

Market Review & Outlook

January 2009

2008 will go down in infamy as one of the worst years in the history of the stock market. A loss of 33.8% marked the 3rd worst calendar year for the Dow Jones Industrial Average since that index started tracking market performance in 1896. Only the losses of 37.7% in 1907 and 52.7% in 1931 during the throes of the Great Depression were worse. As most everyone knows by now, the financial crisis of 2008 was rooted in the housing market correction that has been ongoing since mid-2006, specifically in the sub-prime mortgage meltdown that began to come to light in mid-2007.

Too many people had taken out home loans they couldn't afford, and when they began to default on those loans, lenders began to collapse. Banks posted huge losses on complex securities linked to those sub-prime mortgages, and this, in turn, led banks to become more reluctant about lending money to businesses and each other. As events continued to unfold in 2008, it became clear that most market participants had severely misjudged the risk of securitizing these mortgages and the damage that it would inflict on the financial system, including the destruction of trillions of dollars of stock market wealth and the demise of a number of large financial institutions.

Will 2009 usher in a brighter future for stock investors? The conventional wisdom says it will, but the economy and markets are not out of the woods yet, despite the massive monetary and fiscal stimulus that is flooding the economy both here and abroad. Most folks would assume that the market would bounce back after such a dismal year, but history does not provide much evidence to support this notion. In 1908, after losing 37.7% the previous year, the market did bounce back with a healthy 46.6% gain, but in 1932, after the 52.7% loss the year before, the market declined an additional 23.1%. Furthermore, an analysis of the entire history of the stock market does not yield any statistically significant correlation of year-to-year returns. For a detailed look at how the stock and bond markets performed last quarter, please refer to the table below:

The main reason it remains unclear whether or not the market is poised for a broad recovery is that the economy is mired in a recession that may end up being the most severe post World War II recession and one that could last throughout 2009. At the beginning of December, the National Bureau of Economic Research confirmed that we have been in recession since December 2007, so



already this downturn is longer than all but two previous postwar recessions. Moreover, this is the first time in the post-war period that we have experienced a globally synchronized recession where the U.S., Japan, and Western Europe

have all experienced a substantial decline in business activity.

For the markets, a prolonged recession, where corporate earnings estimates are continually being revised downwards, means that we could experience a very choppy recovery, with rallies punctuated by sharp declines. For the past 3 months, the Dow Jones Industrial Average has traded in a range from 7,500 to 9,500, and each time it moved up much past the 9,000 mark, it has sold off. Today (January 7) was no different. The market rallied 7 of the past 9 trading sessions. Investors seemed to gain more of an appetite for risk, and the market seemed poised to move even higher with the various financial rescue packages taking hold and with Barack Obama sweeping into office on a wave of goodwill and high hopes. However, there were a number of poor earnings announcements and a worse-than-expected unemployment report that surprised investors. This sent the Dow down 245 points.

Index	December 2008	4th Qtr. performance	Year-to-date Performance	Description (what the index is comprised of)
S&P 500	1.06%	-22.40%	-37.01%	Large cap stocks
DJ Industrial Average	-0.60%	-19.10%	-33.84%	Large cap stocks
NASDAQ Composite	2.70%	-24.30%	-40.53%	Large cap stocks
Russell 1000 Growth	1.81%	-22.79%	-32.31%	Large cap growth stocks
Russell 1000 Value	1.39%	-22.18%	-36.85%	Large cap value stocks
Russell 2000 Growth	5.42%	-27.45%	-38.54	Small cap growth stocks
Russell 2000 Value	6.15%	-24.89%	-28.92%	Small cap value stocks
MSCI EAFE	6.01%	-19.95%	-43.38%	International stocks
Barclays Cap Agg Bond Ind	3.73%	4.58%	5.24%	U.S. Government bonds
Lehman High Yield	7.70%	-17.90%	-26.20%	High yield corporate bonds
3-month Treasury Bill	0.00%	0.30%	2.50%	

We can envision a scenario where President Obama takes office and the economic stimulus plan being discussed on Capitol Hill passes soon afterwards. The numbers being tossed around have ranged between \$775 billion and \$1.25 trillion, with a goal of saving 3 million jobs and providing tax cuts to middle income families and small businesses. There has also been much discussion about "infrastructure" projects and "investments" as a way for the government to put money into the economy and generate growth to expedite a recovery.

While we are generally skeptical when politicians begin to talk about "investments" with our tax dollars, if at least part of this stimulus package is implemented in the right way, it could certainly have a positive effect on economic growth. It would not be a surprise to see the markets react initially very positively to this and stage a substantial bear market rally, only to later recognize that the economic recovery will be more drawn out, with stocks reacting negatively and potentially revisiting the market lows from the October-November timeframe sometime in the 1st or 2nd quarter.

While we believe that 2009 could very well be a positive year for stock investors, we are still cautious because residential housing could decline another 15-20% and prolong the recession into 2010. This could continue to be a difficult environment for retirement plan investors, particularly those folks in 401(k) plans with limited choices and strategies. Let's face it, the buy and hold mantra that has been a touchstone of the entire financial services industry (and also in academia for that matter) has not worked out very well for investors who have been invested primarily in stocks over the past decade. If you are an aggressive investor who keeps most of his money in stocks, you have already experienced a significant 35-40% (if not more) decline twice during the past decade, first during the technology bust and now this past year with the financial crisis. Even before the crash of October/November, the S&P 500 index had a 10 year annualized return of 3.08% as of 9/30/2008.

How does an investor do better in an environment where, if history is any indicator, volatility in the financial markets is likely to continue? Last year, for most of our self-directed retirement plan clients, WESPAC Advisors added a unique element to our managed portfolio option by introducing the Fusion Global Long Short fund into the mix. The Fusion fund is designed to play defense in weak markets and actually ended the year with a 3.2% return. While incorporating Fusion into the portfolio didn't prevent them from experiencing sharp losses, they did much better than they would have done had we not done so.

During the first half of this year, we are planning to take the portfolios one step further by going to a collective investment fund arrangement that will allow us to incorporate even more custom strategies into one investment vehicle (or group of vehicles) to manage risk. Similar to the Fusion fund, these strategies will incorporate into the investment methodology elements of technical analysis, a way of measuring market psychology and supply and demand in the markets.

In other words, we will have more freedom to tactically allocate funds and play defense when markets weaken than we do now with the Russell Lifepoint funds still comprising the majority of the portfolios. While we believe the Russell Lifepoint funds are fine investment products, they will stay fully invested no matter market conditions because that is the mandate of the underlying managers that Russell hired. For most clients, we will be replacing the Russell component with the custom strategies that will allow us to more actively

manage the portfolios with the objective of getting a better result for them over the long term.



If you have a general question about your account, please contact our customer service at extension 152. If you need investment advice, please contact me or your firm's designated consultant. You can reach me at 800-535-4253 ext. 178 (510-740-4178) or at john.w@wespac.net. John Williams, Manager of Advisory Services – WESPAC