



# Market **OUTLOOK**

Economic and Financial Market Outlook — January 2009

## Financial Markets Buried Under the Weight of the Credit Crisis

### INTRODUCTION

Too much household debt, excessive leverage, and illiquid risky investments all combined to create a mountain of financial instability last year. Eventually, parts of that mountain broke loose resulting in the current avalanche overwhelming the financial markets. We can trace most of our problems back to the housing bubble. Lax lending standards, speculation, and various forms of loan syndication helped fuel the landslide's breadth. The cascade grew in size and speed with the demise of Bear Stearns and reached critical mass with the failure of Lehman Brothers, the fourth-largest U.S. securities firm. As this avalanche progressed, it was accentuated by the mark-to-market problems with many fixed income structured products (e.g., Collateralized Debt Obligations) creating a self-reinforcing downward spiral.

It didn't take long for all of these issues to begin to overwhelm many financial institutions. Asset write-offs in some cases nearly entirely wiped out their capital. Foreign investment funds, bargain hunters like Warren Buffet and government relief actions, like the Troubled Asset Relief Program (TARP) and the Term Asset-Backed Securities Loan Facility (TALF), have helped gradually

slow the freefall. LIBOR\* rates have improved, some liquidity has returned, and the complete failure of the largest financial institutions has largely been taken off the table. Obviously, concerns remain elevated and additional action will be forthcoming from our new administration before we can begin to dig out. While Fed Chairman Bernanke, Treasury Secretary Paulson, Congress and even our President-elect have all been trying their best, more help from a Saint Bernard (read, you the taxpayer) will still likely be needed.

### ECONOMIC OUTLOOK

The U.S. economy is currently struggling through a painful de-leveraging process. This is an unusual position for the world's largest economy, as the system has long been built on growth fueled by easy access to cheap capital. But as liquidity and solvency concerns over the past year led to erosion in consumer and business confidence, a different cycle began to emerge. Worried consumers and corporations started to spend less and save more. This has led to an economic contraction and smaller balance sheets, as assets are sold in order to reduce debt levels. This process can feed upon itself

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\*London Interbank Offered Rate

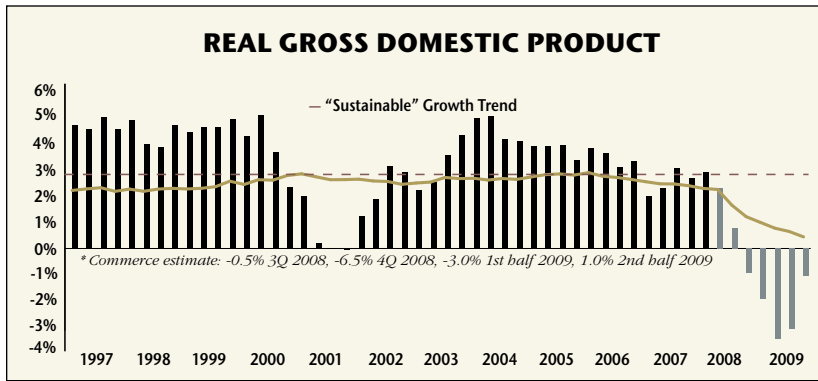


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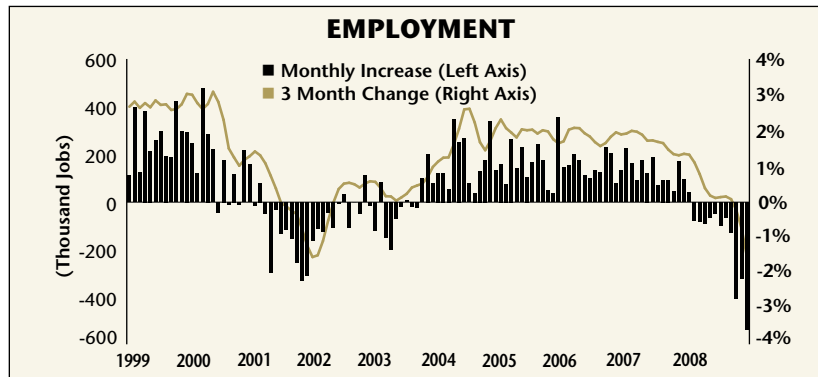
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**CHART 1**  
**REAL GROSS DOMESTIC PRODUCT (in percent)**  
 A contracting economy is expected to result in GDP's fourth quarter rolling average to stay negative for all of 2009.

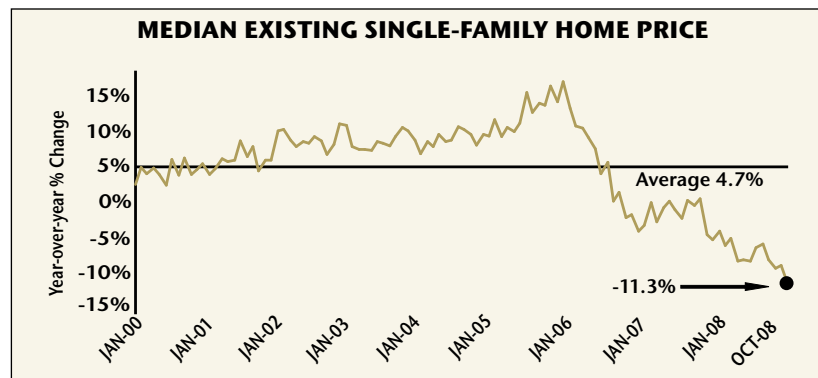
■ YEAR-OVER-YEAR  
 ■ YEAR-OVER-YEAR (ESTIMATE)\*  
 — 10-YEAR TREND



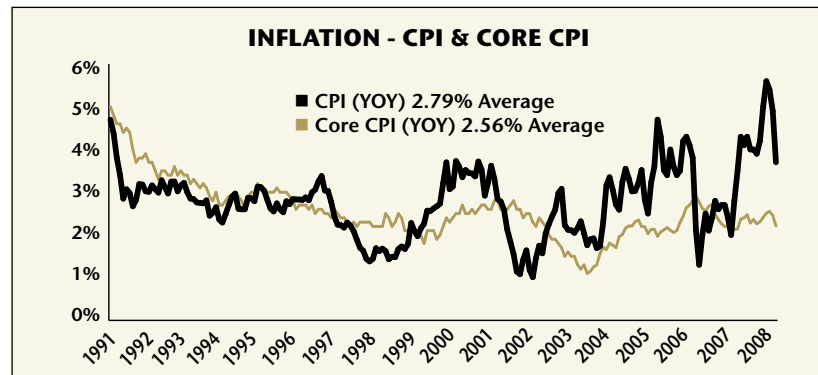
**CHART 2**  
**EMPLOYMENT**  
 Declining employment is one of the many negative forces contributing to the economic slowdown.



**CHART 3**  
**MEDIAN EXISTING SINGLE-FAMILY HOME PRICE**  
 Delinquencies and foreclosures are expected to rise as unemployment increases, further pressuring home prices.



**CHART 4**  
**INFLATION — CPI & CORE CPI**  
 Lower demand has led to falling consumer prices, raising the danger of deflation.



as assets are sold into a market that is less and less able to buy them, thereby lowering asset prices even further. We have seen the effects of this process in the historically weak and now declining GDP statistics that have signaled a recession (**Chart 1**).

Consumers, as we've heard, are the driving force behind the economy. Personal consumption declined at a 3.1% annual rate in the third quarter and is projected to have declined another 4% during the fourth quarter. This decline reflects many negative fundamentals, including the waning of stimulus provided by the mid-year tax rebates, a further decline in banks' willingness to lend, a further widening in borrowing costs (spreads), sharp drops in equity and housing prices, and last but certainly not least, declining employment (**Chart 2**). In the near term, these negative forces will overwhelm the positive impact of a very sharp decline in energy prices. However these negative influences are expected to dissipate later in 2009 and into 2010 as the massive stimulus programs take effect and the crisis abates over time.

Housing has long been cited as the major cause of this downturn, and has continued to be a major sector of concern. After subtracting 1% from GDP growth in 2007, residential investment is likely to have shaved nearly that much off growth in 2008. Construction is likely to remain under pressure in 2009. However, the U.S. Government is very focused on a solution to limit the downside. To this end, the Fed has announced a new program to purchase mortgage-backed securities and Federal Agency debt to bring down mortgage rates, which

until recently have remained stubbornly high. Early indications of improvement are that mortgage applications and housing affordability have increased somewhat, and further progress is expected, and needed as home prices continue to decline (Chart 3).

Until recently, inflation had been growing at a worrisome rate, but concerns about inflation are now dissipating as slack continues to develop in the economy. The boom in raw materials and food prices in the past five years appears to have failed to sustain a broad-based rise in consumer prices and wages. This was surprising given the strength in the economy, falling unemployment rate, booming financial and housing wealth, and weak dollar. But now, headline consumer price inflation is headed lower, due to plunging energy and commodity prices, and a continued fall in housing. Many observers now worry about the possibility of price deflation (Chart 4).

The current fiscal and monetary stimulus may eventually cause inflation pressures down the road, but this risk is being accepted in the near term to stave off the potential for debt deflation if not an outright depression. Excesses will eventually show up first in asset prices, then an overheating economy, and then finally the CPI if policymakers do not respond in a timely manner once we are making forward economic progress again. But for now, the Fed is willing to risk the potential for future inflation to stabilize the economy today.

While efforts to halt the credit crisis are finally gaining some traction, the road to recovery is going to be a long one, with what will likely be an unusually modest upturn.

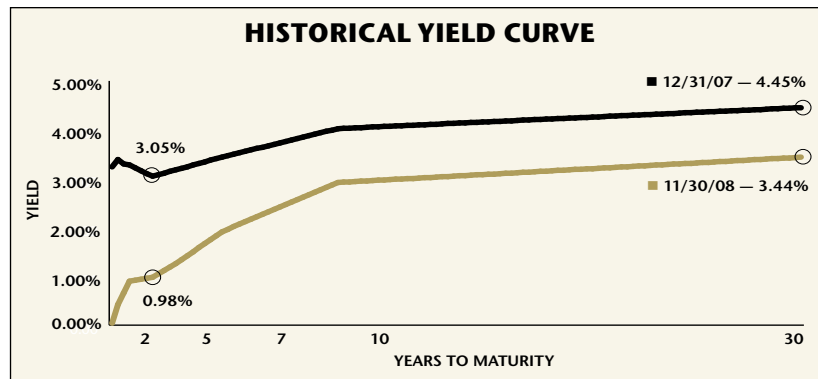
The economic news will be grim for at least the next few months, and this will continue to have a negative effect on consumers. However, there are some positive developments that are occurring that will help move the economy back to positive growth over time. Along with mortgage rates declining, the incoming Administration is working overtime on a large new fiscal stimulus package. Energy, commodity and shipping costs are low and declining, and policymakers around the world are becoming very aggressive in trying to stimulate growth. So, while we remain cautious regarding overall investment recommendations, we are encouraged that all parties are working diligently to stabilize and ultimately improve the economic and investment climate around the globe.

#### FIXED INCOME OUTLOOK

With the economy mired in the most serious financial crisis since the Great Depression, the U.S. fixed income market saw investors seeking safety in Treasuries over the last 12 months. The collapse, or near-collapse, of one U.S. financial institution after another caused risk aversion to skyrocket. Three-month Treasury bill yields

touched 0.02% in mid-September after Lehman Brothers declared bankruptcy and investors worried about the safety of money market funds holding Lehman debt. Spreads between Treasuries and investment-grade corporate bonds widened to historic levels. U.S. policymakers took extraordinary steps to unfreeze the credit markets. The Federal Reserve lowered rates seven times between September 2007 and April 2008, took a break for the next three meetings, and then lowered rates an additional 100 basis points (1 basis point = 1/100 of 1%) as conditions deteriorated further in the fall. From point to point, this dropped the Fed's intended Federal funds rate from 5.25% in August 2007 to today's 1%.

The Treasury yield curve started the year upward sloping, with the 30-year Treasury note yielding 141 basis points more than the two-year Treasury bond. As we end the year, yields are down significantly across the yield curve and the upward slope has steepened, with the two to 30-year yield difference at 246 basis points at the end of November (Chart 5). Possible deflation, rising private sector saving, and extreme risk aversion have driven Treasury yields to 50-year lows. The 10-year



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CHART 5  
HISTORICAL YIELD CURVE  
12/31/07 – 11/30/08  
Interest rates have declined and the yield curve's slope remains steep relative to its historic average.

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Treasury has recently bottomed below 2.75%, the lowest since 1955 as measured on a monthly basis.

Yield spreads (the difference between a specific risk sector's interest rate and a similar maturity Treasury issue) on investment grade bonds are significantly wider than during the last recession. Credit spreads for both high yield and investment grade bonds have moved to their widest levels since 2002 (**Chart 6**). For most of the past year A-rated corporate spreads were wider than BBB corporates. This rare occurrence was due mostly to the higher risk premium assessed to financials, which comprise a good portion of the A-rated corporates. It reflects the fact that investors are now demanding additional return to compensate for

additional perceived risk.

With a deep and protracted U.S. recession anticipated, high-yield corporate default rates are expected to climb sharply throughout 2009. Corporate default rates in this economic cycle will likely match or exceed the peak levels reached in the previous two U.S. recessions of 1990-91 and 2000-01. For U.S. speculative-grade issuers, Moody's rating agency foresees default rates increasing to 4.9% by the end of 2008 and 11.2% a year from now. Despite the extremely attractive level of spreads, moving down in quality is not advised at this point. The prospects for lower-rated corporate bonds rarely improve until the default rate begins to show signs that it is starting to moderate. Another sign of improvement in

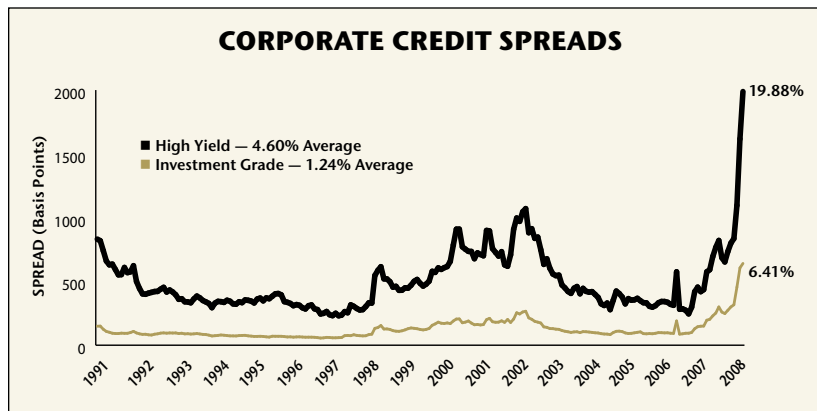
the credit markets to watch for is an increased willingness to lend on the part of banks. When banks begin to relax lending standards, spreads should peak and corporate bonds should outperform.

Despite the turmoil in the financial markets and the widening of yield spreads during the year, returns through November 2008 for the bond market were up 1.45% (as measured by the Lehman Aggregate Index). The negative impact of credit spread widening nearly wiped out the gains resulting from lower interest rates.

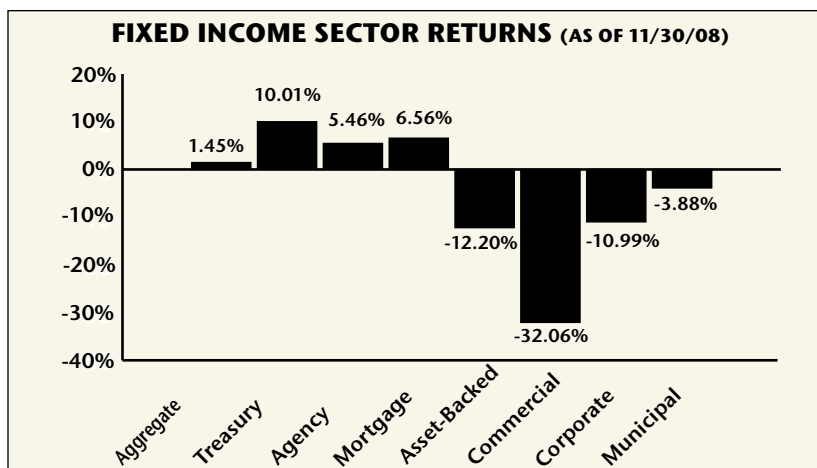
For 2008, Treasuries are expected to finish as the top-performing fixed income sector for the second consecutive year. Risk aversion caused corporate bond and mortgage-backed securities to lag well behind Treasuries. Corporates, asset-backed and commercial mortgage-backed sectors are anticipated to end 2008 with negative returns. Besides Treasuries, agency debentures and residential mortgage-backed performance should finish the year in positive territory (**Chart 7**).

This past year was as turbulent for the municipal market as it was for all other financial markets. Many investors shunned municipal bonds and chose instead the safety of Treasuries. Issues ranging from bond insurer downgrades, to the implosion of the short-term market, as well as the forced selling by leveraged institutional accounts, all worked in unison to push municipal bond yields higher for the year. This extraordinary confluence of events disrupted the long-standing traditional relationship of tax-free municipals yielding less than taxable Treasuries. By the last quarter of the year, the highest

**CHART 6**  
CORPORATE CREDIT SPREADS  
12/31/90 – 11/30/08  
Credit spreads for both high yield and investment grade bonds have moved to their widest levels since 2002.



**CHART 7**  
FIXED INCOME SECTOR  
RETURNS YEAR-TO-DATE  
(AS OF 11/30/08)  
Volatile markets and very limited liquidity continue to produce great disparity in sector returns year-to-date.



quality municipal borrower was paying tax-free interest rates 1.50% to 2.00% higher than the level at which the U.S. government could borrow in the Treasury market.

As we enter 2009, the taxable bond market seems likely to remain volatile as the market works through the credit crisis and an economic recession. As a result, credit spreads are also likely to remain wide in the near-term. Over time, a reduction in market fears and volatility should allow spreads to decline from their historic highs, which will help both mortgage-backed securities and corporates outperform Treasuries. For the tax-exempt market, we believe that municipal bonds present exceptional relative value. The ratio of municipal to Treasury bond yields is still well above historic averages.

Treasury issuance is expected to explode next year due to the government's need to finance Fed programs and run their stabilization programs such as the TARP. There is concern that a sudden increase in the supply will put upward pressure on Treasury yields (downward pressure on prices). Some indigestion problems are possible; however, there are some factors that will help mitigate the blizzard of new Treasuries hitting the market. With domestic savings expected to rise, an increase in the household sector holdings of Treasuries should help finance a portion of the new Treasury issuance. Also, with the financial sector's Treasury holdings near historic lows, these investors (i.e., mutual funds, insurance companies, banks, etc.) should be available to purchase Treasuries.

The strategy employed in

our taxable bond mutual funds is focused on higher-quality opportunities and favors senior financial debt issues. There appears to be more downside risk with the industrial sector of the corporate bond market. The government has stepped in to help the financials; however, the same type of aid is not expected for most industrials as the recession gets worse. To manage risk we will avoid interest rate timing and continue to focus on diversification in order to generate consistent outperformance relative to our peer group and benchmarks.

#### **EQUITY OUTLOOK**

2008 is shaping up as being one of the worst years for equities since records began in 1825. Only in 1937 and 1931 did large-cap stocks decline more than 30%. The severity of the bear market this year has set many records for extreme readings in sentiment and volatility as the worldwide financial crisis intensified. The current bear market, along with the one earlier in the decade, has sent the rolling 10-year return for stocks (based on November 20<sup>th</sup> prices) to -3.2%, which is worse than the 10-year return low set in 1939. So, where do we go from here?

The Dow's decline to 8,451 on October 10<sup>th</sup> marked the low for a majority of stocks. Nearly 2,900 issues reached new 52-week lows – the most ever! We think there is a good chance that the Dow low of 7,552 on November 20<sup>th</sup> will be the absolute low. On that day, only 1,894 stocks hit a new 52-week low. As the year comes to a close, with the economy in shambles and investors' nerves frazzled, there are some indicators that give us opti-

mism that next year will be better.

First, let's look at the economy. The year-over-year change in real GDP has slipped to below +1% and is headed toward -2% next year. Since 1960, the economy has grown at an annual rate of less than 1% only 14% of the time. In these slow-to-no-growth periods of economic activity, stocks, on the other hand, have risen an annualized 13.1%. In the 75% of the time when the economy shows moderate economic growth (1% to 6%), stocks have historically gained at an annualized rate of only 7.0%. The worst rate of gain for stocks, -4.6% annualized, has typically occurred in time periods when the economy grows faster than 6%. Now, clearly, the stock market doesn't prefer a low-growth economy. It is anticipating change in the economy. Thus, when the economy is weak, the stock market looks through the weakness and discounts the eventual improvement and vice versa.

Similar historical statistics are available regarding employment and corporate earnings. Unemployment is currently on the rise, recently crossing above 6% and probably headed toward 8%. Over the last 60 years, stocks have shown their best performance when unemployment is above 6%. This has occurred 31% of the time and, during those periods, stocks surprisingly rise 14% on an annual basis. Stock returns are 9% better than when unemployment is below 6%. Again, the stock market discounts both the current weakness and the upcoming improvement.

With this year's financial crisis and the very weak economy, earnings for corporate America are collapsing. Reported earnings for

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the S&P 500 have declined 35% for the 12 months ending September 30<sup>th</sup>. By the end of the calendar year, earnings will have declined 26% from the year-end levels of 2007. From the peak in corporate earnings in 2006, profits will have fallen 40%. Again, what does history tell us about how stocks react to declining earnings? The worst time to own stocks has been when earnings are falling more than 20%. In that environment (and the current situation) stocks decline 22% on an annual basis. Fortunately these severe earnings declines only happen 5% of the time. Surprisingly the best time to own stocks is when corporate earnings are in the -20% to +5% range with rate of change rising. During those periods, stocks post their strongest annualized returns of 14.1%. We believe this pattern for earnings will be the case in 2009.

At current levels the market is at some of the most attractive valuation levels we have seen in 30 years. The S&P 500 Price/Operating Earnings Ratio (excluding write-offs) is 13.74 times, the lowest since 1991. The 50-year average is 16.25 times. The S&P 500 Price/Book Value Ratio is at 1.6 times, the lowest since 1985. The high for Price/Book Value was 5.0 in 2000 and the 30-year average is 2.41 times.

Another area of notable improvement is the S&P 500 dividend yield. At the end of November, the cash yield was 3.22%, near the normal level of 3.70%. The low for yields was 1% in 2000. With a 3%+ yield, stocks look attractive compared to both money market funds and U.S. Treasuries. Speaking of money market funds, the balances on the market sidelines

continue to build. At the end of November, money market fund assets were 41.8% of the value of the Wilshire 5000 index. The two previous highs were 28% in 2003 and 24% in 1982.

The last area we want to look at is consumer confidence. In October, consumer confidence hit the lowest point since the survey began 40 years ago. Consumers felt awful as both financial assets and home values were in a downward spiral. The good news is that

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***With a 3%+ yield, stocks look attractive compared to both money market funds and U.S. Treasuries.***

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when consumer confidence is this low and turns up (which it did in November), it has marked the last six major lows for equities. Not surprisingly, consumer confidence was at a 40-year high at the end of 1999, just before we began eight agonizing years of investing in stocks.

We believe that the pieces are falling into place to allow positive performance for stocks over the next several years. We are closely monitoring the state of the equity market and, while we believe November lows will hold, we have not yet increased our equity exposure, but we are close to doing so. We expect a high level of market volatility to continue over the next several months as we proceed through rough economic waters.

#### **INTERNATIONAL OUTLOOK**

The interconnectedness of global markets has clearly been exhibited in the turmoil of the past year. Overseas exchanges have

reacted strongly to the credit and de-leveraging crisis that began in the U.S. and has engulfed the rest of the world, giving up some of the outsized equity returns achieved in recent years. As of November 30<sup>th</sup>, the MSCI All Country World Index ex-U.S. year-to-date return was -48.46% versus the S&P 500 return of -37.66%. International small-cap stocks and emerging markets were hit even harder, with year-to-date returns of -51.40% for the S&P Developed ex-U.S. Small-Cap Index and -56.70% for the MSCI Emerging Markets Net Index, as investors took flight from all risk-bearing sectors. Value stocks have declined somewhat more than growth stocks, but both areas have been subject to powerful selling pressure.

As in this country, foreign central banks have responded with a number of interest rate cuts in an effort to jumpstart stalled credit markets and stimulate economic activity. The U.S. dollar continued to rally against virtually all major foreign currencies except the Japanese yen, providing a headwind for U.S. investments in international markets. Sector themes reflected the turbulence in the U.S., with financial stocks plummeting more than 30% in October, and energy and materials stocks falling along with commodity prices. Emerging market countries with the highest growth rates, such as China, India and Russia, were hit hard on fears about the sustainability of their growth, and some of these markets halted trading during October. The U.S. Federal Reserve and the International Monetary Fund stepped in with special currency and credit facilities to aid emerging market central banks. Yet despite the

seismic proportions of the market action, a number of these countries continue to experience robust (albeit lower) growth rates, and China announced a sweeping infrastructure spending program to sustain its remaining growth trends. The substantial drop in these markets coupled with continued economic expansion will likely present future investment opportunities for any investor that missed the rally in these geographic sectors earlier in the decade. However, the U.S. may lead the eventual market recovery.

## ALTERNATIVE INVESTMENT OUTLOOK

Unfortunately, hedge funds in general did not provide shelter for investors reeling from the market action in equities and fixed income. The frozen credit markets, panic in the equity markets, the need to de-lever, the ban on financial short sales, and anticipated redemptions, all converged on hedge funds, which fed the chaos through their own sizable liquidations. The HFRI Global Hedge Fund Index year-to-date return of -22.30% as of November 30<sup>th</sup> reflected the worst four-month period for the industry on record. Convertible arbitrage managers fared the worst as the unwinding of the Lehman portfolio of convertible bonds was unloaded in the marketplace and the short sale ban caught some hedge funds in a squeeze. Only a few hedge fund strategies, including market-neutral and short-bias strategies, came through unscathed or posted positive returns. Many hedge funds with high leverage, onerous counterparty terms, and dependence on performance fees to fund operations may ultimately fail. Although

many hedge fund managers have never faced a market environment this difficult, those that survive may never again encounter a market environment presenting so many opportunities.

Commodities reversed the gains led earlier in the year by soaring oil prices and emerging market demand for raw materials. As of November 30<sup>th</sup>, the Dow Jones AIG Commodity Index year-to-date return was -32.63% versus +27.22% year-to-date on June 30<sup>th</sup>. Although real estate investment trusts (REITs) substantially outperformed overall

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equity markets through September, concerns about the stability of the global financial system and a possible sharp recession caused prices of real estate stocks to collapse in October. In the U.S., the FTSE NAREIT REIT Index fell almost 50% in October and November, bringing November 30<sup>th</sup> year-to-date returns to -46.51%. All sectors posted double-digit declines, with huge losses in industrial and retail sectors. For private equity, significant challenges in assessing private equity returns are posed by illiquidity, lack of transparency, and inconsistent accounting, but it stands to reason that private equity values have dropped precipitously along with their publicly traded counterparts. The publicly traded Listed Private Equity Fund's November 30<sup>th</sup> year-to-date return of -63.40% may serve as a proxy for

the return of the private market. We've heard anecdotally that private equity managers are finding great opportunities for investment given credit market challenges and depressed prices. Our philosophy on alternative investing continues to focus on diversification and a thorough understanding of the underlying strategies in the various alternative investments employed to increase the efficiency of an overall portfolio.

## POLITICAL OUTLOOK

Voters on November 4<sup>th</sup> clearly expressed their desire for change. In addition to winning the White House, Democrats picked up additional seats in both the House and Senate. Some observers see this election as the political opposite of the 1980 big win for the Republicans. President-elect Obama and a dominant Democratic Congress will have the ability, over the next few years, to restructure many facets of American life, in addition to the appointment of several Supreme Court Justices and Federal Reserve Board members.

Early indications are that an additional stimulus package of roughly \$300 billion (approximately 2% of GDP) will be ready for approval soon following the seating of the new Congress and the inauguration of the new President. While Obama ran on a middle class tax cut platform (combined with higher taxes on the top wage earners), it seems likely that the broad tax increases will be delayed until there is more closure on arresting the current economic problems. Political observers whose opinions we value

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# Market **OUTLOOK**

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## Locations

**ILLINOIS**  
Belleville  
Bloomington  
Peoria

**KANSAS**  
Leawood  
Wichita

**MISSOURI**  
Columbia  
Kansas City  
Springfield  
St. Joseph  
St. Louis

suggest that the top income tax rate will remain around 40% for those earning less than \$200,000, but may also include two surcharge steps above that. Those would be a surcharge of 4% on incomes between \$200,000 and \$500,000 and a surcharge of 4.6% on incomes above \$500,000. They expect capital gains and dividends to continue to be taxed at the same rate, but higher than the present code – perhaps, 25-28%. They also expect the “carried interest” component of hedge fund compensation and many partnership vehicles to be taxed as ordinary income going forward. The biggest impact of the election may be on corporate income tax. Under McCain’s proposals corporate taxes would have gone down. Under the Obama plan, they will almost certainly go up, primarily through phasing out provisions benefiting multinational companies and LIFO accounting for tax purposes.

Among industry sectors, the winners are expected to include companies involved in wind and solar energy, infrastructure improvement/rebuilding and automakers. Those on the other side of expected policies would be oil, gas and coal producers, coal-burning utilities, tobacco, managed health care and pharmaceuticals.

## CONCLUSION

The de-leveraging of U.S. consumers and businesses is underway, but it will take much more time and probable pain to reach conclusion. Our view has been and continues to be that housing will not cease detracting from economic growth until at least the second half of 2009, if not later. The good news is that all the fire engines around the world have been called. From here on, it is a question of how well the various recovery policies are executed.

In the financial markets, we find municipal bonds to be very attractive, both relatively and absolutely compared to taxable issues. We urge clients to stay up in quality and seniority when looking at taxable fixed income instruments. On the equity side, we are working from the assumption that the lows for most stocks have been seen already, but we have not yet moved cash reserves back into the markets. We expect volatility to continue at very much higher levels and that it may take several tests of the fall lows before the market can begin moving ahead on a broad scale.

December 12, 2008

For more information on this or on other topics important to you as an investor, please call your local Commerce Trust Company portfolio manager.

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