

February 6, 2009

MARKET LEVELS

	Friday*	Last week	Dec. 31, 2008	One year ago
Dow Jones Industrial Avg	8,255	8,001	8,776	12,247
S&P 500	864	826	903	1,337
NASDAQ	1,580	1,476	1,577	2,293
Russell 2000	464	444	499	703
DJ STOXX Europe 600 (€)	199	191	198	314
Nikkei Index (¥)	8,077	7,994	8,860	13,207
Fed Funds Target	0%-0.25%	0%-0.25%	0%-0.25%	4.50%
2-Year Treasury Yield	0.97%	0.95%	0.77%	2.05%
10-Year Treasury Yield	2.95%	2.84%	2.21%	3.76%
U.S. \$ / Euro	1.29	1.28	1.40	1.45
U.S. \$ / British Pound	1.48	1.45	1.46	1.94
Yen / U.S. \$	91.88	89.92	90.64	107.49
Gold (\$/oz)	\$913.30	\$927.85	\$882.05	\$910.51
Oil	\$39.20	\$41.68	\$44.60	\$88.11

*Levels reported as of 8.30 am. Pacific Standard Time

MARKET RETURNS

Year-to-date (1/1/09-2/06/09)

Year-to-date (1/1/09-2/05/09)

Dow Jones Indus Avg.	-5.94%	90 Day T-Bill	-0.01%
S&P 500	-4.38%	2-Year Treasury	-0.18%
NASDAQ	0.18%	10-Year Treasury	-4.97%
Russell 2000	-7.06%	ML High Yield Index	5.97%
MSCI World Index	-7.31%	JPM EMBI Global Diversified	0.62%
DJ STOXX Europe 600	0.15%	JP Morgan Global Hedged	-1.59%

RECAP OF THE WEEK'S ECONOMIC RELEASES

February 2

Personal Income and Spending – Personal income fell 0.2% in December, marking its third consecutive monthly decline and the longest string of declines since 1954. Consumer spending dropped 1% during the month which was worse than economists had expected.

ISM Manufacturing Index – The ISM Manufacturing index rose to 35.6 in January from 32.4 in December. Even so, the index remains well below the 50-level that divides an expansion from contraction.

Construction Spending – Construction spending plunged 1.4% in December as builders reduced the number of new homes they were building in the face of declining demand.

February 3 Pending Home Sales – The pending home sales index jumped 6.3% to 87.7 in December, marking the first increase since August 2008.

February 4 ISM Non-Manufacturing Index – The ISM Non-Manufacturing index increased to 42.9 in December, but is still well below the 50-level that divides an expansion from contraction.

February 5 Productivity – Nonfarm productivity, which measures output per hour, rose at an annual rate of 3.2% in the fourth quarter as businesses trimmed payrolls in the face of declining demand.

February 6 Employment Report – The US economy shed 598,000 jobs in January and the unemployment rate rose to 7.6%, which is its highest level since 1992.

OVERVIEW

- The US economy shed nearly 600,000 jobs during the month of January and the unemployment rate rose to a 16-year high of 7.6%. The layoffs are broadly spread across the manufacturing and service sectors of the economy. In fact, out of 271 industries surveyed, fewer than 70 are hiring at this stage. The total number of job losses dating back to the beginning of this recession in December 2007 has now reached 3.6 million. Approximately three-quarters of these jobs have been lost during the last six months as the global credit crisis deepened.
- Unfortunately, our forecast for US economic growth in the year ahead suggests that we are probably only about half way through the labor market adjustment. Consequently, we anticipate that the unemployment rate will continue to rise into 2010, eventually topping 9%. Although fiscal and monetary stimulus should help cushion the blow, they cannot reverse the tide in the near term.

US MARKETS:

TREASURIES

- The bond market sell-off continued this week as the Treasury announced its quarterly refunding plans which contributed to a slight bear-flattening of the curve. This trend could not even be stopped with the labor market performance in the first month of the year being just as grim as in the previous two months: job losses totaled 598,000 in January and the unemployment rate rose another 0.4% to 7.6%. It appears that the Treasury market is solely focusing on supply for the moment.
- In addition to announcing \$32 billion 3-year, \$21 billion 10-year, and \$14 billion 30-year Treasuries being auctioned next week, the Treasury also introduced a new 7-year benchmark bond which will be issued for the first time at the end of February (monthly thereafter). Plus, the Treasury stated that it is considering “the reintroduction or establishment of other benchmark securities.” Possibilities include adding 4- or 20-year notes. The Treasury expects to reach the debt ceiling in the first half of 2009.
- US agency spreads tightened across all maturities this week. On-the-run issues were able to outperform off-the-run bonds. Furthermore, the Fed bought back another \$1.7 billion in the 2-4 year sector. The current trend in agencies is still towards tighter spreads, as the Federal Reserve still has \$75 billion worth of purchases to conduct during the first and second quarters of this year.

LARGE-CAP EQUITIES

- The equity markets rallied this week despite a lousy jobs report and weak same store sales figures from retailers. Investors are positioning themselves for next week's bailout plans by Treasury Secretary Geithner. The S&P 500 rallied nearly 5% and the Dow Jones Industrial Average gained about 3.5%. Small-cap stocks performed in-line with large-cap stocks for the week. In terms of style, large-cap growth stocks outperformed large-cap value stocks. The best performing sector was information technology and the worst performing sector was consumer staples. This earnings season has seen a

drop of 37% in profits for the 307 companies in the S&P 500 that have already reported fourth quarter results. Notable companies that reported positive earnings this week were Akamai Technologies, Cigna, Dolby Labs, Visa, and MasterCard. Companies with disappointing earnings were Mattel, Disney, Cisco Systems, and Hartford Financial.

CORPORATE BONDS

- Investment grade primary activity slowed down slightly as earnings continue to remain the center of attention for investors. Today's payroll number of -598,000 (the estimate was around -540,000) actually gave the market a slight boost, since it was not as bad as many feared. Most investors are in a holding pattern, waiting patiently for concessions in new issue rather than scouring the market for value in secondary issues.
- Investment grade corporate spreads widened slightly as the market tried to digest the considerable amount of new issue seen in the first month of 2009. Investors shifted their attention to vintage issues taking advantage of any fair value between off-the-run and on-the-run issues. With the broker community hesitant to extend themselves or harbor securities on their balance sheets, the "Work an Order" trade remains a common way to match buyers with sellers. The Lehman Credit Index Option-Adjusted Spread (OAS) finished the week at +436, 2 basis points (bps) wider. Telecom/cable/media remained unchanged, utilities tightened by 35 bps, industrials tightened by 6 bps, and financials widened by 23 bps.

MORTGAGE-BACKED SECURITIES

- Mortgages outperformed Treasuries in a quiet, low volume trading week. The US Government remains committed to digesting mortgage originations to support the mortgage rates. The modest back-up in Treasury yields had limited impact on fixed rate mortgages as prices hovered in a narrow range. The prepayment report released today was in-line with expectations with faster prepayment speeds for newly minted mortgages with 5 and 5.5 coupons. High coupon mortgages actually showed a favorable prepayment experience as tight lending standards influenced borrower refinance options. For the week, the 30-year current coupon spread versus the 10-year Treasury narrowed 7 bps to 137 bps.

MUNICIPAL BONDS

- The municipal market yield curve flattened over the last week as 2-year AAA-rated general obligation (GO) bonds fell about 2 bps and 10-year GO bond yields fell about 13 bps. In the 30-year maturity area, yields tumbled about 25 bps. This is in stark contrast to the Treasury market, where a dark cloud of new supply continues to hang over the market and drive yields higher. Two key themes are driving the municipal market action: manageable new supply and a relatively steep yield curve. First, despite worries over a glut of new supply heading into 2009, supply has actual been very manageable with many deals wildly oversubscribed. One example is this week's Los Angeles Unified School District GO bond deal. Due to significant demand for the issue, the deal was priced then re-priced and yields were "bumped" lower by 5-8 bps across the curve. Overall for the week, approximately \$3.4 billion in new issuance came to market. To the extent that supply remains manageable, a back-up in yields does not appear imminent.
- The other key theme is the slope of the yield curve. Last week, the difference in yield between 2- and 20-year bonds reached its widest level in 25 years, at +350 bps. This presented buy-and-hold investors with an opportunity: venture out the yield curve into longer maturities to pick-up additional yield. In light of this move, the curve flattened. Finally, the feeling that the Federal government's fiscal package will carry good news for the municipal bond market serves as a supportive backdrop.

HIGH-YIELD BONDS

- The High Yield market finished January solid, with the Merrill Lynch High Yield Constrained Index up 5.9% on a total return basis for the month. The higher-quality BB-rated end of the market rallied the strongest in January, with the more risky CCC-rated end of the market lagging significantly. The rally

was driven largely by the significant amount of new cash that has entered the market since the beginning of the year and needed to be deployed. High Yield mutual funds, which are less than 10% of the market, have received over \$2.8 billion in net new cash in 2009 to-date, including \$725 million this past week. These figures, of course, do not include the significant amount of cash at pension fund and insurance company managers, which are the bulk of the high yield market. While there has been over \$4 billion of new issuance year-to-date, the new issue flow has been insufficient to absorb the torrent of cash flowing into the market. We are now entering the phase of the quarter when many of the larger high yield issuers will report their fourth quarter operating performance. Market focus will shift more towards fundamentals and away from market technicals.

INTERNATIONAL MARKETS:

WESTERN EUROPEAN EQUITIES

- Stocks in Western Europe gained ground over the past week. The stocks with the best performance were basic resources (+20.2%) and construction and materials (8.4%). Last week's recovery of cyclical stocks continued this week. With the exception of paper, shares related to basic resources performed best, driven by mining companies and positive expectations of commodity prices such as copper and steel. In the construction and materials sector, riskier companies saw a rebound this week after losing heavily earlier this month. Companies that are more leveraged, such as French-based Lafarge, gained more than 10% over the week.
- Among the sectors that did not fare well were food and beverage (-3.1%) and health care (-0.6%). Unilever provided a disappointing outlook and abandoned its 2010 operating-margin target. Danish brewer Carlsberg is suffering from its large exposure to the ruble as Russia is one of the largest foreign key markets. As cyclical sectors were not in high demand this week and sentiment for stocks improved, the poor performance of the health care sector persisted.

EASTERN EUROPEAN EQUITIES

- In Central Europe, Czech Central European Media Enterprises lost the most (-28.4%), followed by Polish construction services company Polimex Mostostal (-13.7%) and Polish PKO Bank (-12.0%). CETV and Polimex Mostostal both dropped after their price estimates were lowered by two different brokerages. State-controlled lender PKO Bank saw a four-day decline and is considering selling new shares to a government bank to raise capital for corporate lending. Among the leaders of the week were copper and silver producer KGHM Polska (+16.1%), Polish refinery Grupa Lotos (+15.8%), and Hungarian pharmaceutical company Gedeon Richter (+4.0%). KGHM rose for four days this week as copper traded near a one-week high in London on speculation that government spending plans in China and the US will boost demand. Grupa Lotos gained on forecasts that earnings will improve during the first quarter of 2009. Gedeon Richter's price estimate was raised by a local brokerage.
- In Russia, fertilizer producer Uralkali sold off the most (-23.5%), followed by energy company OGK-2 (-11.4%) and Sberbank (-10.6%). Uralkali plunged after reports that the company may have to pay as much as \$2.9 billion for damages related to a 2006 flood at one of its mines. OGK-2 suffered from a 7.3% overall decline in electricity production in January. Sberbank dropped due to financial shares falling in Europe as a consequence of Deutsche Bank reporting a loss in the fourth quarter of 2008. The leaders of the week included metals and mining company Mechel (+35.7%), steel producer Cherepovets Severstal (+33.6%), and Polyus Gold (+26.7%). Mechel surged after announcing good progress in the construction of a railroad project which is built to access a coal deposit. Severstal gained after indicators for renewed demand for metals surfaced. Polyus Gold rose on speculation that the global recession will boost demand for precious metals.

GLOBAL BONDS AND CURRENCIES

- Sovereign bond markets had a mixed week. The European Central Bank (ECB) kept rates on hold at 2% as universally expected, but the short end of the Bund curve drew support from the dovish tone of ECB

President Trichet's comments at the post meeting press conference. Trichet made it clear that rates are set to fall to 1.5% in March and further thereafter. Short-dated Bunds also benefitted from yet more grim economic news, which showed euro zone retail sales contracting and industrial production down sharply. An unexpectedly large fall in German industrial orders pointed to more weakness in manufacturing activity in coming months. By the end of the week, 2-year Bund yields were down about 13 bps. Ten-year Bund yields, however, rose several basis points, mirroring losses in the US Treasury market, which remains concerned about forthcoming new issuance. In Japan, the same factors, combined with proposals to support stock prices and fund infrastructure projects, pushed 10-year Japanese government bonds several basis points higher on the week, while leaving the short end virtually unchanged. In the UK, the Bank of England's (BoE) decision to cut rates by 50 bps to 1% was widely anticipated and shorter-dated Gilt yields rose in the days before the decision as investors apparently saw little chance of a larger rate reduction and moved to lock in profits. Two-year yields ended the week up about 15 bps, while 10-year yields finished virtually unchanged.

- Currency markets also had a mixed week. The US dollar was weaker against the sterling on optimism that the currently ultra-low BoE rates will eventually trigger a recovery. The US dollar was also lower against the Australian dollar, supported by the view that Australian rates may be approaching a low after the Reserve Bank of Australia cut rates 100 bps to 3.25% in the past week. However, the greenback was virtually flat against the euro on the week and it rose slightly against the yen.

EMERGING-MARKET BONDS

- A continued positive in credit markets caused emerging markets spreads to tighten this week.
- The Central Bank of South Africa cut its benchmark interest rate by 100 bps from 11.5% to 10.5%. In an expected move by the market, the Central Bank indicated that with the economy sliding into recession and lower inflation, a cut of this magnitude was appropriate. Local bonds were mixed following the news, with the shorter maturities outperforming the longer dated bonds.
- In Kazakhstan, the Central Bank devalued its currency by approximately 18% versus the US Dollar. Market participants anticipated widely this move due to the steady devaluation seen in the Russian ruble over the previous months, Russia being a key trading partner, and both economies experiencing similar terms of trade shocks.

FACTORS SHAPING THE MARKET NEXT WEEK

- Next week, economic data might be overshadowed by the unveiling of a new bank rescue plan by Treasury Secretary Tim Geithner on Monday. Later in the week, the Commerce Department will report on advanced retail sales for January setting the tone for consumer spending in the first quarter of 2009.
- In global markets, new employment figures are due out in the UK and the BoE will release its Quarterly Inflation Report. The euro zone will report on industrial production and fourth quarter GDP.

NEXT WEEK'S US ECONOMIC RELEASES

<i>February 11</i>	<i>International Trade Report</i>
<i>February 12</i>	<i>Advanced Retail Sales, Business Inventories</i>
<i>February 13</i>	<i>University of Michigan Consumer Sentiment</i>