

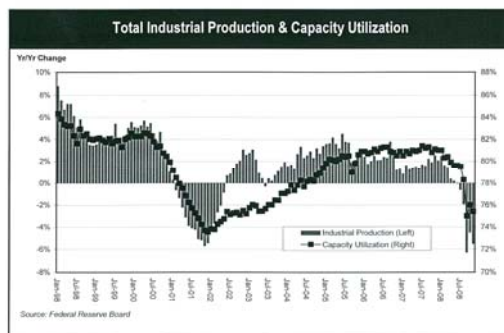
INVESTMENT OUTLOOK

Year End 2008

I have read numerous year-end recaps from money managers, research analysts and financial publications. They all rehash 2008's horrific financial events. We all know what happened. Some of those one-time events created stress, strain and personal portfolio losses. What we don't know is how "Bail out America" will emerge with such enormous government ownership and intervention. One thing is for sure: the financial free-for-all is over. Hopefully that's good news.

Frequently, when the government releases economic statistics, pundits say, "But those are last quarter's rear view mirror numbers." I say, "Yes, but the numbers are a glaring reflection of what's coming towards us." I am specifically speaking about the lousy economic prospects for 2009.

The figures on the charts below portend worse numbers ahead when you examine Industrial Production & Capacity Utilization and Purchasing Manager's & New Orders Indices. And because of these declines I rhetorically ask equity investors, "Where's the E in PE ratio coming from?"



For corporate bond investors, we have a couple of specific things happening. First, corporate CEO's are becoming fiscally conservative. That is, they are reducing debt and finally cleaning up their balance sheets as we saw them do after the technology wreck. With new-found religion, corporations aren't squandering cash or increasing debt for their share repurchases. Those days are over. Corporate America spent hundreds of billions of dollars buying back their shares only to see the bear market send their stock's price down in flames. This reliquification of corporate balance sheets is sweet music for corporate bonds.

The deleveraging of America means we all will be forced to live within our means. Not squandering, not borrowing, but cutting back on indebtedness. The process hurts. But individuals, corporations, cities, states and municipalities all will ultimately benefit after the unwinding and the pain is over. Constrain spending and provide adequate revenues...that will be our new national mantra. My problem, as the Federal Reserve and Treasury bloat their balance sheets with \$8.5 trillion in bailouts and various liquidity facilities, *what's their exit strategy?*



Certainly there will be corporate bond defaults, bankruptcies and even an increase in municipal bond defaults. That is what corporate bond spreads and municipal bond yield comparisons are telling me.

With all these moving parts “the” most disturbing is the lackadaisical and indiscriminant ways our elected officials have mismanaged our states, counties, cities and municipalities. Bowing to what appears every union wish, promising retirement packages that are unaffordable, over spending, over building, over indulging. Yes the

deleveraging in municipal bond land is being felt in every state, city and school board.

State and local budgets are getting squeezed due to, high unemployment, reduced tax revenues without taking their medicine and reducing spending. At year end, 41 states had shortfalls; big shortfalls. Congressman Barney Frank wants some of the unspent TARP money to go to the States. Good idea but that won’t cure the overspending disease. No matter, reductions in state and local services are on the way.

This too will be painful but the cut backs are already beginning. Brace yourself...it won’t be pretty but it will be necessary.

So where does this leave us? We bond investors? Struggling to be sure. Striving to stay on top of downgrades, declines in ratios and an overall credit restriction. There continues to be a lack of liquidity in the bond market since the dark days of fourth quarter 2008. With fewer brokerage firms, fewer trading desks, less capital to inventory bonds it’s still challenging to buy and sell bonds. Both institutional and retail brokerage bond prices have large bid/ask spreads and trading desks avoid committing their capital. This won’t last forever. As the markets and economy heal over the long run, this is the ultimate medicine to remedy the irrational leverage, borrowing, speculation we baby boomers have been a part of.

What the economy really needs is to revive our economic confidence which in conjunction will revive our investment confidence.

I look forward to the time when the deleveraging is over and the markets return to rational behavior once again.

All the best for the New Year,

Marilyn Cohen