



HIGHLAND ASSOCIATES

QUARTERLY MARKET REVIEW

April 2009

Worsening economic conditions and another frustrating period in the investment markets characterized the first quarter of 2009. Entering April, the US economy remained in a recession that began in December 2007. At 14 months, the duration of the current contraction is approaching the 16 month span of the 1973 and 1981 recessions, the longest of the post World War II era. Expectations for 2009 reflect further slowing (including another sharp decline in Q1) until an eventual rebound in either late 2009 or perhaps 2010. Positive news is scarce, but market participants do appear to be somewhat encouraged by data that suggest that the economy is weakening at a decelerating pace. The Conference Board's Index of Leading and Coincident Economic Indicators continue to fall, but now show some signs of stabilizing. Three of the 10 leading indicators, real money supply, interest rate spread, and the index of consumer expectations, and 2 of the 4 coincident indicators, personal income less transfer payments and manufacturing and trade sales were actually positive in March. Many are optimistic that the worst is now behind us. However, with the expectation of a 1st quarter contraction in GDP nearing the degree of last quarter's drop, rising unemployment, and further asset price declines, the short term outlook remains grim. It appears that the current recession is likely to surpass the duration and depth of any contraction in the last 60 years. The US government continues to deploy a dual approach of traditional as well as non-traditional measures aimed at stabilizing the financial system and stemming the current

economic downturn.

Government Action

The coordinated policy response from the Federal Reserve, the Treasury, and the FDIC continues into 2009. The FOMC recently announced that it would expand its agency mortgage backed security and agency debt purchase program to a total program size of \$1.45 trillion to enhance liquidity in those markets. The pending Public-Private Investment Program (PPIP) and Term Asset-Backed Securities Loan Facility (TALF) programs commit another \$2 trillion to promote stability and liquidity in the financial system. The goal of the PPIP is to facilitate the purchase of distressed assets from banks by reviving the market for distressed asset-backed securities through a combination of guarantees and low cost leverage. Capital will come from the TARP plan (\$75-100 billion) and financing from the FDIC (\$820 billion) which will oversee the asset auctions and private fund managers participating in the program. The TALF will extend 3 year non recourse loans to investors purchasing AAA rated asset-backed securities. The New York Fed may loan up to \$1 trillion, and the Treasury will backstop the first 10% of any losses. The Fed also announced that it would begin purchasing up to \$300 billion in long term Treasuries, so-called quantitative easing, utilizing yet another monetary policy tool in an attempt to combat the economic crisis. Critics point to the overall size of the current government commitment of nearly \$12 trillion (roughly equal to current US GDP), but it is important to

note that this figure includes both guarantees and spending commitments. Utilization across the spectrum of government programs has been relatively low to date. As of April 9, 2009 only \$3.1 trillion, roughly 25% of the total commitment, is deployed. A large portion of the \$12 trillion total commitment is in the form of guarantees that will only be called on in a worst-case scenario where the government is forced to step in and backstop assets. It is difficult to forecast the ultimate dollar amount of capital deployed through the various programs, given the government's ability and tendency to alter current and prospective programs, uncertain participation rates, and differences in actual spending and budget projections. Clearly, at even current utilization levels, government commitments are large enough to cause a myriad of concerns including unintended consequences within the system and any subsequent economic fallout.

US Economic Update

Fourth quarter GDP fell 6.3% the sharpest drop since 1982, with a 4.3% drop in personal consumption responsible for nearly half of the decline. Consumer spending on durable goods (including autos) was down 22% for the quarter highlighting the ongoing troubles in the auto industry. Overall, motor vehicle output contributed -2% to GDP in the 4th quarter. Most economists expect that 1st quarter 2009 GDP will likely fall at a rate similar to last quarter. Industrial production continues to fall as companies seek to reduce inventory levels in response to lighter final demand. Consumer spending is showing some life in 2009, exhibiting a slight increase after the sharp decline last quarter. There could be further positive news on the income front. Social Security adjustments should result in a \$3 billion increase in

monthly income while one time \$250 Social Security payments expected in May could boost income by \$13.5 billion. President Obama's "Making Work Pay" withholding tax reductions begin in April, and could increase after tax income by \$4 billion. Finally, preliminary estimates for tax refunds reflect a \$25b increase over last year's levels. These measures are expected to more than offset the lost wage and salary income through mid year and provide a boost to consumption. Spending may actually be a positive contributor to GDP for the first time since the 2nd quarter of last year.¹

The jobs outlook however, remains bleak, as the unemployment rate, now at 8.5%, continues to rise. The economy has shed over 5 million jobs since the recession began, and job losses are likely to continue in the short term with the unemployment rate expected to approach double digits later this year. Even a rebound in economic activity is not likely to have a sizable immediate impact on employment, as job growth typically lags the broader economic cycle.

Price levels appear to be stabilizing after a deflationary trend in the 4th quarter. Headline CPI was slightly positive each of the first 3 months of 2009, but current price levels reflect a 0.4% YOY decline. It is important that price levels remain stable in the current environment to allow the Fed to continue to aggressively combat the economic slowdown and take additional measures to secure the banking system. While deflation remains a short term threat, the most ominous danger, in terms of consumer prices, is the longer term prospects for inflation given the sheer volume of liquidity injected into the system through US government policy.

¹ Chandler, Marc, "Good News To come on US Income and Spending", April 10, 2009

The Great Depression, Great Moderation, and Great Recession

The current economic environment has been dubbed the “Great Recession”, recognizing that this contraction is likely to be longer and more severe than any other in the last 60 years, while also acknowledging that our current struggles have not reached the devastation exacted on both the US economy and the American people during the Great Depression. While some have offered the 1930’s as a sign of what the US may face in coming years, the extent of and government response to the crisis of today differs greatly from the economic catastrophe of the 1930’s.

Federal Reserve Chairman Ben Bernanke has argued that the Great Depression was caused by tight monetary policies instituted by the Fed in the late 1920’s into the 1930’s. While this assertion may oversimplify the cause of the Depression, it offers a powerful assessment of the monetary policy mistakes and the ability of the Fed to implement effective policy measures to address the crisis. The Fed had begun raising the Fed funds rate in 1928 and continued to do so through the early 1930’s. In 1900, the Gold Standard Act officially placed the US on the gold standard requiring the Treasury to hold at least \$150 million in gold reserves with a set price of \$20.67 per ounce. US “gold dollars” were redeemable for gold, and the Treasury was required to issue bonds to replenish the gold reserve if it dipped below the prescribed levels. In essence, the gold standard capped the money supply in the US at the required amount of the gold reserve held by the Treasury. The Fed was therefore limited in its ability to increase the money supply. As the crisis intensified, a run on the dollar ensued where dollars were sold (redeemed) for gold. In an attempt to stem the run, the Fed increased interest

rates again to support the value of the dollar. The measure was unsuccessful. The money supply continued to shrink while interest rates rose. In 1933, FDR made it unlawful to own or hold gold coins, bullion, or certificates and gold as a form of payment was outlawed. The Gold Reserve Act of 1934 essentially nationalized all gold and devalued the gold dollar to \$.60 (by increasing the price of gold to \$35/oz) in an unsuccessful effort to generate inflation in the system.

FDR’s New Deal policies (including Social Security, the FDIC, and the SEC introduced by the Social Security Act of 1935) ushered in an unprecedented era of fiscal response to the economic crisis.

Although the US economy rebounded between mid 1933 and 1937, the economy slipped back into recession by May 1937 as government spending and investment declined. It was not until 1940 and the onset of WWII that US GDP approached pre-depression levels.

Through the Depression, deflation was rampant as the money supply fell by 30%; there were simply not enough dollars in the system to reverse the economic freefall. GDP was cut in half from \$103 billion in 1929 to \$56 billion in 1933, and US unemployment skyrocketed from 3% to 25% of the workforce. Bank runs led to 9,000 bank failures and businesses were unable to access capital, spreading panic through the system. Consumer confidence and faith in the system was destroyed. As poverty spread, social safety net mechanisms were limited and inadequate. Unemployment insurance, welfare, and social security programs did not exist as they do today.

By comparison, in the current cycle, US Real GDP has fallen from a peak of \$11.727 trillion in the 2nd quarter of 2008 to \$11.522 trillion at year end, a decline of 1.75%. The unemployment rate has increased to 8.5% from 4.9% since the official beginning of this recession in

December 2007. Over the same period, money supply (M2) has grown by 12%. While the economy is likely to continue to struggle through 2009, a cataclysmic decline comparable to Great Depression seems unlikely given the structural, political, and economic differences between the 1920's and 1930's and today. Recent economic history (leading up to 2008) has been characterized as the "Great Moderation". While the historical volatility of inflation and economic growth had been high prior to the early 1980's, over the last 25 years GDP growth has been half as volatile as it was prior to 1982. The reasons for the "Great Moderation" are the subject of much debate among economists. On the one hand, the Fed was successful in taming rampant inflation in the 1970's ushering in a period of stable economic growth. Perhaps both effective use of monetary policy and the public's faith in the Fed could be responsible for moderating economic volatility. On the other hand, practically speaking, much of the historical GDP volatility has come from inventory adjustments as manufacturers were typically late to respond to slowing business cycles. With the advent of effective inventory management technology and the migration from a manufacturing to a service based economy inventory adjustments have had much less impact on aggregate GDP growth. Finally, it could be that the Great Moderation is (was) a result of luck; simply the happenstance of an abnormally steady secular economic cycle. Recent developments may portend a return to a secular period of higher economic volatility. In the 3Q08, investment newsletter, we pointed to the seemingly counterintuitive notion that despite lower levels of economic volatility, capital markets have exhibited much higher volatility over the last 25 years. Financial "innovation" and leverage

appeared to be the culprits leading to several shocks to the system in the last 20 years. If financial engineering and free-flowing liquidity fueled dual credit and asset bubbles that burst dragging the economy into recession, perhaps the economy now represents the proverbial dog, wagged by the global financial market tail. Theoretically, the asset markets should reflect the health and growth of the global economy. However, given the extreme levels of leverage, derivatives, and sheer size of the capital markets and its players, it seems plausible that the markets have grown large enough to alter any prevailing economic course. If the economy has reached an inflection point and now faces a period of higher volatility, the effect on asset prices could be significant. Higher economic volatility may have a negative impact on valuations going forward, as investors demand higher return potential in order to assume an increased level of fundamental economic risk.

Market Update

Fixed Income

As interest rates rose across the yield curve, the Barclays Aggregate Index managed a modest gain of 12bps for the 1st quarter. The yield curve steepened dramatically; shorter term Treasury yields were flat to slightly higher while long term yields rose sharply as the 10 year Treasury yield jumped 45 bps to 2.66% and the 30 year climbed 86 bps to 3.53% at quarter end. The Barclays Capital Treasury Index fell 1.32% while the Long Term Treasury Index dropped 5.23% for the quarter. Mortgage backed securities rallied 2.2% as MBS spreads tightened nearly 100 bps supported by additional government purchases (\$300 billion of agency MBS during the 1st quarter) and further policy

moves by the new administration aimed at supporting homeowners and the mortgage market.

The best performing issues were found in the riskier bond sectors; asset backed securities (ABS) (+7.6%), high yield bonds (+6.0%), and emerging market bonds (+4.8%) rebounded after posting steep losses last quarter. ABS, led by credit card and auto issues, surged on the heels of the Fed's March launch of the TALF program.

Investment grade credit spreads widened after tightening early in 2009, but at quarter end remained well below their widest levels of 2008. As of April 24th, the yield spread on the US Corporate Index was nearly 480bps, down from a high of 618 bps last year. High yield spreads have tightened further since quarter end, and now stand at 1512bps over Treasuries compared with 2168bps in November 2008.

Finally, as the liquidity driven selling and deflationary fears that drove Treasury Inflation Protection Securities lower in the fourth quarter abated, TIPS (+5.5%) bounced back, outperforming nominal Treasuries across the yield curve. At quarter end, the 10 year breakeven inflation rate (the difference between the nominal yield on Treasuries and real yields on TIPS) stood at just over 1%.

Equity Markets

During the first quarter 2009, the domestic equity market posted another double digit loss with the S&P 500 falling 11%. The late year rally proved short lived as the index slipped to new lows in early March 2009. However, modest positive news on the economy and optimism that government intervention would be successful in stabilizing the banking system lifted the market 18% between March 9th and quarter end. The rally extended into April pushing the

index to a closing price of 866 on April 24, nearly 30% above the March 9th low. Still, the market remains lower for the year, down approximately 4% as of April 24th.

Financials continue to weigh on the S&P 500, falling another 28.8% in the first quarter. (The trailing one year return for the sector as of March 31 was -63%.) At March 31, the Financial sector was 10.8% of the S&P 500 index, near its historical average weight and down from over 22% in late 2006. Information Technology was the only sector to post a positive return in the first quarter, gaining 4.3%. As of April 24th technology shares in the S&P 500 were up 16% year to date, by far the best performance of any S&P sector. Investors have been encouraged by the sector's strong balance sheets and profit outlook despite the slowing economy, pushing the Technology sector to its best start since 1998.

Corporate earnings results in 2008 were abysmal. Operating earnings were down 40% from 2007 to less than \$50, and as reported earnings (including write-downs) on the S&P 500 fell nearly 80% from 2007 levels. AIG's \$61.7b fourth quarter loss alone had a -\$7.10 impact on S&P index earnings, as the index posted its first negative quarter of earnings *ever*. In fact with -\$23.25 EPS for the quarter, the index lost more in the fourth quarter than it ever made in any quarter, *ever*. So far, first quarter 2009 earnings indications are somewhat positive. With approximately 40% of the S&P 500 market value reporting, actual earnings are 16.5% ahead of estimates, but still 29.9% below last year; 76 issues beat estimates, but only 25 beat last year's earnings; 54 missed with 11 beating last year. Health care is expected to contribute over 20% of Q1 earnings and with some earnings growth over last year. Consumer staples are expected to post lower EPS, but earnings have held up relatively well in the current

environment. The sector continues to pay and increase dividends, and now accounts for the largest share of dividends among index sectors (16.8%). Financials share of dividends have fallen to 9.6% from a peak of over 30%.²

In local currency terms, the developed international equity market posted similar results to the US market falling 10.1% while emerging markets surprised with a 4.2% gain for the first three months of 2009. Generally, the US dollar strengthened, however, reducing international market returns for US investors to -13.9% for developed and +0.9% for emerging markets. Returns in the BRIC countries (Brazil, Russia, India, and China) were positive (4.9% USD terms) with commodity driven economies in Brazil (+12.5%) and Russia (+5.9%) responsible for most of the gains.

Alternatives

Real Estate

Property valuations continued to decline in the commercial real estate market in the first quarter dragging the NCREIF index down 7.3%. Valuation declines of 8.7% were partially offset by a 1.4% income return for the index. Returns for real estate funds as measured by the NCREIF Open End Diversified Core Equity index were worse, losing 13.9% reflecting over 15% of property value declines. (Note the NCREIF ODCE index incorporates fund level leverage.) Deteriorating economic conditions, poor liquidity, and a lack of transactions has created a difficult environment for commercial real estate. Real estate fundamentals have been under pressure, but the capitalization rate for the NCREIF remains in the mid 5% range and vacancy rates are still below 10%.

² Source: Standard and Poor's

Public real estate (REITs) also continues to struggle. The NAREIT index was off 31.9% for the quarter and nearly all of the 58% one year loss has occurred in the last 6 months. However, the market has shown some signs of life since quarter end. The NAREIT Equity REIT index has skyrocketed in April gaining nearly 33% through April 24th. The dividend yield for the index now stands at 6.6%.

Hedge Funds

After government intervention, extreme market volatility, and massive redemption requests weighed heavily on hedge fund returns in 2008, hedge funds generated modest gains in the first quarter of 2009. The HFRI Fund of Funds Composite and FOF Conservative Indices posted slight gains of approximately 0.5% for the period. Redemption requests remain a challenge, but the pace of withdrawal requests has slowed from last year. With many funds suspending redemptions and enforcing gating provisions, as well as increasing regulatory pressures, further industry shakeout is likely. Going forward the hedge fund universe is expected to continue to shrink and return dispersion among funds is likely to increase.

Additional Sources:
Ned Davis Research (NDR)
Blackrock
Wall Street Journal
Standard and Poor's
NAREIT
US Federal Reserve Board
Bureau of Labor Statistics (BLS)
The Conference Board
Wilshire Compass

