
Market Update

November 2008 Review

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Every Cloud has a Silver Lining

The historic election of Barack Obama as the 44th President of the United States did little to change the nervousness and volatility of the financial markets during the month of November, 2008. The realities of a rapidly deteriorating economic environment, both domestically and abroad, continued to spook the markets and cause an already volatile market to gyrate wildly throughout the month.

A quick review of what has led us to this point in 2008 may be helpful to fully digest the magnitude of the issues and challenges that lie ahead. Coming into 2008 with a housing bubble that had burst and a credit crisis that was unfolding, we have dealt with the freezing of the auction-rate markets, the forced takeover of Bear Stearns, the government takeover of Fannie Mae and Freddie Mac, Lehman Brothers going bankrupt and then not being saved, the emergency takeover of AIG, the credit market strains in the money markets, the battle in Congress to agree to the Troubled Asset Relief Program (TARP) and the subsequent redirecting of funds from buying bad loans to direct equity infusion into the financial markets, and finally the growing trouble and request for funding for the automakers. The markets, and investors, could use a huge step back to catch their breath, but there doesn't seem to be any quiet time in this environment.

The impact of these historic events has put a stress on the fundamentals of the economy, driving the world into a global recession. During the month of November, it was announced that Japan and the Euro zone were officially in recession and that China was funding a nearly \$600 billion stimulus package. Not the least bit of a surprise to most, it was also recently announced that not only was the United States in recession, but has been so since the 4th quarter of 2007. In the 3rd quarter of 2008, real GDP was revised downward from -0.3% to -0.5% based on downward adjustments in consumer spending, business investment and real government spending. Much of the economic data supports a weakening economy as existing and new home sales were down 3-5%, and median home prices fell sharply from \$191,000 to \$183,000. Consumer spending was down 1% in October after falling at an annualized rate of 3.1% in the 3rd quarter, which was the first time consumer spending had a negative quarter in 17 years. Retail sales were picked up by Black Friday during the Thanksgiving Holiday, but sales were coming off the worst monthly decline on record during October. Consumers continued to pull back on fears of further job losses as the weak labor market showed unemployment rising to 6.5%, initial jobless claims at 529,000 and continuing claims at 4 million.

However, in every cloud there is a silver lining and November's highlights included a slight rise in personal income and the Consumer Price Index (CPI) falling by 1%. CPI's decline represented its largest monthly drop since 1947 as global oil demand continued to deteriorate, mitigating the inflationary fears of the summer months. Oil prices per barrel, which started the year at \$95.92

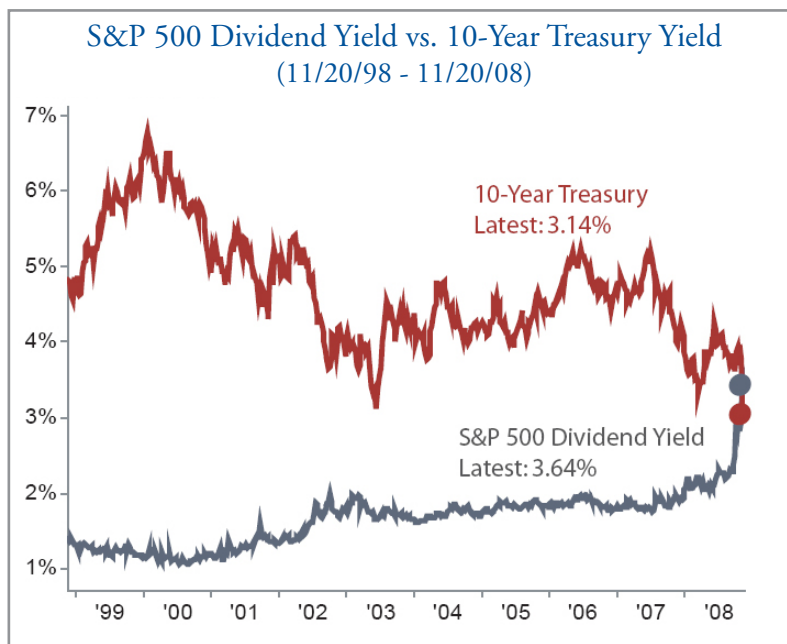
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and at one point during the year reached into the upper \$140's, closed November at \$55.18. The national average for a gallon of gasoline also dropped more than a dollar from start of the year prices to \$1.89. This is potentially a significant impact as every one cent saved at the pump translates into one billion dollars back to the consumer. On corporate earnings, while the S&P 500 operating earnings showed a 21.6% decline year over year during the 3rd quarter, the same index absent financial companies actually increased 18.1% over the same time period. While all this alone does not mitigate or lessen the realities or possibilities of a deepening economic recession, it provides hope that the sky is not completely falling.

The impact on the financial markets was mixed in November. The equity markets continued to lag as the S&P 500 was down 7.2% for the month. The mid cap and small cap markets were hit even harder, dropping between 10% and 12% respectively in November. Year-to-date, the S&P 500 Index was down 37.7%, while the international equity markets, as measured by the MSCI EAFE Index, were down 46.3%. As a result of a flight back to quality and a lowering of short term rates, many of the fixed income markets rebounded in November, led by high quality and longer duration indices. The Barclays Capital U.S. Aggregate Index was up 3.26% for the month, while the Barclays Capital Long U.S. Government/Credit Index was up 9.5%, and the Barclays Capital U.S. Treasury Index was up 5.3%. Taking risk in the fixed income markets did not pay off in November as the High Yield indices all showed negative returns during the month. With spreads widening to 16-19% over Treasuries of similar maturities, the high yield markets have priced in a much higher default rate on these securities over the next two years. This may provide the potential for attractive return opportunities for a fixed-income investor with a medium to long-term horizon.

What is of interest is that in November we witnessed the S&P 500 dividend yield exceed the 10-year treasury yield (see chart) for the first time in 50 years. The flight to Treasury quality in the fixed income markets and the subsequent impact of lowering the 10-year treasury yield, combined with the drop in equity prices increasing the dividend yield of the S&P 500, would suggest that at some point equities, relative to Treasuries, may become a very attractive alternative.

Where do we go from here? The equity markets' initial response to President-elect Obama's naming of his economic team of Larry Summers, Tim Geithner and Christina Romer was met enthusiastically. Cash is piling up, both for individual investors who left the markets and also for institutional investors such as mutual and hedge fund managers, who all wait for what they consider the right time to get back in and redeploy. The government is expected to continue to support the economy as best they can. While the ability to help through monetary stimulus is becoming increasingly limited, a continuation of rate cuts is expected. In fact, the futures markets have already priced in the strong possibility of a cut in the Fed Fund's rate to a historically low 0.50%. We would expect to see more direct involvement from a fiscal stimulus package of larger size and longer duration from the Obama administration with the goal of getting the relief directly into the hands of the consumer. We would also expect the future administration to redirect TARP assets from recapitalizing financial institutions towards enticing lenders to modify loans. Finally, the possibility still exists of some sort of government intervention within the domestic automobile industry.



Source: JPMorgan

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The challenge ahead is that record market volatility has made traditional fundamental analysis nearly impossible, resulting in decreased differentiation of returns amongst styles and asset classes. Furthermore, there has been an erosion of wealth from downward pressures on home and equity markets, as well as a fear that the economic recession may be deeper and longer than first thought. While acknowledging that this perception may indeed be reality for now, we also strongly believe that the economy will ultimately get back on track, based on the fundamental strength of its long-term viability, combined with both enacted and anticipated governmental actions. The volatility and dislocation of the markets may prove to have opened up some significant opportunities for the long-term investor. Understanding and appreciating the long-term strength of the economy and taking a long-term investment approach from a logical and non-emotional perspective can help the investor hold onto, reestablish, or create an appropriate life and risk oriented personal investment strategy. Remember, every cloud has a silver lining.

Definitions & Disclosures:

An index is a measure of value changes in a representative grouping of stocks, bonds, or other securities. Indexes are used primarily for comparative performance measurement and as a gauge of movements in financial markets. You cannot invest directly in an index and, for comparative purposes; they do not reflect the effect of the various fees inherent in actual investment vehicles.

The Barclays Capital U.S. Aggregate Index covers the U.S. Dollar denominated investment grade, fixed-rate, taxable bond market of SEC-registered securities.

The Barclays Capital U.S. Treasury Index consists of public obligations of the U.S. Treasury with a remaining maturity of one year or more.

The Barclays Capital Long U.S. Government/Credit Index is the long component of the Lehman US Government/Credit Index, a widely recognized index that features a blend of U.S. Treasury, government-sponsored (U.S. Agency and supranational), mortgage, and corporate securities limited to a maturity of more than ten years.

Consumer Price Index (CPI) – The CPI is a cost of living index, released monthly, and published by the U.S. Bureau of Labor Statistics within the Department of Labor. It measures prices of a fixed basket of goods hypothetically bought by a typical consumer. This basket of goods includes food, shelter, utilities, transportation, medical care, clothing, entertainment, and other items.

Federal Funds Rate: The Federal Funds Rate is the interest rate at which banks lend money, usually overnight, to other depository institutions in order that they may meet reserve requirements. It is one of the most sensitive indicators of the direction of overall interest rates.

Gross Domestic Product (GDP) is the market value of the goods and services produced by labor and property in the U.S. It is comprised of consumer and government purchases, net exports of goods and services, and private domestic investments. The Commerce Department releases figures for GDP on a quarterly basis. Inflation adjusted GDP (or real GDP) is used to measure growth of the U.S. economy.

Market Capitalization – A company's market capitalization is equal to the number of company shares outstanding multiplied by its current stock price. Large-cap stocks are often classified as companies with market capitalizations of more than \$10 billion; Mid-cap stocks between \$2 billion and \$10 billion; and Small-cap stocks with less than \$2 billion.

The MSCI Europe and Australasia, Far East Equity Index (EAFE) is a market capitalization weighted unmanaged index developed by Morgan Stanley Capital International to measure approximately 1,100 securities in 21 major overseas stock markets. It is a commonly used measure for foreign stock market performance.

The S&P 500 Index is a market value weighted index showing the change in the aggregate market value of 500 U.S. stocks. It is a commonly used measure of stock market total return performance.