

2008, Goodbye

2008 was a year of extreme moves in the financial marketplace. It began with a rogue trader losing a record 7 Billion dollars and ended with the collapse of a Ponzi scheme that could result in up to 50 Billion dollars in losses. 2008 should be remembered as the year of the alphabet. SIV, ARS, CDO, CDX, AIG, LIBOR, FDIC, TARP and ZIRP all had an influence on the markets. Every Investment Bank in the United States disappeared, either being absorbed into another entity, recreating them as a bank holding company or declaring bankruptcy. The Republic Money Market Fund “broke the buck”, which caused the Treasury to step in and offer unlimited insurance for the group.

The Commercial Paper market froze up as a result of the rush of redemptions from Money Market accounts. CP is the lifeblood of the industrial world. Companies access the market to provide short term funding for their day to day activities. Money Market Funds are the largest purchaser of Commercial Paper. With the funds hoarding cash in anticipation of investor’s redemptions, companies were forced to pay extremely high short term rates in order to finance their operations. This caused the companies to reduce payroll, reduce expenditures and hang on to their cash.

Equities had their worst monthly performance on record in October. Ironically, it also contained the best daily and weekly returns. Hedge Funds, the sophisticated investment vehicles that charge 2% management fees and receive 20% of the overall return, saw massive redemptions that forced them to liquidate holdings to raise cash. As a result, almost every asset class lost value. Commodities, Equities and REITs were all sold to fill cash coffers. Through it all, the fear of losing money pushed the yields on Treasuries lower. The desire for a return on capital became the desire for the return of capital. Three Month Treasury Bills traded to almost 0% yield and Ten Year Notes yielded 2%. All of this took place in an environment where the Federal Reserve nearly doubled the size of their balance sheet.

Looking ahead to 2009, it appears that the worst may be behind us. Equity markets appear to be forming a base. The credit crisis, which has put a strangle hold on the banking industry, is easing. LIBOR, the rates banks charge to each other, has fallen dramatically after remaining stubbornly tight for most of 2008. Oil prices, remember \$140 per barrel, have fallen over 70%. This has taken gasoline prices, one of the consumer’s largest expenditures, back to five year lows.

The consumer still remains the key to the whole recovery process. They are concerned about their jobs, their wealth, their houses and the economy. Houses, usually their largest investment, still are not selling. That should change now that mortgage rates are beginning to fall. Food and gas prices are all lower than they have been in years, giving them some additional discretionary income that they didn’t think they would have. The shock of 2008 will have to wear off before the consumer’s confidence in the economy will begin to increase. That should happen sometime in the second half of 2009.

The market should be range bound for the first few months of 2009. There will probably be a small rally in the January in anticipation of the Obama administration taking office and a fiscal relief package being passed. However, it should be short lived as the realities of the economy take hold. Most analysts

have the S&P 500 earning between \$62 and \$68 for 2009. As a pure pricing mechanism, a P/E of 10 to the lower end and 15 to the upper end implies a range of 620 to 1020 for the Index. While the market may revisit the lows from November, there is a large amount of cash on the side that will be invested.

There is plenty of opportunity in the fixed income markets to garner equity like returns with lower volatility. Longer dated Corporate Bonds and Municipal Bonds (backed by a taxing authority) are all attractive. Treasuries hold little value at their current yields. With the current FDIC insurance, investors are better off with bank CD's than with Treasury Bills. The only exception is Treasury Inflation Protection Securities, TIPS. These securities pay a fixed yield and have their principal adjusted up or down depending upon what the Consumer Price Index returns. Currently these securities are anticipating the lower inflation that will result from the drop in commodity prices from the second half of 2008. However, the drop in prices experienced in 2008 was not from price deflation but rather from price destruction and should eventually rebound.

With the Treasury's printing presses in overdrive, dollars are flooding the monetary system. As these dollars are released into the economy, one of the byproducts will be inflation. This is something that the Federal Reserve is hoping to occur. The Federal Reserve wants to have inflation lift the economy so the spiraling effect of deflation doesn't get a foothold. The psychological effect of deflation is far worse than the economic impact of inflation.

2009 will probably have some surprises and offer opportunities to tactically allocate portfolios along the investors risk parameters. It will most likely not make up the losses from 2008. However, long term investors may want to take the view that they are being given the chance to invest in quality companies and securities at attractive prices. Globally, China, Latin America, and the Pacific Rim will continue to grow. Infrastructure will become the new hot sector. The housing sector should begin to see a turnaround as the inventory of unsold homes declines. Commodity prices should rebound. The dollar will most likely be stable to slightly lower in the coming year. All of these ideas are taken into consideration when structuring your portfolio.

I would like to wish all of you a Happy New Year. I look forward to continuing our valued relationship with each other. I hope that you feel free to contact myself or your advisor if you have any questions or comments.

Best Wishes for the Coming Year,

Mike Marietti

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