

Stock Market:
Quarter in Review

After a very challenging beginning to the year, the equity markets continued their bear market declines in early March only to explode upward in a rally that has carried the major indices markedly off their recent lows. Concerns about the possibility of bank nationalization, continued strain on the financial sector, and increasing fear of much greater economic depths led the market down sharply in January and February. However, investor sentiment improved dramatically as the market vaulted off its March lows on hope that the massive fiscal and monetary stimulus programs and the slow down in the deterioration of the economic data might be the beginning of a stabilization that could allow the market to start discounting a recovery.

Fundamentals

The fundamental picture for stocks remains challenging given the continued unfolding of the detrimental effects of last year's massive declines on consumer spending and corporate earnings. Signs of financial strain have eased somewhat from the dramatic levels of last fall but credit markets are still far from functioning in a healthy enough fashion to support a lasting recovery. The housing market has slowed its rate of decline but a sustainable bottom will need to form to create a solid foundation for a healthier banking system and economic growth. Economic releases, while easing from their dramatic rates of decline, still show continued deterioration in performance, an ongoing and worsening recession, and sharply higher unemployment. However, attractive valuation assuming no further unexpected economic deterioration, highly negative sentiment, and notably accommodative monetary and fiscal policy should help to support the market during further probes lower.

Style, Sectors, and Volatility

Largely due to the weakness in financials and the notable strength in technology, the wide disparity in favor of growth stocks this quarter continued the recent trend of growth out performance. Large caps easily outpaced their smaller counterparts. Top sector performers were information technology, materials, and consumer discretionary while the downside leaders were financials, industrials, and energy. The volatility in the first quarter continued the trend toward large price swings consistent with conditions since the bear market began. However, option fear gauges such as the VIX remain far from their peaks from last fall.

Outlook

After dashing hopes of a strong first quarter in the first two months of the year, the market finally found its footing and rallied hard to cut some of the previous sharp quarterly losses. Unfortunately, it is still very early to assume the bear market is over even as the recent rally has helped investor sentiment. The market remains in a wide and volatile range and the bottoming process could be lengthy given the tremendous declines and

1st Quarter Scorecard
Table 1

<u>Index</u>	<u>Quarter</u>	<u>1 Year</u>
S&P 500	-11.0	-38.1
Russell 1000	-10.5	-38.3
Russell 2000	-15.0	-37.5
Russell 3000	-10.8	-38.2
Russell 3000 Growth	-4.5	-34.4
Russell 3000 Value	-17.0	-42.1
Barclays Capital US Aggregate	0.1	3.1
3 Month T-Bills	0.1	1.2

downward momentum over the last year and a half. However, there are some positive technical signs in the relative strength of technology and consumer discretionary stocks, fewer new lows on each probe lower, and improving advance-decline statistics that the market may be working on the bottoming process. Despite these positive signs, the fundamental headwinds for stocks, economic growth, and consumer spending remain formidable and could keep stocks in the current range until participants can begin to discount a longer lasting economic recovery.

The Economy: Stepping Back from the Abyss

At 15 months and counting, the economic contraction is the longest since 1982. On the safe assumption that it persists through the current quarter, the current recession will go down as the longest in duration since the 1929-33 experience. While many indicators point toward continued weakness, some early signs are emerging that a process of stabilization may be underway. Labor markets remain weak (Graph #1) and will likely deteriorate further in the months ahead. Of the 5.3 million jobs lost since the start of the recession, over 2 million were lost in the first quarter of 2009 alone. Weak employment conditions continue to weigh on the consumer sector as loan delinquencies and mortgage foreclosures will remain problematic for the foreseeable future. However, more encouraging data is beginning to emerge from some of the hardest hit sectors. In particular, home sales appear to have bottomed, albeit at low levels. The combination of low mortgage rates, low prices, foreclosure "fire sales" and first time homeowner government incentives appear to be gaining some traction as sales overall have steadied and the most distressed markets appear to be improving (Graph #2). Moreover, mortgage applications are currently running at a rate twice that of six months ago. While refinancing applications comprise the bulk of this activity, it remains a source of economic stimulus.

Based on data from the National Association of Realtors, the index of Housing Affordability (Graph #3) is at its highest level on record, going back to 1986. *While there are encouraging signs that the rate of decline is leveling, it would be unrealistic to expect economic conditions to improve dramatically in the near future. We continue to believe that, on balance, gradual improvement will be evident in the second half of 2009.*

Interest Rates & the Federal Reserve—Pushing Hard (Hopefully Not on a String)

The role of central banks and the tools to implement that role are in the process of being re-defined. Until recently, monetary policy essentially consisted of incrementally adjusting short term rates based on the prevailing trends in inflation and economic growth. In the current environment, the Federal Reserve along with the Treasury Department are employing a variety of tools, many of which have never been tried, all in the interest of freeing up the credit markets and restoring lending activity. Judging by the pick up in mortgage lending, the increased ability of companies to issue public debt (at least among the most credit worthy) and the modest narrowing of yield spreads between corporate and U.S. Treasury debt, there is evidence that credit conditions are easing somewhat. Barring any further “shocks,” we would expect this trend to continue during the months ahead.

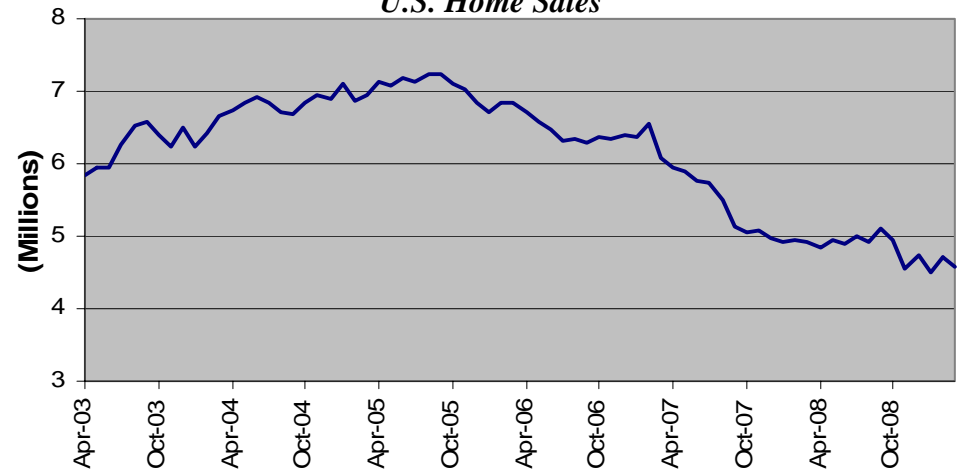
Treasury yields rose somewhat during the quarter as bond investors began feeling somewhat more comfortable with corporate debt (see Table #2). In fact, while long term Treasury Bonds rose by over one-half percent, longer term high quality corporate bonds were essentially unchanged during the quarter. *While we do not expect interest rates to change significantly in the near term, we do anticipate that as economic conditions improve and market fears subside, rates will begin to move higher.*

Interest Rate Summary

Table 2

	3/31/08	12/31/08	3/31/09	Qtr Change	12-Month Change
3 Month T-Bills	1.2	0.1	0.2	+0.1	-1.0
5 Year Treasury	2.4	1.5	1.7	+0.2	-0.7
10 Year Treasury	3.6	2.2	2.7	+0.5	-0.9
30 Year Treasury	4.3	2.7	3.5	+0.8	-0.8
5 Year Corporate ('A')	4.6	5.7	5.4	-0.3	+0.8
10 Year Corporate ('A')	5.7	6.3	6.4	+0.1	+0.7
30 Year Fixed Rate Mortg.	5.7	5.3	4.9	-0.4	-0.8

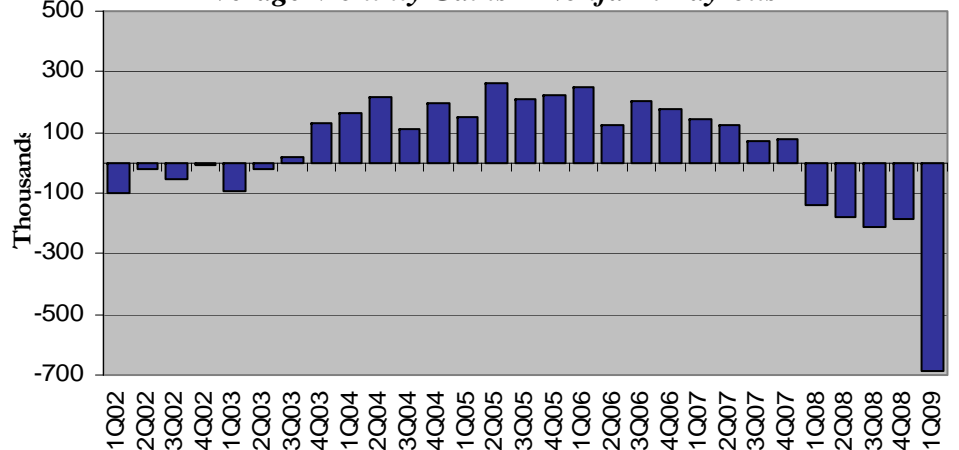
U.S. Home Sales



Graph 2

Source: Bloomberg

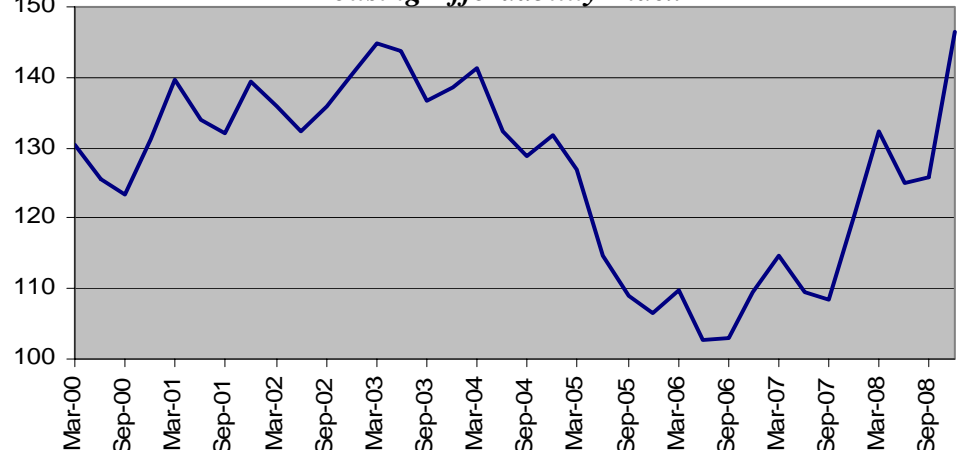
Average Monthly Gains—Nonfarm Payrolls



Graph 1

Source: Bloomberg

Housing Affordability Index



Graph 3

Source: National Association of Realtors