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# Market Update

## December 2008 Review

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### 'Tis the season to be...

Investors may have learned something from National Lampoon's Christmas Vacation's Clark Griswold over the holiday season: how to make the best of a bad situation. Over the past year, we may have all felt like the turkey was over cooked, Uncle Lewis burnt down the tree and blew up the front yard, an unwelcomed guest crashed the party and his dog terrorized the house. However, amidst all that was going wrong, somehow there was an upbeat ending to the story. That is not to say by any means that the story of our current day financial crisis is over, but there was at least a glimmer of hope by the end of the month thanks to an interest rate cut and an aggressive statement by the Federal Open Market Committee on December 16, a capital injection into Citigroup, a lifeline to Detroit and welcomed cabinet appointments by Barack Obama.

Most major equity and fixed income indices finished strong in December, but calendar year numbers were simply brutal. The S&P 500 Index improved 1.06% for the month, but finished the year down 38.5%. Small cap stocks rallied, as the Russell 2000 Index was up 5.8% for the month, while the international MSCI EAFE Index gained 5.9%. Despite the modest gains in December, both indices declined 33.8% and 43.1%, respectively, for the year. The closely watched Dow Jones Industrial Average ("DJIA") was off 0.39% for the month and declined 33.8% for the year, the worst drop in percentage terms since 1931 and the third worst in the DJIA's history.

The Fed's interest rate cut and investors' appetite for government bonds (return-of-capital rather than a return-on-capital objective) drove yields sharply lower in December and bond prices higher. The yield on the 10-year U.S. Treasury plummeted from 2.96% at the start of the month to 2.24% by month end, while the yield on 3-month Treasury Bills fell to near-zero. Long-term bonds were the biggest fixed income winners for the month, as the Barclays Capital Long U.S. Government/Credit Index gained 11.23%. Meanwhile, the Barclays Capital U.S. Aggregate Index finished up 3.73% and the Barclays Capital U.S. Corporate High Yield Index gained 7.68%. The magnitude of these gains may indicate investors' willingness to take on some credit risk in December, a trend which if continues would benefit most asset classes in 2009.

One thing is for sure, neither the U.S., nor the global economy, is out of the woods based on just one month of positive market performance. If one considers the raw economic data, the picture remains bleak. While the first official reading of fourth quarter GDP arrives in late January, monthly data from industry activity to retail sales clearly indicates a sharp drop in

# Market Update

economic activity. On the labor front, the national unemployment level jumped to 6.7%, a 15-year high, and initial jobless claims skyrocketed as high as 586,000. ISM's (Manufacturing) most recent reading indicates a rather severe fall in manufacturing. Uncertainty in employment, as well as a sharp decline in housing and 401(k) values helped contribute to one of the weakest Christmas seasons in years. It was not surprising to see consumer confidence drop again to a new recession low.

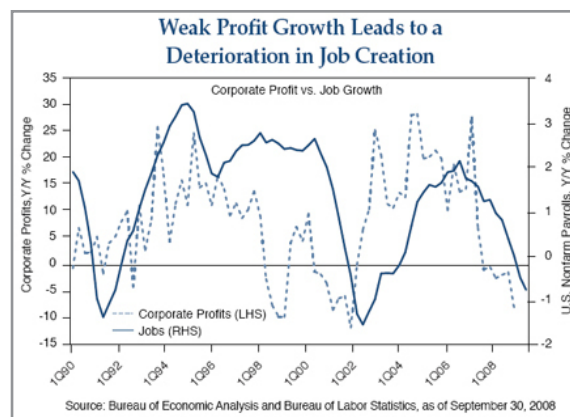
If there are any silver linings in this crisis, they continue to be the dramatic fall in energy and commodity prices, declining stock market volatility and modest improvements in the credit markets. A barrel of oil closed the month down 29% to \$39.22 and was down 53.5% in 2008, while gasoline prices finished, on average, at \$1.65 a gallon. Declines in energy markets continued to be the driving factor in changes of the Consumer Price Index ("CPI") and the Producer Price Index ("PPI"). Month over month numbers showed CPI down 1.7% and PPI off 2.2%. Within the credit markets, corporate bond spreads narrowed in December and coordinated global government actions have helped to restore order in the inter-bank market which is an essential part of the global banking system. Stock market volatility, as measured by the Chicago Board Options Exchange Volatility Index ("VIX"), has retreated to 40 (still high by historical standards), but down from a staggering 81 following the collapse of Lehman Brothers. Throughout 2008, the VIX and the S&P 500 Index moved as almost perfect opposites – the market falls as volatility rises. During 2008, a 4% change in the VIX was generally accompanied by a 1% change in stock prices. This simple math helps explain the market's run up since mid November.

## Looking Ahead

Whether the market has bottomed out or we will again test the October/November lows, the new year will likely not bring declines of the same magnitude, if only because many assets already are at depressed levels and the pace of deleveraging – the selling of assets by financial institutions and investment firms – is likely to slow. Most every asset class appears extremely undervalued, using historical measures, especially when valued within the context of a financed-based economy once dominated by leverage, cheap financing and lower corporate tax rates. For example, the "Fed Valuation Model" compares yields between stocks and bonds. According to this approach, stocks are "very cheap." The real question is whether the "E" in "P/E" is too high. In applying Yale University's Robert Schiller's approach, where one is compelled to look at earnings on a historical 10-year moving average so as to remove adverse or fortuitous cyclicity, stocks are cheap but less so, slightly below their mean average for the past century.

As we have commented in our previous newsletters, real estate played a huge role in getting us into the current crises and will surely play a pivotal role in leading us out. Residential and commercial property remains the predominant collateral backing our banking system. As such, the financial system will remain vulnerable until home values stabilize. A combination of readily available credit and further price declines is necessary before home values can stabilize. Concerned about additional declines, it is not surprising that banks have chosen to hoard government capital infusions rather than lend. It is critical that these dollars eventually re-circulate back into the economy.

We think the more compelling argument is that the unprecedented amount of fiscal and monetary policy will eventually have its desired effect. Talks of a second stimulus package heats up, with expected beneficiaries being the middle income taxpayer and infrastructure projects designed at creating jobs. There is no doubt that politics and the capital markets will most certainly remain intertwined for at least the early stages of the new year.



Source: Bureau of Economic Analysis and Bureau of Labor Statistics, as of September 30, 2008

# Market Update

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## *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 can not 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 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.

The Dow Jones Industrial Average is a price weighted index comprised of 30 actively traded blue chip stocks; primarily industrial companies, but including some service oriented firms.

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.

The Russell 2000 Index is a market capitalization weighted index consisting of approximately 2000 small cap U.S. stocks. It is a subset of the larger Russell 3000 Index and is often used as a benchmark for small cap stocks.

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 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 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 US Treasury, government-sponsored (U.S. Agency and supranational), mortgage, and corporate securities limited to a maturity of more than 10 years.

The Barclays Capital U.S. Corporate High Yield Index covers the U.S. Dollar denominated, non-investment grade, fixed income, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody's Fitch, and S&P is Ba1/BB+/BB+ or below.

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.

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.

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The Chicago Board Options Exchange Volatility Index (VIX) shows the market's expectation of 30-day volatility. It is constructed using the implied volatilities of a wide range of S&P 500 index options.

Producer Price Index (PPI) – The PPI is a wholesale price index, released monthly, and published by the U.S. Bureau of Labor Statistics within the Department of Labor. It tracks the prices of oil and gas, metals, lumber, food, and many other commodities. It does not measure the price of services. The PPI is monitored by economists seeking to identify trends delineating upward or downward pressure on wholesale prices, as these price movements are usually passed through to consumer prices over time. Therefore, the PPI can be an accurate precursor to changes in the CPI.