WEEKLY MARKET REVIEW

Week ended January 16th

Bank Woes Continue to Weigh on Markets

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Stocks declined last week on renewed worries over the health of key U.S. banks—a reminder that the issues at the core of the financial crisis remain unresolved. Citigroup, whose share price has fallen –80.69% since the company was bailed out in October, reported an $8.3 billion fourth-quarter loss, and announced it would split into two companies in order to rebuild its capital. One of the companies, to be called Citicorp, will retain the firm's core assets, while the second company, Citi Holdings, will consist of "non-core" assets, including money-losing divisions and over $300 billion of mortgages and other loans guaranteed by the government. While the companies will legally remain unified for now, last week's breakup may be a precursor to the disposal of Citi Holdings' assets later.

Also last week, Bank of America, whose shares have fallen –72.38% since announcing its takeover of Merrill Lynch in September, reported its first quarterly loss since 1991 and received $138 billion ($20 billion in capital infusions and $118 in loan guarantees) worth of government aid, in part to help facilitate the acquisition.

While there are tangible signs in the credit markets that government action has brought the financial system back from the precipice of collapse, the potential for a near-term economic recovery is highly implausible given the still-deteriorating conditions on banks' balance sheets. As delinquencies in everything from residential and commercial mortgage payments to credit card and auto loan payments mount, the banks continue to write-downs assets often to aggregate levels that fail to meet long-term liabilities, rendering the entities essentially insolvent without government support.

This dynamic has provoked a massive government response. Most recently, last week the second $350 billion installment of the Troubled Asset Relief Program (TARP) was released, and $20 billion of TARP funds went to help Bank of America absorb Merrill Lynch's huge losses. It is clear however that the immense capital injections into the banks have not addressed the dominant issue of potential landmines still remaining on bank balance sheets. This is why the government has focused, with thus-far limited success, separately on programs that could slow the pace of decline in home prices and broad economic activity. Government action has not yet successfully stemmed the vicious cycle gripping the broad economy as

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further bank losses have led to weakening confidence and tighter lending standards, causing economic activity to stall. This has triggered job losses, leading to lower spending and higher rates of defaults on consumer loans, resulting in additional bank losses and the beginning of the cycle anew.

The Federal Reserve Board, with the likely backing of President Barack Obama's advisors, is now focusing on the option of setting up a so-called "bad bank" that would acquire hundreds of billions of dollars of troubled securities now held by lenders. The hope is that such a measure would allow banks to reduce write-offs, free up capital, and begin to increase lending. Details of the plan are still in the works and it is difficult to handicap the cost as well as the potential success of the strategy until we learn how the assets will be priced. As Paul Krugman opined in yesterday's New York Times (and I summarize) "fair value" purchases of toxic assets is likely to come at a huge taxpayers' expense.

Eyes on the proposed stimulus package

At the same time that we attempt to cure the disease (i.e. credit not flowing), Congress is also negotiating a proposed $850 billion stimulus package to help treat the symptoms of the disease (i.e. plunging aggregate demand and rising unemployment). The controversial proposal contains about $300 billion in tax cuts, with most of the rest going toward various spending programs, including investments in technology, aid to states and infrastructure projects.

While the final makeup of the plan is far from decided, I don't expect it to produce an immediate economic kick-start, whatever form it takes. As with most such assistance measures, this will take time to work through the financial system. That said, the stimulus package may indeed fuel higher growth a couple of quarters after it's enacted.

Generally speaking, however, the spending programs under discussion are likely to provide more immediate stimulus to the economy than the tax measures. Aid to states will keep services running and prevent layoffs, while spending on infrastructure and technology initiatives, such as upgrading broadband capabilities, could produce very favorable economic results—especially over the long-term.

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Tax rebates, on the other hand, are more likely to be saved than spent, and further deleveraging—in essence, transforming household and corporate debt into federal debt—is not likely to stimulate an economy currently suffering primarily from weak demand.

Data still recessionary

For the time being, economic reports remain mostly dreadful, as would be expected in a deep recession. **Industrial production**, for example, fell a worse-than-expected –2.0% in November, primarily on weakness in manufacturing. Motor vehicle assemblies were a particularly soft spot in the data. A rise last week in **initial claims** for unemployment benefits, and poor **retail sales** figures, rounded out the gloomy picture.

Two inflation reports last week carried mixed messages, however. The **Producer Price Index**, which measures wholesale inflation, fell –1.9% in December, but rose 0.2% excluding the volatile food and energy categories. And the **Consumer Price Index**, a key measure of consumer inflation, fell –0.7 in December, but was flat excluding food and energy. Non-existent inflation may sound great, but is simply a reflection of today's moribund economy. However, falling or flat prices do translate into higher real wages—wages net of inflation. This means that for the majority of Americans who still have a job, there are some real bargains out there, on everything from gasoline to clothes.

Looking to 2009

I expect job losses to continue to build over the near term, as growth stagnates. However, it's worth bearing in mind that job losses are lagging indicators, not signals of economic conditions to come.

As we move further into 2009, I also expect a gradual stabilization process to take hold, and like most economists, I am anxious to see the final results of the stimulus negotiations. In the short term, investors may be best served by focusing on investments offering a "bird in hand"—income. These include investment-grade corporate bonds, municipal bonds and quality stocks that pay and grow dividends.

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Later, when we begin to see clearer signs of recovery, such as a return to bank profitability, greater credit availability for corporations and perhaps signs of growing demand for commodities, I would expect increased investor risk appetite to help support stocks of smaller companies. Emerging-market equities may also benefit, particularly as developing economies should continue to enjoy higher growth rates than their developed counterparts.

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