Global Credit Crisis
Special Market Report

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Financial markets have been thrown into turmoil in recent weeks. The credit crisis that began last year with the collapse of the subprime loan industry resulted in the government takeover of several major financial firms and the failure of several financial institutions and banks; we expect more related market news to follow. These events culminated in the creation of the new Troubled Asset Relief Program (TARP) as well as unprecedented central bank action. In this report, we provide a perspective on these events, discuss the broad outlook for the US and global economies, and offer suggestions on where investors may find value in the current market.

The Rescue Plan: How It Will Work

As the credit crisis began to expand, the US Treasury Department and the Federal Reserve injected liquidity into the financial system, brokered the sale of several large financial institutions, and helped coordinate the government takeover of others. As it became apparent that this piecemeal approach proved unable to stabilize the markets, the Treasury proposed creation of the $700 billion TARP.

The TARP is designed to allow banks to sell assets to the Treasury, which may initially purchase $350 billion worth of assets from financial institutions and have access to another $350 billion at the discretion of Congress. Exact details of how the program will work are still being determined. The Treasury indicated that it plans to work closely with the Financial Deposit Insurance Corporation (FDIC) to help remove problem assets from bank balance sheets. Ideally the government's purchase of this distressed debt will prompt other buyers to re-enter this market, creating additional demand, and the TARP will eventually be able to re-sell these assets back into the open market. The FDIC, in addition to providing insurance coverage on bank deposits, will continue to use its "lines of credit with the Treasury to…protect depositors, guarantee liabilities, facilitate orderly wind downs, mergers, or adopt other stabilizing measures," according to the Treasury.

Central Bank Action

In several ways, the recent actions taken by the Fed and other central banks may have just as significant an impact as the TARP in terms of unlocking credit markets. First, the Fed greatly expanded its Term Auction Facility program it established last year to allow the Fed to issue short-term loans at a rate below the discount rate. Second, the TARP legislation included a provision that allows the Fed, for the first time in history, to pay interest on reserve balances, helping the Fed to expand its balance sheet and stabilize overnight interest rates. Last, the Fed announced that it would begin lending money directly to nonfinancial corporations by purchasing commercial paper, the short-term debt issued by companies. Altogether, these actions effectively doubled the size of the Fed's balance sheet, with expectations of additional growth, and have increased the Fed's flexibility to lend across financial markets.

Following these actions, on 8 October 2008, the Fed, the European Central Bank, and the central banks of England, Canada, Sweden, and Switzerland simultaneously cut interest rates by 50 basis points in a coordinated effort, which brought the US fed funds target rate to 1.5%. In separate moves, central

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banks in China, Hong Kong, and Australia also recently cut rates. These coordinated interest rate cuts signal that the world's central banks are focused on the global financial crisis and that they will act as necessary to loosen seized up credit markets.

What Will the Impact Be?

We believe that the TARP and the steps taken by central banks should eventually help stabilize the banking industry and allow banks to remove bad debt from their balance sheets. As a result, lending should grow again and some measure of liquidity should return to the markets. While banks have already begun to take advantage of the Fed's new programs, and bank borrowing has increased, it is important to emphasize that credit markets will not be fixed overnight. The Treasury will take some time to get the TARP up and running, and we expect to see the impact of this program occur over the next six to nine months. Likewise, the actions taken by central banks will help, but the effects of the new programs and rate cuts will take some time to work their way through the system. These moves will help the banking system stabilize so that credit can begin flowing again, but the prospects for the overall economy remain troubled.

The Outlook for the Economy

The US economy was fragile even before the most recent financial panic. Consumer confidence has been low as their reluctance to spend has been reinforced by the latest plunge in equity prices, a weakening labor market, and falling home prices. We expect that there will soon be a contraction in consumption levels—an event that has not occurred since 1991. Home sales levels continue to fall, and the market is not clearing. In addition, the corporate sector has come under pressure in an environment in which most companies do not want to increase investment or hiring. Exports have been the one bright light in the US economic picture, but even this sector is dimming given the deteriorating prospects for the global economy. Conditions seem likely to worsen before they improve.

Until recently, although the US economy had been weakening, its relative resilience had been a positive surprise in the context of recent negative market news. Given the severity of such events, however, we now believe that the economy is in a recession and the recovery will be slow in coming next year.

The outlook is equally difficult outside the US. The global economy is likely to slip into a recession, marking the first time since the 1970s that both the US and international economies would be simultaneously in a recession.

Outlook and Opportunities in Fixed Income

The main theme within fixed income markets that has endured for some time is a flight from assets perceived to have exposure to credit risk into the safety of Treasuries. As a result, credit spreads have widened significantly. We believe this widening suggests there is value to be found in some higher-yielding securities. And, in the near-tem, we believe the credit markets provide some of the best opportunities available to investors.

While Treasuries appear to be overvalued at current yields, a specific area of the market that we find attractive is the agency mortgage market. In particular, yields on Ginnie Mae securities have been pushed higher in recent weeks. This market sector is backed by the "full faith and credit" of the US government and, at current yields, we believe this sector represents some of the best value available for investors. We also favor Fannie Mae and Freddie Mac securities. On a more selective basis, we see value in corporate bonds, including some higher-quality financial institutions, in non-agency mortgages, and in selective high-yield bonds of selected companies.

We also encourage investors to look for opportunities in international markets where many bonds are attractively valued. In general, government bond yields in most developed non-U.S. markets are higher than those in the United States, in part because non-U.S. central banks have been reluctant to lower interest rates.

Finally, we have a favorable view of the municipal market. A number of municipalities are suffering from lower tax revenues and the effects of the housing recession, and municipal yields, as with other sectors of the market, have been widening relative to Treasuries. In our opinion, at current levels, municipal yields represent an attractive investment opportunity.

Outlook and Opportunities in Equities

Recently, equity markets have been largely driven by macro issues, such as the TARP legislation, rather than by fundamentals, and this pattern will likely persist for some time. Looking ahead, we are optimistic that the government rescue plan and central bank action will provide help, but a sustained rally in equities will require evidence that the measures are working. In particular, we are keeping a close watch on credit spreads, which have widened as investors have become more risk averse. If spreads begin to narrow, it could signal a real and lasting bottom in equity markets. In addition, we believe equity markets will require ongoing capital raising and continuing consolidation in the financial sector. The equity market sell-off appears to be well advanced, but not yet exhausted. Investors should continue to approach the markets cautiously.

In our opinion, the best value in this very uncertain period can be found in higher-quality companies that have relatively strong balance sheets, strong levels of free cash flow, and adequate financing. In general, this quality bias leads to an overweight in large cap and growth stocks. From a geographic perspective, non-US markets have recently been hit harder than US stocks largely due to the flight-to-quality theme, as well as to the aggressiveness of US monetary and fiscal policy. Going forward, we expect US stocks will continue to outperform other developed markets. Emerging markets have experienced some of the worst performance lately, but we believe the long-term fundamental case for these markets remains intact.

Regarding market sectors, we do not believe that the worst is yet over for financials, and we continue to recommend underweight positions. We see value, however, in some financial companies,

including some of the larger global banks that are likely to be net beneficiaries in the current environment. An area of the market that we continue to find attractive is US multinationals. The rise in the US dollar has negatively impacted this sector, but this area of the market continues to provide evidence of good growth. Additionally, we believe that resources continue to represent a strong sector theme. A final sector theme that we believe is important can be found in the resources area. We believe energy companies remain well positioned and are attractively valued despite the pullback in oil prices, but we do not currently find most of the materials area of that market attractive.

Conclusions: What to Expect

As we have indicated, we do not believe that the passage of the TARP and the recent central bank moves will instantly fix the global economy's problems, and indeed, equity markets around the world fell again recently as investors remained focused on the downside risks to the global economy. We believe that real evidence that credit markets are starting to recover will be seen eventually, but such evidence is likely to appear in mid-2009 rather than during the fourth quarter of 2008.

In these circumstances, it is best that investors remain cautious and focused on capital preservation for the time being, even at the cost of missing some near-term gains in higher risk assets. This view applies particularly to investors with a shorter time horizon.

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