

January 15, 2009

COMMENTARY

GDP growth, which increased 2.8% in the second quarter, fell off sharply in the third quarter, dropping 0.5%. Consumer spending, fueled by stimulus checks in the second quarter, dropped 3.8% in the third quarter as consumer sentiment plunged and access to credit became increasingly difficult. Preliminary data present a bleak outlook for the fourth quarter as both exports and consumer spending declined substantially. Some analysts have predicted that growth could decline by nearly 7.0%, making it the third worst quarter in 50 years.

The Fed responded aggressively as the prospect of a global recession increased. Fed officials lowered the Fed Funds rate at all three meetings during the quarter. By year end the rate was dropped to a target range of 0.00% to 0.25%. This unprecedented move at the December meeting was primarily driven by data indicating that the economy was continuing to weaken.

The US consumer has historically been the primary driver of economic growth. As the year progressed it became increasingly clear that consumer spending was headed lower. The employment outlook worsened during the quarter as job losses mounted and weekly unemployment insurance claims jumped above 500,000 for the first time since 2001. About 2.5 million Americans lost their jobs in 2008 and the unemployment rate finished the year above 7.0%, reaching a 16 year high.

In addition to a weak employment outlook, consumers also faced tighter credit standards. In response to a difficult credit market and increasing defaults, many lenders dropped credit limits on credit cards and home equity loans. Lenders also increased standards, making it more difficult for potential borrowers to get approved for loans. In December the government reported that household debt in the third quarter fell for the first time ever. Consumer spending also fell for the first time in 17 years in the third quarter. Although cutting spending may be advisable for most consumers, it further exacerbates economic troubles for the overall economy.

As the quarter ended, president-elect Barack Obama was laying out plans for a large stimulus package. Many believe the US government has to do more to help the country avoid a long and deep recession. The Federal Reserve has reduced the Fed Funds rate to zero in an effort to spur lending. In addition, the Treasury's \$800 billion TARP program has provided much needed funds to many of America's largest financial institutions. However, as the year ended neither the Fed nor the Treasury's actions had noticeably improved credit conditions and the economy continued to weaken. President-elect Obama is considering many options to help spur economic growth. He has indicated that the emergency stimulus package could very well come in the form of direct spending measures as well as corporate and individual tax cuts.

EQUITIES

Stock prices tested new lows in November before recovering solidly in the last 45 days of the year. Despite the year-end recovery, stock prices plunged in the fourth quarter. Losses were widespread and deep, pushing 2008 returns for several indices to the lowest calendar year levels since the 1930's. The 37.0% decline in the S&P 500 index for 2008 is the second worst performance since the index's inception in 1926. Volatility registered record levels in the quarter, with the S&P 500 index moving up or down more than 4.0% in a day 21 times. To put this volatility in perspective, in the prior ten years, including the fourth quarter, the S&P had 38 moves of this magnitude.

Fear dominated the markets in the fourth quarter! Selling was heavy in every asset class, region, style, and sector. Large, mid, and small cap stock indices all fell more than 20.0% in the quarter.

All ten S&P 500 sectors suffered losses, with Telecom holding up the best, dropping 1.4%, while Financials brought up the rear after falling 36.9%. For the year, Financials was again the worst-performer, falling 55.3%. Consumer Staples, which is considered to be the most economically defensive sector, fell 15.4% in 2008.

International stocks outperformed domestic stocks in the fourth quarter even though the MSCI EAFE declined 21.2%. Foreign governments, particularly in Europe, were slower than the US in reacting to the global slowdown. In the fourth quarter the European Central Bank (ECB) reduced the euro-zone rate from 4.25% to 2.50%. The ECB held rates steady for the first nine months of the year. Although quarterly performance was poor, investors welcomed the monetary stimulus as a signal that the ECB had shifted its focus from curbing inflation to spurring growth.

Emerging market stocks were again hit hard in the quarter. The biggest declines came from the most resource rich countries, such as Russia and Brazil, which dropped 51.3% and 37.3%, respectively. Rapidly falling commodity prices hurt several countries, but were helpful to importers. China fell a modest 10.8% in the quarter as the cost of imported commodities dropped. Emerging market stocks were hit particularly hard this year as tighter credit conditions and slower global growth were significant headwinds for countries that historically have small domestic markets and rely heavily on exports.

FIXED INCOME

Strong returns in the fourth quarter pushed the LB Aggregate Bond's return well into positive territory after very modest return in the first nine months of the year. As money left equities during the quarter it headed toward safe fixed income investments. The LB Government index jumped a handsome 8.1% as prices rose on heightened demand. Investor demand for Treasury Bills was so strong that yields spent much of the quarter near 0.0%. Money spilled into the credit and mortgage sectors as well, with both indices rising over 4.0%. In addition to a flight to safety, lower inflation expectations contributed to heavy buying within the fixed income market. The DJ Commodity Index fell 47.0% in the quarter and inflation expectations fell to near zero for the upcoming five years.

Non-investment grade securities suffered huge losses, with the LB High Yield index falling 17.9% in the quarter. As economic conditions deteriorated in the fourth quarter, the implied default rates on high yield bonds spike to unprecedented levels. High yield bonds finished the quarter offering a yield about 17.0% above Treasuries, well in excess of any level reached historically. Investment grade bonds, on the other hand, performed quite well, rising about 7.0% in the quarter. Fixed income investors were drawn to corporate bonds as yields hit near double-digit levels in October. Investors began moving a little further out on the risk spectrum during the quarter as yields were very attractive.

2009 MARKET OUTLOOK

Last year in our fourth quarter commentary we said "the US economy enters 2008 on shaky ground!" Although we entered the year somewhat cautiously positioned, we did not fully anticipate the problems facing financial institutions and that a global credit crisis would develop during the year. The massive deleveraging that occurred during 2008 pushed the US economy into recession and stock price declines rivaled those seen during the depression.

So what will 2009 look like? Although it is always difficult to accurately make economic and financial predictions, doing so for 2009 is even more difficult than normal. The degree of clarity surrounding future corporate earnings is cloudy at best. Consumer spending, which accounts for approximately two-thirds of US GDP, has dropped off dramatically. Rising unemployment and falling asset values have soured consumers' moods and put a significant damper on spending. Tighter credit conditions have also reduced borrowing opportunities for those that are willing to spend. It will be very difficult for consumers to commence spending anytime soon and the most likely catalysts are lower borrowing rates, easier access to credit, an improving employment

outlook, and stable or rising home prices. Any combination of these catalysts could push stock prices above their depressed levels.

The US Government has taken several actions to revive the economy, including dropping the Fed Funds rate to 0%, setting aside \$700 billion for financial institutions, bailing out the big 3 auto companies, and purchasing mortgage backed securities. So far the results have been negligible and as the year ended the economy was deteriorating at a fairly rapid pace. Since many of these actions are unprecedented, it is difficult to estimate the timing and size of their future impacts. However, it is clear that the government is willing to take non-traditional actions in an effort to stabilize the struggling economy.

We believe the US economy's struggles will continue throughout much if not all of 2009. However, we are beginning to see some positive signals that indicate that the worst from an investment standpoint may be behind us. Specifically, credit spreads on investment grade corporate bonds fell in the fourth quarter. Mortgage interest rates declined and the conforming 30 year mortgage ended the year near 5.0%. Lower rates and lower house prices have pushed housing affordability to a six year high. Although it is difficult to quantify the impacts from the government's stimulus efforts, we believe in the long run that these and future moves will help liquefy credit markets and support economic growth.

Very truly yours,

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