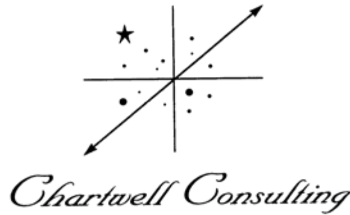

CHARTWELL REVIEW

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Alphabet Soup

Like characters in a Samuel Beckett story, investment markets were Waiting for Geithner during the first quarter. Hope for the Treasury Secretary's plans to buttress the banking and credit system was initially replaced with despair. Investors were disappointed by the initial realization that no immediate plan or quick salvation was forthcoming. Markets seem to have become mesmerized by what the Federal Government is doing, will be doing, could be doing, and shouldn't be doing, as it attempts to replace massive doses of private sector liquidity and final demand in an effort to counter the worst domestic and global economic contraction since World War II.

Treasury Dept.

TARP: AIG, PPIP, AGP, AIFP, ASSP, CPP, MHA, TIP ($700bn committed; $378bn invested)

Federal Reserve

CPFF, MMIFF, TALF, TAF, TSLF, bailouts, swaps ($6.2T committed; $1.7T invested)

Federal Stimulus Programs

ESA2008, ARRA2009, Student Loan G'tees ($1.1T committed; $185bn invested)

Other Initiatives: AIGR, MMGP, TLGP, GSE bailouts

($2.6T committed; $624bn invested)

The US Government is fully engaged in a far-reaching and fiscally enormous effort to rescue our economy from the clutches of a second Great Depression. There are no parallel examples of this initiative in our history, or in that of any other nation. You can track developments in these programs via this link,

http://money.cnn.com/news/storysupplement/economy/bailouttracker/

Table 1: Index Benchmarks

Market Index	Trailing Returns *				
	Q1 09	**1 Yr**	**3 Yr**	**5 Yr**	**10 Yr**
S&P 500	(11.0)	(38.1)	(13.1)	(4.8)	(3.0)
U.S. Large-cap Stocks	(11.0)	(37.3)	(12.3)	(4.9)	(4.1)
U.S. Mid-cap Stocks	(9.0)	(40.8)	(15.5)	(3.5)	2.3
U.S. Small-cap Stocks	(15.0)	(37.5)	(16.8)	(5.2)	1.9
Foreign Stocks (**devel**)	(13.9)	(46.2)	(14.1)	(1.7)	(0.5)
Foreign Stocks (**emerg**)	1.0	(46.9)	(7.9)	6.2	8.1
T-bills (3 month)	0.1	1.0	3.4	3.2	3.3
U.S. Aggregate Bonds	0.1	3.1	5.8	4.1	5.7
High Yield Bonds	5.0	(20.3)	(5.0)	(0.3)	2.4
Global Bonds, unhedged	(4.8)	(3.7)	7.7	4.6	5.8
CPI, annualized	***2.2***	***(0.4)***	***2.1***	***2.6***	***2.6***
Dow AIG Commodity	(6.3)	(45.0)	(9.8)	(3.3)	6.4
Chartwell Global 65/35	(6.3)	(26.6)	(5.5)	1.0	3.0

Table 2: Average Mutual Fund Returns

Fund Category	Trailing Returns *				
	Q1 09	**1 Yr**	**3 Yr**	**5 Yr**	**10 Yr**
U.S. Large-cap	(8.8)	(37.6)	(13.2)	(4.4)	(1.6)
U.S. Mid-cap	(6.9)	(38.1)	(14.1)	(3.4)	2.7
U.S. Small-cap	(11.5)	(37.8)	(16.4)	(4.7)	4.0
International Lg. Cap	(13.2)	(46.0)	(14.1)	(1.7)	1.0
International Sm. Cap	(10.2)	(49.4)	(16.9)	(1.4)	4.6
Emerg. Mkt. Equity	(1.6)	(48.0)	(9.7)	5.3	8.6
Balanced/Hybrid	(5.1)	(24.9)	(6.7)	(1.3)	1.5
General Bonds	0.4	(5.1)	2.0	2.1	4.5
Government Bonds	(0.2)	6.7	7.1	4.8	5.7
High Yield Bonds	3.6	(19.1)	(5.2)	(0.7)	1.6

* Annualized trailing returns for periods ending 3/31/09.

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Overview

All of today's investment decisions are clouded by confusion over what direction to proceed. It is truly unchartered waters for today's plan sponsors and boards of trustees. This uncertainty casts a continuing shadow over risk markets in the first quarter, reversing the bear market rally that had taken place through early January. By March 9th, the US stock market had thoroughly breeched its November low, as the S&P hit a devilish 666, down from 903 at year-end (that's -26%!), before staging a sharp rally through quarter's end and into April. Even so, as table 1 indicates, the damage to equity holdings during the quarter was deep and substantial, except for emerging markets portfolios.

The S&P 500 has posted its sixth consecutive quarterly loss, which sad event has occurred only one other time in the past 80 years. Employment, a key to economic recovery, instead continued to fall in the quarter, with the largest losses in the construction and manufacturing sectors. Consumer sentiment is low, given the loss of wealth (housing prices have declined by 19% since last March), tight credit, and a dismal job market. Thus, consumer spending and investment have been curtailed. Businesses have responded by slashing capital spending and inventories, in response to slowing sales and tighter lending conditions. Further pressure on our domestic recession has been exacerbated by a steep decline in foreign demand for U.S. goods and services, as our major trading partners have also fallen on hard times.

As we now move through the 2nd quarter, many market strategists are expressing a cautious optimism that the worst is behind us. With new and recent accounting changes promising to help bank assets, and economic news ranging from no worse to slightly better than expected, a wave of positive sentiment has entered the marketplace. The S&P 500's recent rally from 666 to 875, has certainly helped the mood. This was initially attributed to market favor for Geithner's mid-March announcement of the Private-Public Investment Partnership to buy up at least $500bn of "toxic assets" from financial institutions, in order that the latter might be enabled to make new loans and investments.

While market sentiment may be on the upswing, our financial and economic crises are clearly not over. In fact, when compared to previous market cycles, the pace and scope of any recovery is expected to be severely limited. Concerns center on the current level of national indebtedness relative to our collective income (i.e., GDP), which is far higher than it's been in the past 100 years. In a depression, debt levels are too high, and cash flow is insufficient to service the interest on debt. Debt deflation then occurs, which started in 2006 for households with slumping real estate values. The ideology that curing private (consumer and corporate) debt problems with increased public debt (which still has to be serviced by taxpayers) is risky business.

The Recession Deepens Further

Non-farm **payroll employment** declined 2.1 million persons in the first quarter, after dropping 1.5mm persons during the fourth quarter. The "seasonally-adjusted" unemployment rate shot up from 7.2% to 8.5%. In fact, there are an additional 1mm persons not employed if you discount seasonal adjustments, making the unemployment rate is 9.0%. We expect to see continued very weak employment numbers in the months ahead. Domestic businesses are hemorrhaging jobs as they attempt to right-size themselves in order to protect operating margins in the face of lower activity.

Last quarter we reported that some economists were predicting an additional two million job losses in 2009, on top of the 2.6mm jobs lost in 2008. We hit that additional number in the first *quarter* of 2009.

Consumer prices, including food and energy, rose at an annualized rate of 2.2% during the first quarter, after declining at an annualized rate of 14.7% during the 4th quarter. The CPI index ***decreased*** over the past year (down 0.4%), driven by steep declines in energy and transportation prices. It was the first year-over-year decline since 1955, and is definitionally *deflation*.

Our country's **industrial production** declined at an annual rate of 20% during the 1st quarter, compared to a 13% rate of decline in Q4 and a 9% drop in Q3. Manufacturing production has declined for 5 straight quarters. At 97.4% of its 2002 average, total output in March fell to its lowest level since December 1998. The capacity utilization rate for total industry also continued to slip, falling to 69% versus its 25-year average of 81%. Utilization of manufacturing capacity slipped to 65%. Capacity utilization is at a 25-year low point, and poised to decline further. Not surprisingly, business investment spending dropped at a huge 22% annualized rate in the 4th quarter, and is reported to have declined at an even faster -38% rate in the first quarter!

Pulling all the data together, the Commerce Dept's final indication was that our **GDP** fell at an annualized rate of 6.3% during the 4th quarter, sharply lower than the original estimate of -3.8%. Last quarter we noted the final figure would be worse than originally indicated. The Fed's estimate that 1st quarter GDP declined at an annual rate 6.1%, is a 2% greater decline than had been forecasted by the economic community.

- Exports declined at a 30% rate, but imports declined even faster. Net trade added 2% to GDP (watch that this doesn't turn around in the final numbers);
- Personal spending surprisingly rose by 2.2%, and in the process added 1.5% to GDP growth;
- Business inventories were cut by $104bn, subtracting 2.8% from GDP growth. The positive spin is that businesses will soon have to begin re-stocking.
- Government spending was indicated as *lower*. That's poised to change!

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"Spread" Bonds Mount a Comeback

By the end of December, Treasury bill, note, and bond yields had plummeted to post-WWII lows, as investors paid up for the certainty of being paid back. As Will Rogers said, "sometimes return ***on*** investment is important, other times I'll take return ***of*** investment."

Thus, entering Q1 the bellwether 30-year T-bond was priced at 137% of its par value, and yielded just 2.7%. Two-year Treasuries yielded just 0.8%. The Federal Reserve had just taken the unprecedented step of slashing its Fed Funds rate target to the "0-0.25% range," thus reducing short-term base rates to their lowest point ever in America. Finally, the Fed had pledged to "employ all available tools" to turn the economy around, including the direct purchase of long-term Treasury securities if the circumstances warrant.

In short, everyone who wanted to buy Treasuries, had probably already bought 'em, and the stage was set for Treasury bond prices to falter compared to non-Treasury sectors ("spread bonds"). That's exactly how the first quarter ultimately played out (see table 3, below).

Table 3: Spread Bonds Excess Returns

Excess Returns versus Treasuries, duration-adjusted (%)

Bond Sector	1Q '09	4Q '08	2008
Lehman Aggregate	0.7	(3.0)	(7.1)
US Agencies	0.4	0.1	(1.5)
Agency MBS	1.7	(2.0)	(2.3)
Comm'l MBS	(1.4)	(20.4)	(32.7)
Asset-Backed bonds	7.7	(11.7)	(22.2)
Invest. Grade Credit	(0.2)	(5.4)	(17.9)
High Yield Credit	6.4	(24.9)	(38.3)
Primary Non-U.S.	2.0	(5.1)	(6.4)
Emerging Markets	5.6	(17.8)	(28.4)
AAA MBS (subprime)	(38.4)	(27.8)	(40.1)

Nearly all of spread bonds' outperformance was shoehorned into January. The Aggregate index beat relevant Treasuries by 0.9%. Corporate bonds were especially strong in January, outperforming by 3.8%, as BBB's beat by 5.5% and A's beat by 3.3%. But by quarter's end, the Corporate index had *underperformed* by 0.2%. Industrial corporate bonds were very strong relative performers in January (+5.1%), and pretty much stayed that way throughout the quarter (+3.3%). The difference makers between January and the quarter were the bonds of financial institutions. They outperformed Treasuries by 1.2% in January, but closed the quarter on a very sharp down note, underperforming by 6.6%.

Most of the securitized bond sector (which makes up nearly half of the Aggregate benchmark index), was steadily attractive throughout the quarter.

Agency-backed mortgage bonds (representing 90% of securitized bonds) outperformed by 56bps in January, and by 172bps for the quarter. With the Fed purchasing up to $500bn of Agency guaranteed MBS, and the Treasury implementing an agency mortgage purchase plan, mortgage prices have rallied. Together, these plans have pushed spreads tighter and have been very supportive for the agency MBS market.

The big negative in the securitized arena was again non-agency securitized bonds backed by home loans. Good performance in January (+3% in relevant terms) was obliterated in February, as the sub-sector fell over 30%. Prices rallied back some in March, especially following Giethner's outline of the P-PIP program, but most feel this program is a long way from getting up and running. In the interim, confidence in non-prime mortgages remains in decidedly short supply. The remainder of the ABS sector enjoyed superior outperformance.

The White House projects the federal deficit for the 2009 fiscal year ending Sept '09 will total $1.75 trillion. Last year's record-setting deficit was only $455 billion. After taking into account fiscal deficits and funding for the alphabet soup of market support programs, it is estimated the Government's cash borrowing needs will exceed $2.5T trillion this year.

Unprecedented levels of new bond issuance will ultimately put pressure on the Treasury yield curve to rise (and prices to fall), despite the Fed anchoring short-term rates at 0%. We saw the beginnings of that in the first quarter (and through April). T-bill yields rose just 10bps, to 0.2%, the 2-year Treasury yield was unchanged at 0.8%, but the 10-year yield rose by 35bps (to 2.7%), and the 30-year yield rose by nearly 90bps, to 3.6%. The resulting price declines saw the 10-year Treasury bond post a total return of -2.7% in the quarter, while the 30-year returned -13.5%! Table 4 details the first quarter's total returns of primary bond sectors.

Table 4: Bond Market Total Returns

Bond Index	1Q '09	4Q '08	2008
Aggregate Bonds	**0.1%**	**4.6%**	**5.2%**
3-mo. T-bills	0.1	0.3	1.8
US Treasury, long	(5.2)	18.7	24.0
U.S. TIPS, 1-10 yrs	5.9	(5.2)	(2.4)
Agency MBS	2.2	4.5	8.5
CMBS	(1.4)	(15.0)	(22.7)
ABS	7.8	(6.8)	(12.7)
Inv. Grade Credit	(1.8)	4.0	(3.1)
High Yield Credit	5.0	(17.6)	(26.4)
Non-US Global, Hedged	0.1	5.5	8.0
Non-US Global, Unhedged	(5.8)	9.9	11.4
Emerging Local Markets	(4.0)	(6.8)	(3.9)

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U.S. Equity Markets: Bust and Boom

The first quarter of 2009 ended much differently than it began for global equity markets. During January and February, markets resumed the collapse that first began in July 2008, after what had been a sharp December rally. On March 9th, the S&P500 hit 667, down 26% since December 31st, and then abruptly changed direction. Geithner's long awaited plan, the P-PIP, to deal with toxic assets in the US financial system was announced, and global quantitative easing gained footing. Both have been cited as catalysts for the rally. Regardless of the proximate cause, during March global equity markets experienced their best monthly returns since December 1999. In what some have called a "dash to trash," those stocks that were down most and seemingly priced for bankruptcy, rallied the most. Despite this quarter-end rally, global equity markets finished the quarter deeply in negative territory.

The value effect (value > growth) was once again *not* evident during the quarter, across the capitalization spectrum. This represented a continuation of what we saw in 2008. Growth-oriented portfolios lost far less than value (see table 5), largely because most value portfolios continue to be much more heavily invested in financial services stocks than are growth portfolios, and the financial services sector was the weakest in the 1st quarter (see table 6). Conversely, growth portfolios are normally more heavily invested in info tech stocks, which was the best performing sector of the quarter.

Table 5: U.S. Equity Market Size/Style Returns

Periods ending March 31, 2009; % returns

	1Q '09	2008	Trailing Periods 3-Years	10-Years
Growth				
Large Cap	(4.4)	(36.1)	(9.8)	(6.2)
Mid Cap	(3.4)	(44.3)	(14.9)	(0.9)
Small Cap	(9.7)	(38.6)	(16.2)	(1.6)
Micro Cap	(8.8)	(44.6)	(21.8)	na
Value				
Large Cap	(17.5)	(36.1)	(14.8)	(2.2)
Mid Cap	(14.7)	(38.4)	(16.7)	3.1
Small Cap	(19.6)	(28.9)	(17.5)	4.9
Micro Cap	(20.5)	(34.9)	(21.7)	na

The size effect (small > large) was a mixed picture during the 1st quarter, with mid-cap stocks outperforming both large-caps and small-caps. This had been decidedly *reversed* in the 4th quarter, as the absence of market liquidity favored large cap stocks.

We have been recommending reduced small-cap exposure relative to the "market neutral weight" for the last two years. This followed years of recommending just the opposite. Both strategic positions turned out to be right (go figure!). However, longer-term experience continues to support the size effect, and we're mindful of a turnaround in the relative performance of small-cap stocks. For now, though, our continued caution with small caps is supported on fundamental grounds (although they did outperform in April). The domestic economy is not helping domestic companies' local sales, nor is the Dollar's relative value helping with exports. Further, the credit crunch we're experiencing is a decided negative for smaller firms, which are the first to lose bank lines and access to public debt markets.

Table 6: U.S. Sector Returns in the 1st Quarter

	Large-cap Returns *(%)*		Small-cap Returns *(%)*	
Sector	**1Q '09**	**2008**	**1Q '09**	**2008**
Cons. Disc.	(7.2)	(46.5)	(1.3)	(46.5)
Cons. Staples	(10.5)	**(15.6)**	(8.8)	**(29.8)**
Energy	(11.0)	(35.7)	(15.1)	(55.4)
Financials	**(26.7)**	**(53.4)**	**(24.2)**	**(29.6)**
Health Care	(7.3)	(22.2)	(7.6)	(31.5)
Industrials	**(20.3)**	(41.1)	**(20.9)**	(39.1)
Info Tech	**4.0**	(42.5)	**0.3**	(45.2)
Materials	**(0.8)**	(46.6)	(12.5)	(46.8)
Telecom Svcs	(4.7)	(36.0)	**(3.0)**	(45.0)
Utilities	(11.5)	(29.7)	(11.0)	**(23.5)**

In a weak market, the quarter's weakest performers were again the "headline" financial stocks, especially those in the diversified banking, regional banking, and insurance industries. Prospects in this sector are poor, but one must be careful with that conclusion. All financial services firms aren't going to be bankrupted or nationalized. Recognizing this, markets rotated heavily into these stocks in March, and the sector was up 18%.

In the first quarter, the industrials, materials, financial services, and consumer discretionary stocks slotted into the growth indices, significantly outperformed (by 10% or more) stocks of the same sectors that were slotted into the value indices. Hence, the term, "dash to trash."

US Equity investors continued to endure enormous intra-market volatility during the first quarter. In fact, by the long time definition of the terms, we've experienced two bear and two bull markets in the 161 trading days since Lehman was allowed to fail. During this time frame, the US stock market has posted peak-trough-peak runs of -28%, +12%, -25%, +24%, -28%, and +29%.

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International Stocks – Beginning to Simmer

As in the United States, the first quarter of 2009 ended much differently than it began for international equity markets. Through February, markets fell steadily to an interim low on March 9th. During this 10-week period, international stocks in every sector declined by double digits, with financials being hit the hardest (dropping more than 40%). Bad economic news peaked out from every window. Unemployment rose in every major region; consumers switched from being spenders to savers and global trade contracted significantly. Industrial production seized up in the manufacturing juggernauts – Germany, Japan, and China. By the end of February, equity valuations were driven down to 1980's levels and stock dividend yields around the developed world were well above government bond yields.

Enter quantitative easing (in the UK and Japan) and the long-awaited US plan to deal with toxic financial assets. During the last three weeks of March, every international sector posted gains, with financials surging 35%. March proved to be the best month for global equity markets since December 1999. The US$, which had been strong through February, retreated in March.

Table 7: International Markets Returns

	U.S. Dollar Return %		Local Currency Return %	
(index level = net)	*1st Qtr 2009*	*2008*	*1st Qtr 2009*	*2008*
EAFE + Canada	**(13.1)**	**(43.4)**	**(9.4)**	**(40.3)**
- EAFE Growth	*(12.4)*	*(42.7)*	*(8.6)*	*(39.7)*
- EAFE Value	*(15.5)*	*(44.1)*	*(11.7)*	*(40.9)*
- Europe	(14.5)	(46.4)	(17.0)	(38.9)
- Pacific, ex-Japan	(2.2)	(50.5)	(18.4)	(42.2)
- Japan	(16.6)	(29.2)	(22.3)	(42.6)
- United Kingdom	(10.7)	(48.3)	(8.7)	(28.5)
Int'l Small Cap	**(8.9)**	**(47.0)**	**(4.6)**	**(45.0)**
Emerging Mkts	**1.0**	**(53.3)**	**4.1**	**(45.9)**
- EM Asia	*1.6*	*(53.0)*	*5.9*	*(47.3)*
- EM Europe & ME	*(3.6)*	*(63.2)*	*2.7*	*(59.6)*
- EM Latin America	*4.9*	*(51.4)*	*4.2*	*(37.8)*
- EM BRIC	*4.9*	*(59.4)*	*4.9*	*(54.0)*

Despite this quarter-end rally, international markets finished the quarter in negative territory. International stocks did fare slightly better than our domestic markets, due in large part to emerging markets. This is apparent when comparing the developed market EAFE+Canada index (-13.1%) result to the MSCI All Country World ex-US index (-10.7%) result. Regionally, Europe was weak, dropping -14.5%, as France, Germany and Italy all fell -16% to -20%. The Nordic countries were the best relative performers in Europe, with Norway posting the only positive result in developed markets (+3.3%). After last year's solid relative performance, Japanese stocks struggled (-16.6%). This pulled down an otherwise resilient Pacific region (-12.7% *including* Japan; -2.2% *excluding* Japan). Buoyed by better relative performance for the materials sector and glimmers of higher growth in China, Australia, New Zealand and Hong Kong all dropped less than 3% during the quarter.

As in the US, value oriented portfolios underperformed growth, although the differences were moderate. The best performing international sectors during the quarter were materials, energy, consumer discretionary, and technology. The weakest sectors were financials and utilities. Unlike the US, international small caps outperformed large caps in all regions except Asia.

During the first quarter, emerging markets were the only positive performing segment of the equity markets, gaining 1% overall in US$ terms, and 4% in local market terms. The largest emerging markets led the rebound, as the BRIC countries (Brazil, Russia, India and China) collectively rose 4.9%. Natural resource-rich Brazil and Chile were best, advancing +12.5% and +13.6%, respectively. Last year's worst performing emerging market, Russia, gained 9.8%. China gained 1.3%, while India was the only negative performer amongst the BRIC countries, falling -1.5%.

Not all emerging countries fared as well. Eastern Europe ex-Russia declined 26.5% during the quarter. Poland continued to struggle, and was the worst performing market, dropping -31.5% during the quarter. This, despite a much better "balance sheet" than most of its regional neighbors. Conversely, the best performing emerging market was one of the smallest and most beleaguered, Pakistan, which gained 37.7%.

The pace of contraction in the global economy may be easing as result of the unprecedented levels of worldwide fiscal stimulus gaining traction. Business sentiment readings have recovered slightly from low levels, the ratio of new orders to inventories has stabilized in Europe and the housing market in the UK is slowing its descent. In China, hope for higher growth has emerged. This has propelled markets that fuel China's growth. A disconnect between prices and fundamentals is providing attractive *long-term* investment opportunities. International stock valuations by the basic metrics of P/Sales, P/Book, P/Earnings, and Dividend Yield are highly attractive. Perhaps it's time to be optimistic.

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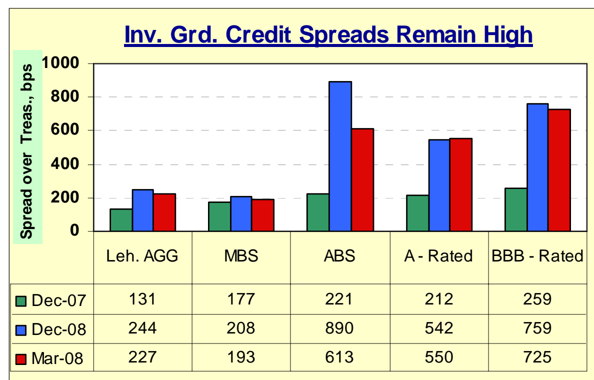
Back Page Perspectives

Conventional “wisdom” holds that value stocks offer better downside protection than growth stock portfolios, because they reflect lower market beta.

In a mean-reverting, normally distributed world, this translates into lower short-term upside, but also lower short-term downside. However, this theory has been virtually unobservable during the past six years. Instead, we’ve seen the impact of large sector weight differentials, followed by a fundamental breakdown in that overweighted sector. In the past eighteen months, it’s been the sharp over-representation of financial services stocks in value indices, and the subsequent crash of the sector. In the early part of this decade, it was the over-representation of information technology stocks in growth indices, followed by a crash in that sector.

Following the tech crash, those supposedly “cheap” stocks did not lead the next upleg, because the market determined the world had changed. We think a similar situation will occur in the current market. Despite the March/April rotation to financial stocks (a dead cat bounce?), it’s likely that in a world focused on de-leveraging, the prime beneficiaries of leverage – banks, will not be the next market cycle’s leaders. If so, value indices will continue to underperform growth. And, value managers who insist on being neutral sector-weighted will underperform every other strategy (unless their security selection is overwhelmingly favorable).

The current equity market rally continued strongly throughout April, as reported Q1 earnings have not been worse than forecasted (and much better than had been feared). US large cap stocks were up 9.6%, US small cap stocks up 15.5%, developed market international stocks advanced 13%, and emerging markets stocks were up 16.5%. Domestic markets are within 2% of year-end valuations (emerging markets are up 18%). The S&P’s May Day close at 878 “took out” the February 9th close of 875. Next stop is either a test of the January 6th close at 935 on the high side, or a possible re-test of the November 20th close at 752.



	Leh. AGG	MBS	ABS	A - Rated	BBB - Rated
Dec-07	131	177	221	212	259
Dec-08	244	208	890	542	759
Mar-08	227	193	613	550	725

The stock markets’ volatility has been great for prop trading desks and, selectively, long/short hedge fund managers. But, it’s anathema for institutional plans which meet quarterly. Strategic asset allocation, with its reliance on normally distributed return patterns, and stable asset class correlations, is at risk of giving way to tactical trading models.

For those exhausted by the stock markets’ volatility, the bond markets remain very attractive. As the table on this page makes clear, one can still capture very handsome excess spreads away from the Treasury sector, with limited credit risk. For those with a greater risk appetite, and more optimism about our economic recovery, junk bonds offer double-digit return potential. Those willing to bet on the ultimate worth of the US consumer and his/her home, can easily find similar return potentials. Conversely, those who are very pessimistic about the domestic investment scene and our ability to finance our way out of the mess we’re in, can gravitate to international bonds, and bet against the US Dollar.

The domestic recession, now well into its second year, is almost certain to be the longest since World War II. The U.S. has once again shared its slump with global neighbors near and far. Although the rise of Asia and an improving picture elsewhere have reduced overall dependence on the U.S. as the leader for global growth, the U.S. is still a key part of the global economic equation. Globalization of trade and capital flows have also resulted in the most synchronized global recession in historical memory, and one that seems likely to be the deepest downturn in the industrial countries since the Great Depression of the 1930s. It comes after an unprecedented period of world economic growth, making the contrast even more severe.

Last quarter, we said, “a portfolio rebuilding phase will be the next major leg – after a natural settling, or cooling off, period.” Further, we noted that volatility would certainly continue into 2009. Finally, and as the 1st quarter GDP estimate made very clear, we noted “companies are undertaking major initiatives to streamline operations, which should enhance stock returns in time.” We continue to believe in all this. We just don’t think that stock markets will simply grow to the sky, *this time*, without interruption.

Sell high, buy low. See you next quarter!

Natalka Bukalo ***Richard Shaffer, CFA***

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