Boston Family Office
Investment Update
Year-End 2008

This has been such an extraordinary year, marked by events that were almost unthinkable a year ago, that it is difficult to come up with an all-inclusive list of the most significant. For example, quickly name the remaining major US investment banks.[1] Therefore, this update will review the last few months and focus on the prospects for the economy and the markets in the coming year, and leave the list-making for other year-end retrospectives.

In late September, we were optimistic that passage of the $700 billion Troubled Asset Recovery Plan legislation would begin to stabilize credit markets and that TARP's interventions would be enough to prevent a credit crunch and a serious recession in the US. At the time, it was still debatable whether a US recession was already underway, and growth in the rest of the world seemed to be continuing.

In hindsight, Lehman's bankruptcy was far more disruptive to credit markets than most anticipated. As a direct result, we have experienced a credit crunch in which credit and lending here and around the world have dried up, economic activity has slowed dramatically, and investors' tolerance for risk-taking has been greatly reduced. All this has happened despite the commitment of most of the initial tranche of TARP funds. Investors, consumers and businesses have hunkered down, and capital spending, exports, vehicle sales and retail sales have all been very weak. Conditions would probably be even worse if not for the declines in energy and other commodity prices since July.

Economic growth as measured by real US GDP was -0.5% for the 3rd quarter, and will likely decline much more through year-end. The employment situation has deteriorated, with the unemployment rate rising to 6.7% in November from 5% early in the year. Unemployment will likely continue to rise even after an eventual economic recovery begins. The credit crunch has amplified long-standing problems most noticeably at the Detroit-based auto companies, but also in several other segments of the economy, particularly financial services and retailing.

On November 28, the National Bureau of Economic Research announced that the US economy entered a recession in December, 2007 when the previous expansion ended. Forecasts ratcheted downward in November and December as the extent of the global slowdown since September became more apparent, and the consensus now calls for several quarters of negative growth in the US, Europe and the rest of the developed world, and major slow-downs in the emerging economies' growth rates.

Without question, today's economic news is awful, and we expect economic conditions to continue to be weak well into 2009. However, the economy will eventually recover from this recession. No one knows when the recovery will start or how strong it will be, but a plausible timeline with recovery beginning some time in the second half of 2009 is as follows:

- *The Federal Reserve's aggressive easing and ongoing combined Fed and Treasury capital market interventions begin to unfreeze credit markets and make credit more available during the last quarter of 2008 and into early 2009.*
- *Some business activity and consumer purchases, deferred after September as credit dried up, resume.*
- *Congress and the new administration pass a significant fiscal stimulus plan early in 2009, with some combination of new spending and tax reductions.*
- *US economic growth, after declining by 4-6% annualized in both the 4th quarter of 2008 and the first quarter of 2009, stops declining and turns positive by the end of 2009.*

The important point is not so much when the recovery will begin, but that it will, and the economic outlook will likely be better a year from now. However, once recovery begins it is probably not going to be smooth, nor will it be as robust as many previous recoveries. De-leveraging by businesses and consumers (less use of debt) will mean lower but probably more sustainable growth. Fiscal policy does not seem likely to include significant growth-oriented tax revisions any time soon. Policy makers then will face further challenges as they attempt to undo their emergency interventions appropriately without choking off the recovery.

Equities

2008 was the worst year for equities since the Depression years, and the 4th quarter of the year was particularly painful. Not only were the declines large, but virtually every equity market and every equity market segment here and around the world ended the year with losses. Of the stocks making up the broad S&P 1500 index, only 162, or just over 10%, showed any gain for the year.

These across-the-board price declines are discounting a great deal of the bad economic news and lower company earnings that are likely over the next few quarters. 2009 earnings estimates for the S&P 500 have been lowered some 34% since July. Even on these lower earnings, the market's price/earnings ratio of 13X is quite inexpensive. One positive trend from the past month is that although the news flow has been as bad as ever, most stock markets have moved up significantly from their November lows, as if the currently weak near-term outlook has now been fully discounted by investors.

We continue to believe that consistently timing the market's ups and downs correctly is impossible, and that investors must stay invested through good times and bad if they are to earn the high long-term returns that stocks have offered historically. Unless a client's personal situation has changed enough to warrant a lower allocation to stocks, we are maintaining our stock holdings, and are more inclined to be buyers than sellers. We expect that stock markets will begin to improve in anticipation of an economic recovery, well in advance of when the recovery is noticeably underway.

Table 1: Market & Sector Returns
(Price Change)

Market Index	2008
Dow Jones 30	-34%
S&P 500	-39%
NASDAQ Composite	-41%
MSCI EAFE	-45%
MSCI Emerging Markets	-55%

S&P Sector	2008
Energy	-36%
Basic Materials	-47%
Industrials	-42%
Consumer Discretionary	-35%
Consumer Staples	-18%
Health Care	-25%
Financials	-57%
Technology	-44%
Telecommunications	-34%
Utilities	-32%

Fixed Income

The relatively low absolute levels of interest rates make us prefer shorter maturities with less sensitivity to any future rise in interest rates compared to longer maturities, and US Treasuries look relatively expensive. High risk aversion means that investors now heavily favor US Treasuries and other government-backed issues over virtually everything else. As a result short-term Treasury bills yield virtually nothing, while 30-year Treasury bonds yield only 2.6%.

The other side of this flight to quality is that investment-grade corporate bonds look very cheap compared to Treasuries. The yield advantage they offer compared to Treasuries is about five times as wide as the average for the past 20 years.

Investment-grade municipals also offer uncommonly wide yield advantages over Treasuries. Pre-refunded municipals are particularly good values in that they offer more than a full percentage point more yield than short-term Treasuries, while their escrowed-to-maturity features mean that investors are subject to minimal credit risk.

Finally, inflation-protected issues seem like good values now. Treasury Inflation-Protection Securities (TIPS) are today priced to imply minimal future inflation. While inflationary pressures have temporarily subsided, over the longer term we expect that they will return given the extent of monetary stimulus that the Fed is undertaking.

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[1] Of the major US standalone investment banks in business at the beginning of 2008, none are left. Bear Stearns was acquired by JP Morgan Chase, Lehman Brothers filed for bankruptcy, Merrill Lynch was acquired by Bank of America, and Goldman Sachs and Morgan Stanley have both converted to commercial bank holding companies.