



Economic & Investment Outlook

First Quarter 2009

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January 2, 2009



Investment Outlook

2009 – First Quarter

Economy

- Negative GDP growth for the first two quarters of 2009 followed by below trend growth in the 2nd half. Q1 '09 negative GDP growth of approximately 4-5%. Full year negative GDP growth 1-2%.
- Federal Reserve's Zero Interest Rate Policy (ZIRP) expected to be in place throughout 2009. Quantitative easing will be the Fed's action of choice in 2009. Create money to purchase Treasuries and finance lending facilities – an attempt to lower long-term rates. Fed's balance sheet balloons to \$3 trillion.
- Inflation is not an issue. The CPI will decelerate in the first half of 2009 and be mildly deflationary for the remainder of the year due to lower energy and commodity prices, a global economic slowdown, the prolonged recession and an easy comparison against the strong first half 2008 inflation (8.7%).
- The U.S. dollar has strengthened against other currencies as the global financial crisis has caused a flight to quality. The U.S. dollar is viewed globally as a safe haven. The U.S. dollar may weaken later in the year if inflation accelerates faster than expected. How will the Fed remove excess liquidity from the banking system.



Investment Outlook

2009 – First Quarter

- We anticipate home prices nationally to drop an additional 10% on top of the 20-25% already experienced from the mid 2006 peak. A housing recovery is not expected before year-end 2009 and most likely during the first half of 2010.

Fixed Income & Interest Rates

- Long term rates will drift higher as 1) investors focus on inflationary pressures, and 2) the supply of treasuries increases dramatically as the U.S. deficit widens due to the \$750B stimulus package, \$350B TARP program, and \$600B mortgage debt purchase program . Bond returns over the next 12 months will be constrained by rising intermediate to long-term interest rates. Yields on Treasuries are at historical lows.
- The gradual rise in interest rates will be periodically interrupted by a flight to quality (lower treasury yields) resulting from disruptions in the financial markets.
- High yield corporate bonds appear attractive at these levels. Interest rate spreads are at historical highs. Investors are adequately compensated for the higher anticipated default rates and bankruptcies of these debt issuers.



Investment Outlook 2009 - First Quarter

Equities

- Financial markets will continue to experience higher levels of volatility until the credit markets stabilize and economic activity improves (Q3/4 of 2009). As a Leading Economic Indicator (LEI), the stock markets may begin to exhibit strength by Q3.
- 2009 S&P 500 estimated operating earnings of \$70(e) will be marginally higher than the 2008 S&P 500 estimated operating earnings of \$68(e). Obviously, there is downside risk to this estimate.
- Equity valuations are at reasonable levels but not cheap with the S&P 500 trading at 13.1 times 2009 estimated operating earnings.
- International equities remain relatively attractive due to favorable valuations. This group will also benefit from a weakening U.S. dollar and falling commodity prices.