500	-21.9%	-37.0%	-2.2%	-1.4%
S&P 600	-25.2 %	-31.1%	0.9%	5.2%
MSCI EAFE	-20.3%	-45.1%	-0.8%	-1.3%
Barclays Agg. Bond	4.6%	5.2%	4.7%	5.6%

Source: Wall Street Journal, January 2, 2009

The S&P 500 is a commonly used measure of common stock total return performance.

The S&P 600 is a commonly used measure of small capitalization stocks.

The MSCI EAFE is a commonly used measure of common stock total return performance of international markets.

The Barclay's Aggregate Bond Index (formerly Lehman Brothers' Aggregate Bond Index) is a commonly used measure of the bond market.

The Dow Jones Industrial Average is a commonly used measure of large capitalization common stock total return performance.

All referenced indices are unmanaged and not available for direct investment.

Past performance is not a guarantee of future results.

Government Bonds Rally

The financial crisis and concerns about risk led people to flock to the safety of government bonds. According to a Merrill Lynch index, Treasury bonds returned 18% while high yielding junk bonds fell 26% in 2008, highlighting investor concerns about risk. The yield on the three-month Treasury bill hit zero percent during the quarter and ended the quarter just under 0.10%. The yield on the benchmark ten-year Treasury bond went from 3.83% at the start of the quarter, hit a low of 2.07% late in December and finished the quarter at 2.24%.

"Bonds on Leading Edge of Crisis; Not a Single Place to Hide," Liz Rappaport and Serena Ng, Wall Street Journal, January 2, 2008.

Economic Slowdown

GDP contracted 0.50% in the third quarter and is expected to be worse for the fourth quarter as the credit crisis was felt throughout the economy. Unemployment reached 6.7% in November, up from 4.5% in November 2007. The housing market is still at the heart of the economy's problems, and economists believe that as long as home prices continue to decline, credit markets and the economy will not be able to fully recover. The S&P/Case Shiller index of home prices fell 18% for

the twelve months ending in October 2008. The Federal Reserve has been buying Fannie Mae, Freddie Mac and Ginnie Mae mortgages to help drive down mortgage rates and spur housing demand through lower mortgage interest rates. At year end, the average rate on a thirty-year mortgage was 5.10%, the lowest level since 1971 when data was first tracked. The following is a chart from the Wall Street Journal that shows the drop in mortgage rates over the past three months:

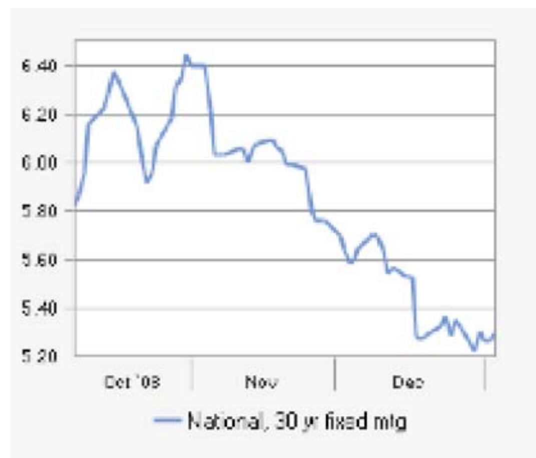


Chart: Bankrate.com via wsj.com

"NBER Makes it Official: Economy Started in December 2007," WSJ.com, Real Time Economics Blog, December 1, 2008.

"US Mortgage Rates Fall to Lowest Level in Three Decades," Kathleen M. Howely, Bloomberg, December 31, 2008.

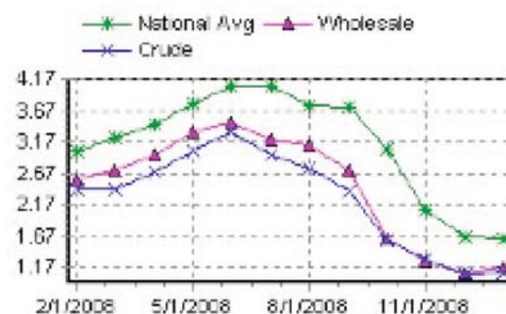
The Fed is using a variety of tools to spur the economy, in addition to the housing boost noted above: it has supported money markets and also injected capital into the market by allowing loans to non-banks. The Fed cut interest rates seven times in 2008 to stimulate the economy. In late December, it cut its target Fed Funds rate to a range of 0% to 0.25%, its lowest level ever recorded. The Treasury used the Troubled Asset Relief Program (TARP) to inject capital into the banking system to help ailing banks and encourage lending. The current administration's Treasury department has used half the original $700 billion, and the new administration's Treasury department will likely allocate the remaining $350 billion. Specifics on the new administration's plan are not yet available, but tax cuts and infrastructure investment are expected, in addition to continued measures to help the housing market.

www.bls.gov

"Bonds on Leading Edge of Crisis; Not a Single Place to Hide," Liz Rapport and Serena Ng, Wall Street Journal, January 2, 2009.

Oil Slick

The price of oil clearly was a bubble. Its precipitous rise and fall highlight the perils of speculative investment. Oil reached a record price of $145 a barrel in early July and dropped to less than $34 a barrel in late December before ending the year at $44.60 per barrel. The stunning 76% drop in oil prices over the second half of 2008 was caused by a variety of factors including the bursting of a speculative bubble and falling demand due to the global recession. To consumers in 2008, the price of gas was a roller-coaster ride. The national average for a gallon of gas started the year at nearly $3.00, peaked at $4.11 in July and then dropped to $1.64 at year end. The following chart shows the fluctuations in gas prices for 2008:



Source: http://www.fuelgaugereport.com/

Auto Bailout

What a difference an industry makes. In October, major banks received a blank check from the government through TARP, and even banks that did not want federal money were forced to take it. By contrast, when auto executives approached congress in November for a bailout, they were given the cold shoulder. After several days of testimony (which revealed that executives from Chrysler, Ford and GM had flown to Washington on separate private jets), the auto chiefs were told to go back to Detroit and return to Washington in December with a specific plan on how they would use government money. After nearly a month of deliberation with the Treasury Department and the White House, the federal government finally agreed to give GM and Chrysler short-term loans under TARP, effectively pushing any long-term solution for the auto industry to the next administration. GM, which received its government loan just before the end of the year, immediately announced new

low-interest rate promotions to help sell cars.

"GM Gets $4 Billion in Low Interest Loans, Chrysler Still Waiting," Jeff Bennett, Dow Jones Newswires, December 31, 2008.

Madoff Fraud

Bernard Madoff's elaborate Ponzi scheme was an exclamation point on the worst market in seventy years. Madoff is alleged to have stolen close to $50 billion from investors over a number of years. He attracted investors by using bogus performance numbers that showed steady, but not spectacular, returns and a network of organizations that directed client money to his firm. He also used his connections in philanthropy and the wealthy enclave of Palm Beach, along with investor word of mouth, to gain investor trust and assets. Madoff's scheme collapsed when the credit crisis, stock market decline and investors' withdrawal requests were too much to keep the fraud hidden. As the year ended, the full extent of Madoff's crime is not known, but many experts are estimating that most, if not all, the money is gone. The depth of this scandal will surely expand in the coming months.

RIP

One refrain that has been repeated since September is that Wall Street as we know it is no longer. It is hard to understand what this means exactly because business and consumer loans, including mortgages, will continue to be made and corporations will continue to issue stock. Despite the market declines, markets are still functioning. However, the days of exotic, illiquid private placements designed by mathematicians are surely over for the near term. As long as taxpayers, through TARP and federal takeovers, own a large chunk of financial firms, outsized compensation for senior executives is over. Many firms that were considered household names are no longer in business. Many careers in finance are over. The investment banking business has changed as Bear Stearns and Lehman Brothers ceased to exist in 2008 and remaining investment banks Morgan Stanley and Goldman Sachs converted to traditional banks to receive federal assistance. Hopefully, it will be a long time before Wall Street sees another week like the one in mid-September when Lehman Brothers declared bankruptcy, Merrill Lynch was bought by Bank America, and mortgage giants Fannie Mae and Freddie Mac and insurance giant AIG were all effectively taken over by the federal government. Since its inception in the late 1700s, Wall Street has been the center of US commerce and is now at the center of global commerce. Despite the credit crisis and stock market declines, this does not appear set to change.

Conclusion

The year ended with hope that the worst was over. Retail sales over the holidays were mediocre, but not as mediocre as some had anticipated. The credit crisis showed signs of easing as investors began selling government bonds and putting capital in corporate bonds. The interest rates that banks charge each other dropped to levels not seen since last summer, indicating a return of confidence to credit markets. Mortgage rates are at historic lows and may keep falling, and the drop in gas prices has given consumers extra cash. The new administration's Treasury department still has $350 billion in TARP money available to asset financial markets. The new presidential administration is promising a huge economic stimulus plan that is expected to include tax cuts and investment in infrastructure. While there will be rough spots ahead, such as a rise in unemployment and a further decline in home prices, some see good reason for optimism.

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