

April 20, 2009

### COMMENTARY

At the start of the first quarter the consensus estimate was that GDP declined 4.0% for the fourth quarter. However, falling consumer spending and exports pulled GDP down a whopping 6.3% in the quarter, the steepest decline in 27 years. Consumer spending, which accounts for about 65% of domestic economic activity, dropped 4.3% and exports fell 23.6% as the global recession put spending on hold. GDP is currently projected to fall 5.2% in the first quarter and 1.8% in the second quarter. Although GDP is not expected to turn positive until the second half of the year, it is projected to trend higher with fourth quarter 2008 marking the low point.

After a short transition period, the Obama administration went to work addressing one of the worst recessions since the 1930's. The Government introduced and amended several new plans during the quarter as the economy continued to falter and job losses mounted. The expansion of the Term Asset-Backed Securities Lending Facility (TALF) and the introduction of the Public-Private Investment Partnership provided support for banks and the securitized debt markets. Despite the Government's efforts to re-liquify the financial markets, banks remained reticent to lend, instead hoarding cash in an effort to shore up their balance sheets. Although banks remained cautious, 3-month LIBOR, the rate that banks charge other banks to borrow funds for 3-months, improved from 1.83% at year-end to 1.27% by the end of the first quarter.

Housing prices continued to slide during the quarter. The most recent Case Schiller home index dropped 19.0% between January 2008 to January 2009. However, the rate of monthly decline slowed in the most recent months. Despite lower home prices, there were some positive developments during the quarter. Mortgage rates fell on continued efforts by the Government to push down borrowing costs. Conventional 30-year mortgage rates fell from 5.2% at the beginning of the quarter to 4.9% at quarter's end. Mortgage applications surged during the quarter, but a majority of applications were for refinancing rather than purchasing homes. The Government implemented a first-time home buyer's credit of \$8,000 to encourage hesitant buyers to purchase during 2009. Although home affordability reached a record high during the quarter, would-be buyers basically stayed on the sidelines as they faced strict borrowing requirements and an uncertain employment outlook.

In response to a declining economy, mounting job losses, and tightening lending standards, consumers focused on repairing their balance sheets. Consumers saved 4.2% of their after-tax income in February and 4.4% in January. Until recently personal savings rates hovered around zero and even dipped into negative territory as consumers' funded their purchases using debt. Consumers cut back spending significantly during the second half of 2008. Finally some pent up demand led to an increase in spending in January and February. Consumer spending improved month over month, but remains well below levels seen 12 months ago.

### EQUITIES

Volatility remained at very elevated levels during the first quarter of 2009. Equity indices experienced both a bull and a bear market during the first three months of the year. By March 9<sup>th</sup>, the S&P 500 index suffered a decline of 25.0% since the start of the year. The major equity indices suffered their worst January and February performance ever. Between March 9<sup>th</sup> and March 26<sup>th</sup>, the S&P 500 Index surged 20.0%. Stocks declined slightly in the last few days of March and the S&P 500 Index closed down 11.2% for the quarter. Despite the quarterly decline, equity indices posted their best three-week run in more than 70 years during the last three full weeks of March and returns for the month offered the best monthly performance in over six years.

Investor sentiment began improving on March 10<sup>th</sup> as Citibank CEO Vikram Pandit stated that the company was profitable through the first two months of the year and was having its best quarter since late summer 2007. Two days later Ken Lewis of Bank of America reported similar results. On March 18<sup>th</sup> the Fed announced it would begin purchasing \$300 billion in long-term Treasuries in an effort to push rates lower and increase money supply. Stock prices jumped as borrowing costs were expected to fall as a result of the Fed's purchases. As March continued, the news generally shifted from pessimistic to optimistic. Durable goods orders increased in March after falling in each of the prior six months. In late March the Federal Housing Finance Agency reported that housing prices rose 1.7% in January, which was the first monthly increase in a year. The positive news kept a stock rally intact through the end of the quarter.

Unlike the fourth quarter, where every equity asset class suffered 20.0% or greater declines, equity returns were much more dispersed in the first quarter. Growth stocks were the clear winners as large, mid, and small cap returns for the growth indices were about 10.0% higher than the value indices. Among S&P 500 sectors, Information Technology was the clear champion, posting a 4.0% return in the quarter. As was the case for 2008, Financials again lagged the other sectors, plunging 28.8% in the quarter despite rising 17.9% in March. The Industrials sector also experienced a 20.0% plus decline and contributed to underperformance by value stocks. Mid cap stocks were the top performers, falling 9.0%, while small cap stocks suffered the biggest declines, dropping 15.0%.

International stocks underperformed large cap domestic stocks by about 2.0% in the quarter. The US Dollar remained a safe-haven for investors and the Euro, Pound, and Yen all declined versus the greenback, which contributed to the underperformance by international equities. Countries which rely heavily on exports logged the worst performance in the quarter. Germany declined 19.5% and Japan fell 16.6%. Despite stimulative measures by the European Central Bank (ECB) and Bank of Japan (BOJ) there remained considerable uncertainty regarding the depth and length of the global recession. The BOJ issued a warning in late March that economic activity continued to worsen and additional stimulative measures were needed. The ECB pushed out recovery expectations to 2010 as economic activity in the region deteriorated over the quarter

In a complete reversal, last year's worst performing asset class grabbed the top spot for the first quarter. Despite rising only 1.0%, emerging market stocks were the clear winners. The same resource-rich countries, Brazil and Russia, that suffered huge declines last year recovered to post quarterly gains of 12.5% and 5.9%, respectively. Commodity prices rebounded from their lows during the quarter and showed signs of stabilizing. Emerging market stocks suffered huge losses in 2008 as investors shied away from risk and sold out of the market. However, as the outlook for the global economy became a little brighter, investor appetite returned quickly and emerging market stocks rebounded nicely.

### **FIXED INCOME**

The bond market continued to behave strangely during the quarter. Investors were attracted to some riskier bond categories, namely high yield bonds and bank loans, but avoided others. High yield bonds, as measured by the CSFB High Yield index, jumped 5.8% in the quarter, and the bank loan funds index increased 8.2%. However, safer investment grade bonds struggled and the LB Credit index declined 1.8%. Government bonds, the top performing bond sector last year, dropped 1.0% despite a 1.8% jump in March as the Government initiated its quantitative easing program and started buying Treasuries. The easing program pushed yields lower, with the 10-year Treasury yield falling 0.47% on March 18<sup>th</sup>. However, by quarter end the 10-year yield had risen 0.15%. The 10-year bond yield increased 0.44% for the quarter and investors lost 2.7% as a result. Longer duration Treasury bonds suffered dramatic losses, with the 30-year bond falling 13.5% in the quarter.

Several fixed income categories posted solid gains in the first quarter after disappointing performance in 2008. During 2008, municipal bond prices fell as investors became increasingly concerned about lower tax receipts and credit downgrades among issuers. Consequently, municipal yields were at historic highs in relation to Treasuries at the start of the quarter. Government stimulus to states notably reduced credit concerns and municipal bonds, as measured by the ML Municipals 3-7 Year index, posted a 2.0% return in the quarter. Asset backed securities (ABS), which include pools of student loans, home equity loans, credit card loans, and auto loans, provided strong returns. The TALF fueled strong demand for these consumer lending instruments. The LB 3-5 Year ABS index returned 9.4% in the quarter after falling 16.7% in 2008.

### **2009 MARKET OUTLOOK**

Investor sentiment improved in the last month of the quarter and continued to improve through the first three weeks of April. Market sentiment was so pessimistic that economic data as well as corporate earnings began exceeding very dreary expectations. "Better than expected" became a commonly used phrase to describe the economic environment. Although, as we stated last quarter, "the US economy's struggles will continue throughout much if not all of 2009" there are some clear signals that perhaps the economy is beginning to mend. The recent six week rally in stocks is indicative of how quickly stock prices can reverse trend and move higher.

The economy still faces some severe headwinds, but we are more optimistic today than we were several months ago. The primary reason for our optimism is that the housing market seems to be forming a bottom. Falling home prices and historically low mortgage rates have pushed housing affordability to its highest level on record. Mortgage application volume has spiked over the last few months and we have experienced an uptick in new and existing home sales. Although inventories remain at elevated levels, they are trending lower rather than higher. An increase in foreclosures could spoil the recovery, but the Government is working with several of the largest lenders in an effort to restructure loans and keep buyers current on their mortgages.

We continue to work diligently to help you achieve your investment goals. Please call us if you have any questions.

Very truly yours,

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