



# Investment Perspective & Analysis

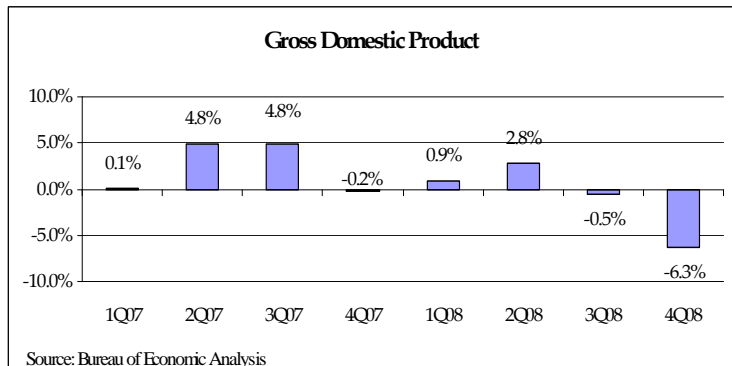
First Quarter 2009

March 31, 2009

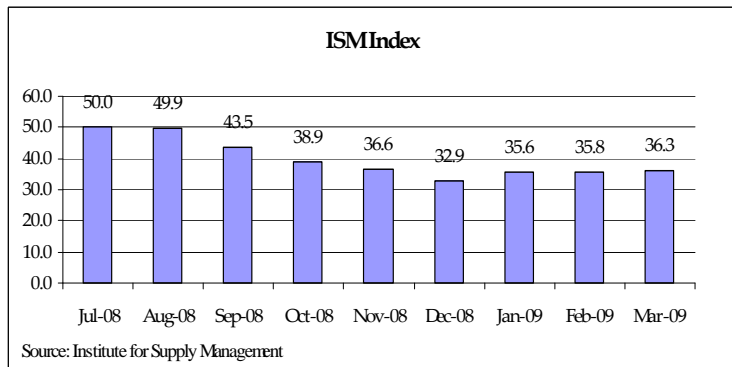
## GENERAL OVERVIEW

### U.S. Economy

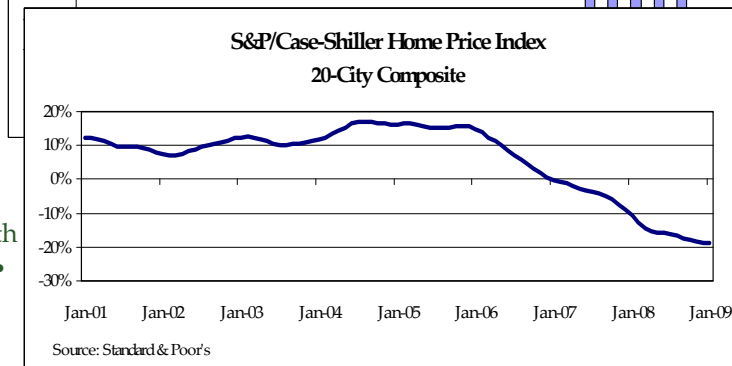
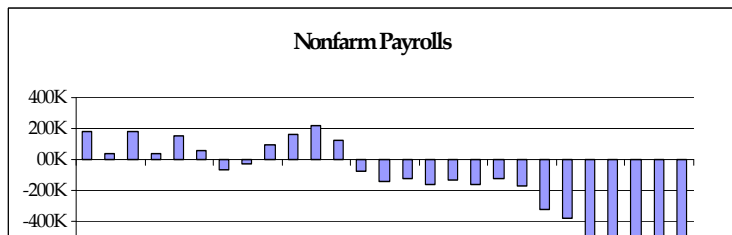
Notwithstanding the recent bear market rally in equities, the U.S. economy is still in bad shape! Released in recent weeks, there has been a smattering of economic data that showed some modest improvement, but nothing neither significant nor sustainable to add fundamental underpinnings to the nascent enthusiasm for stocks. The most sobering statistic was the revised GDP number for the fourth quarter of 2008 which showed the economy grew -6.3%, the largest contraction since 1982.



Another sad reminder of how far growth has contracted can be found in the ISM Manufacturing Index which showed a level of 36.3 in March. Any number below 50 indicates economic contraction. However, this number continues to trend higher after reaching a low of 32.9 in December. The New Orders Index showed some improvement as well, rising to 41.2 in March from 33.1 in February.



Most recently, the payroll report for March showed that the economy lost 663,000 jobs in the month and a total of 5.1 million since the beginning of 2008 when the current economic downturn began. The unemployment rate has now reached 8.5%, a level not seen since 1983. Economists predict we could see this rate approaching 10% by the end of 2009.



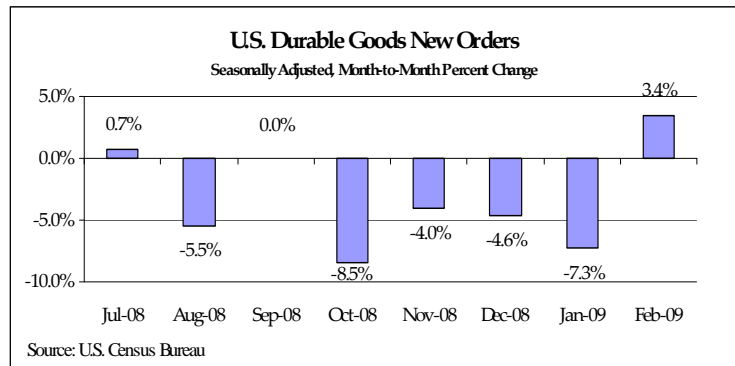
There are few signs of stabilization in the housing

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market as home prices continue to fall. The S&P/Case-Shiller Home Price Index revealed that home prices declined 19% year-over-year in January according to the 20-City Composite. However, there appears to be a recent increase in the sale of existing homes as a result of these lower prices and favorable mortgages rates that have fallen below 5.00%. The Federal Reserve announced plans to purchase long term Treasury Bonds in an attempt to keep mortgage rates low to entice buyers.

The industrial/manufacturing sector of the economy offers a mixed picture as orders have been canceled or delayed due to tighter credit conditions and general risk aversion by CEOs. Industrial production in February was down 1.4%, while durable goods and factory orders were up 3.4% and 1.8%, respectively. Once the U.S. economy slowed, the global demand for equipment and durable goods dried up. However, domestic demand could pick up as a result of stimulus programs recently introduced by the Obama administration.



The historical engine for U.S. growth has been the consumer. However, the housing crisis, uncertain jobs picture and the credit crisis have all left consumers paralyzed and unable/unwilling to spend. Personal spending has fallen in the last six months and was down 4.3% in the fourth quarter. Retail sales have also been poor over the last six months, but displayed some modest strength in January. Auto sales have been awful, but the 9.9 million units (annualized) for March proved higher than most expected. It is no secret that both GM and Chrysler are teetering on the brink of bankruptcy and negotiating with the Obama administration for more bailout funds in exchange for swift and bold reorganization plans. It seems some type of structured reorganization program is inevitable in which all stakeholders share in the pain, allowing the companies to escape crippling legacy costs and past mistakes.

All in all, the U.S. economy is not going to emerge from this current crisis until 2010 as there are many issues to overcome before meaningful growth can resume. Huge deficits are now being accepted in order to avoid a depression, but it seems clear that the Obama administration is determined to solve this dilemma through massive spending, select tax increases and more government control. This is not an inspiring prospect due to the history of failed government intervention. It is our view that we need to cut both government spending and taxes to unleash the entrepreneurial strength and job creation ability of the U.S. economy. We are hopeful, but not confident, that the current course will produce sustainable growth in the near future.

## Policy

Ever since the end of the Bush Administration and the near-meltdown of the financial system, Washington has rolled out numerous trial balloons, rescue programs and stimulus plans. The first priority is to save the banks and financial system. At the present time, that doomsday scenario seems to have been averted, especially following the announcement last week that the FASB has changed the rules regarding "mark to market" regulations. This latest development has taken the pressure off the banks, allowing them more leeway in pricing the toxic assets on their balance sheets. More write-downs would further stress the capital requirements of banks and the ability to function properly to make the loans needed to heal the financial crisis. It is also rumored that the SEC will reinstate the "uptick rule" for short sellers. This change would limit some of the downward pressure exerted on stock prices when negative news provides an opportunity for short sellers to pile-on. Stocks could still be sold short; however, it would be more difficult for these sellers to cause great swings in market prices.

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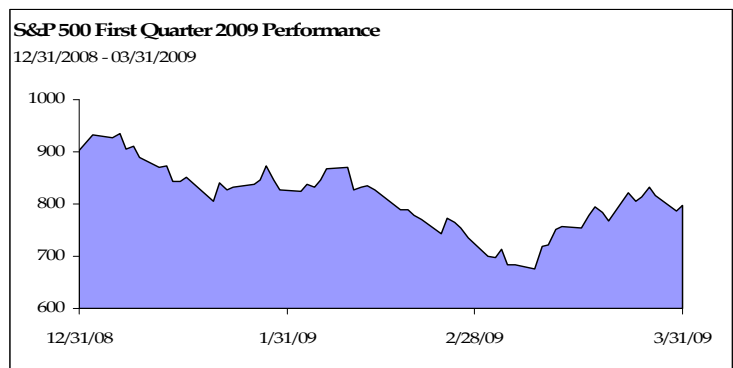
Both the Federal Reserve and the FDIC have been working hard behind the scenes and under the radar of the daily news reports. Progress has been made to slow the number of mortgage defaults and subsequent foreclosures. Vast quantities of liquidity have been supplied to financial institutions in order to avoid a catastrophe. It now seems that the worst case scenario will be avoided. The latest move by the Fed to provide “quantitative easing” through the direct purchase of longer term government bonds is an example of how our government institutions are working together to keep interest rates low and to provide liquidity to the markets. Furthermore, it is clear that the Obama administration is aggressively taking to the air waves (60 Minutes, CNBC, Sunday news shows and others) to build awareness, understanding and confidence in its programs. The recent accord struck in London at the G-20 Meeting further boosted confidence that global governments will cooperate to bring an end to the broad economic contraction.

All of these measures will take time to work. It is difficult to judge by how much or when their effects will begin to influence the markets and/or improve economic activity. Regardless, it will take all of 2009 and most of 2010 before any sustainable growth will occur. This assumes that no further disasters emerge while the economy and markets heal. There are many programs now in place that may produce some improvement later this year. We are certainly hopeful, but until more evidence is available investors will remain cautious.

## EQUITY MARKET OVERVIEW

### Equity Market Performance

Equity markets remained under pressure during the first quarter of 2009 as uncertainty about the financial system and the global economy continued to weigh on the minds of investors. The graph to the right shows the performance of the S&P 500 which returned -11.0% for the quarter. The steady decline from January through the early part of March was followed by a significant turnaround over the last few weeks of the quarter. Positive comments from a number of the banks along with greater clarity concerning the Obama



administration’s plan to stabilize the financial system helped drive financial stocks as well as the overall equity markets significantly higher in March. Yet, this recent advance in stock prices failed to erase the losses from January and February. The Financial sector gained over 40% from March 8<sup>th</sup> through March 31<sup>st</sup>, but was still the worst performing sector for the quarter returning -29.5%.

The NASDAQ was the best performer of the major U.S. indices returning -3.1% for the quarter as technology stocks outperformed all other sectors. In fact, the Information Technology sector was the only group to post a positive performance in the quarter, rising 3.7%. Many of the bellwether technology names such as Apple and IBM benefited from

Equity Performance	2Q08	3Q08	4Q08	1Q09
Dow Jones Industrials	-6.9%	-3.7%	-18.4%	-12.4%
S&P 500	-2.7%	-8.4%	-21.9%	-11.0%
NASDAQ	0.6%	-9.2%	-24.3%	-3.1%
Russell 2000	0.3%	-1.7%	-26.5%	-15.4%
Wilshire 5000	-1.9%	-9.2%	-23.5%	-10.7%
MSCI-EAFE	-2.3%	-20.6%	-20.0%	-13.9%
MSCI-Emerging Markets	-1.6%	-27.6%	-27.9%	0.5%

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renewed investor interest, driving share prices up 23.2% and 15.1%, respectively.

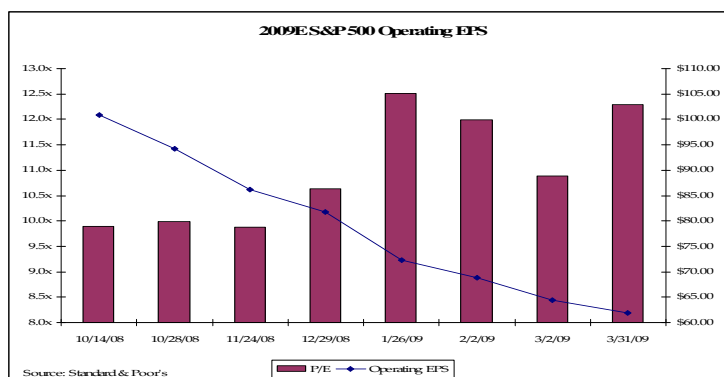
While comments from the Obama administration helped turn around financial stocks in the quarter, the same could not be said for health care. President Obama's declaration to reform our health care system ignited fears that such change would eat into the profits of these companies. This concern caused health care stocks to sell off in February after relatively good performance in the beginning of the year. Despite having the most favorable 2009 earnings outlook of the S&P 500 sectors, health care stocks could remain under pressure as we hear more from Washington on their plans to reform the health care system.

S&P 500 Sector Performance	2Q08	3Q08	4Q08	1Q09
Consumer Discretionary	-8.1%	-1.0%	-23.4%	-8.6%
Consumer Staples	-5.9%	4.1%	-13.5%	-11.3%
Energy	16.9%	-25.0%	-21.1%	-12.1%
Financials	-19.0%	-0.1%	-37.6%	-29.5%
Health Care	-1.7%	0.0%	-12.7%	-8.5%
Industrials	-10.6%	-9.1%	-24.7%	-21.8%
Information Technology	2.3%	-12.1%	-26.0%	3.7%
Materials	3.9%	-22.9%	-31.4%	-2.8%
Telecom Services	-5.1%	-15.7%	-2.9%	-8.5%
Utilities	7.1%	-18.7%	-12.0%	-11.9%

The Health Care sector also saw a number of significant deals in the first quarter. Roche completed its long awaited \$46.8 billion acquisition of Genentech; Pfizer agreed to acquire Wyeth for \$68 billion; and Merck offered \$41.1 billion for Schering-Plough. The large pharmaceutical companies are facing patent expirations on many of their key revenue producing drugs over the next few years and are desperately searching for ways to maintain earnings growth through this transition period. While these deals may provide for significant synergies, they fail to resolve the key issue of a limited number of new drugs in the pipeline to replace lost revenue from those coming off patent.

## S&P 500 Earnings

Now that companies have reported year end 2008 results and provided an outlook for 2009, it is apparent that visibility on earnings is low and management teams remain cautious on 2009. S&P 500 operating earnings were down 40% in 2008 and are expected to show year-over-year declines through the first half of the year. However, it is difficult to put any faith in these estimates since the numbers have been continually revised lower as seen in the graph to the right. Many companies have provided limited guidance due to the



uncertainty of when and how quickly an economic recovery will materialize. 2009 estimated operating earnings for the S&P 500 were down to \$62.00 at the end of March, \$20 lower than they were at the end of 2008. Generally speaking, stock prices are driven by expected future earnings. Until earnings estimates begin to trend higher, it will be difficult to have a sustainable improvement in equity prices.

## BOND MARKET OVERVIEW

### Bond Market Performance

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Bonds and other fixed-income securities outperformed in the first quarter of 2009 as investors flocked to higher quality bonds given increased uncertainty in the credit markets. Credit spreads widened as turmoil in the banking system created fears of liquidity issues for many companies dependent on short term borrowings to finance their operations. Treasury Inflation Protection Securities (TIPS) gained 10.9% as inflation fears continued to

Bond Market Performance	2Q08	3Q08	4Q08	1Q09
90 day T-bills	0.5%	0.4%	0.4%	0.1%
10 year T-notes	-3.5%	2.4%	15.1%	-2.8%
Corporates	-1.0%	-6.8%	4.3%	-1.9%
Agencies	-2.8%	1.7%	9.8%	-0.7%
GNMA Bonds	-0.7%	1.9%	4.4%	2.3%
TIPS	-0.5%	-6.5%	-6.6%	10.9%
High Yield Bonds	2.2%	-9.7%	-20.6%	7.1%
Municipal Bonds	0.7%	-3.7%	0.9%	4.9%

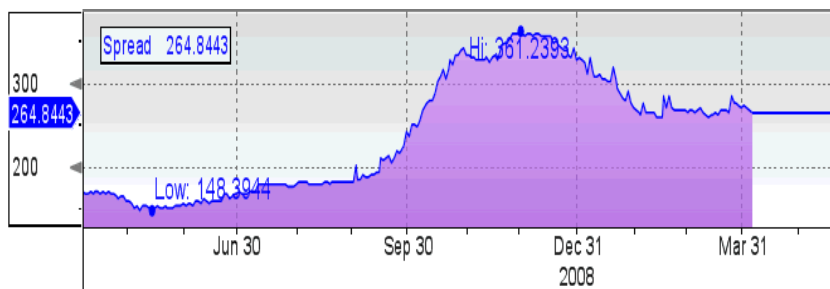
increase due to the rise in food prices (up 4.7%) and the effective printing of money by the Fed. Since June of last year, bond yields fell to record lows in December and January and are only now beginning to recover.

At the end of 2008 we told you about three schools of thought on why Treasuries are expensive relative to inflation and to an expected onslaught of supply to finance the growing federal deficit. The first holds that bonds are mispriced. This has now largely been dismissed. The second school sees the market as forward-looking. Inflation may be moderate now, but bonds are telegraphing better inflation or worse economic news ahead, depending on one's reference point. The third school claims there is a bubble in the Treasury market. Their continuing appreciation has led to more investment.

Corporate bond spreads, or the difference in yield between a Treasury note and a mid level (A rated) investment grade corporate bond of similar maturity, widened dramatically during the market downturn last year. Why were spreads so tight twelve months ago, and so wide now? Treasury yields have moved down dramatically while corporate yields have risen. The demand for Treasuries is far outpacing the demand for corporate bonds leaving their yields high. But there are a number of factors contributing to the rise. The most prominent cause has been fear driving the flight to quality and liquidity.

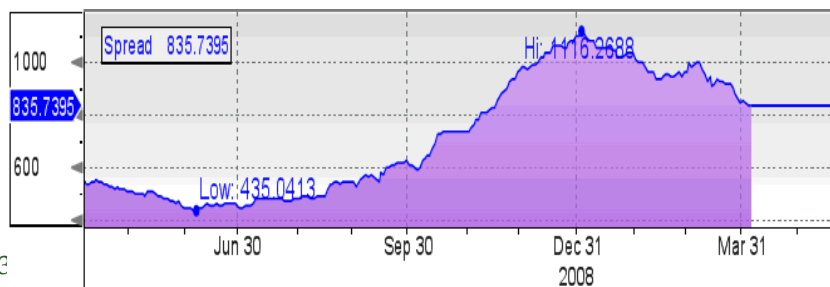
## Credit Spread

The Credit Spread (U.S. Treasuries vs. Corporates), a good measure of fear, was at a twelve month low in May of 2008 at 148 basis points and stayed in a narrow range until the Lehman bankruptcy on September 15<sup>th</sup>. Since then spreads gapped to as wide as 361 basis points before returning to a more normalized level of 264 basis points at the end of March.



## Junk Spread

The Junk Spread (U.S. Treasuries vs. High Yield Corporates), a good measure of risk premium or the amount of additional return necessary to accept more risk, was at a twelve month low in June of 2008 at 435 basis points and stayed in a narrow

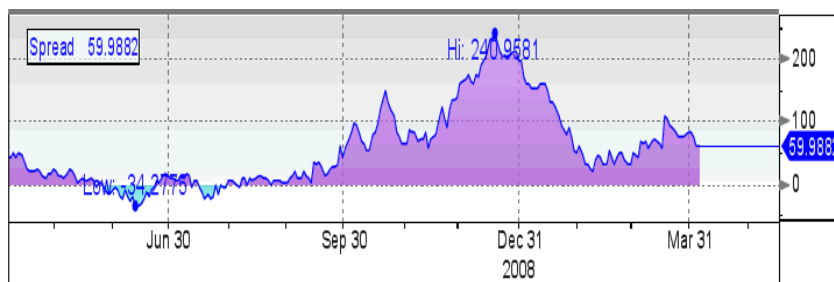


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range until the Lehman bankruptcy in September. Since then the risk premium has roughly doubled to 835 basis points at the end of the quarter after going as high as 1116 basis points in late December.

## Municipal Spread

The Municipal Spread (U.S. Treasuries vs. AA Municipals) was at a low of -34 basis points in May of 2008 and wavered above and below the zero line before moving decidedly positive after the Lehman bankruptcy in September to a high of 240 basis points in mid-December. Since then it has dropped precipitously to just 60 basis points as fears of potential bankruptcies have been assuaged by the Federal stimulus.



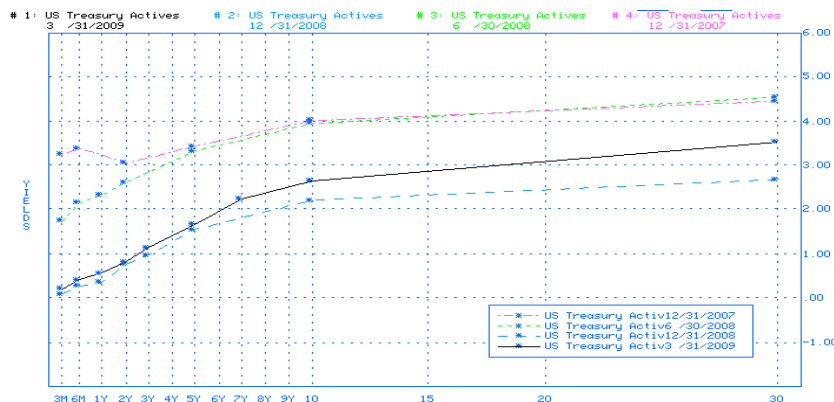
## TIPS Spread

The TIPS Spread (U.S. Treasuries vs. TIPS), a good indication of inflation expectations, was at a high of 260 basis points in July of 2008. Since then we have seen it go negative during the market downturn and begin to recover in early 2009. Now standing at 137 basis points, TIPS are still reflecting low inflation expectations.



## Yield Curve

The Yield Curve as seen in the graph is still close to the December lows. Long rates have crept up over the last three months. However, the Treasury and the Fed are trying to keep them down as many see low interest rates as the engine for pulling the economy out of a recession.



## HIGHLIGHTS & SUMMARY

- THE ECONOMY CONTRACTED 6.3% IN THE FOURTH QUARTER OF 2008 AND IS NOT EXPECTED TO SHOW EXPANSION UNTIL THE SECOND HALF OF 2009.
- S&P 500 OPERATING EARNINGS WERE DOWN 40% IN 2008. EARNINGS ESTIMATES MUST BEGIN TO TREND HIGHER FOR ANY SUSTAINABLE INCREASE IN EQUITY PRICES.
- INTEREST RATES WILL REMAIN LOW AS THE FED IMPLEMENTS ITS PLAN TO STABILIZE THE

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## HOUSING MARKET AND FINANCIAL SYSTEM.

- OIL PRICES HAVE TRENDED HIGHER TO \$50/BARREL FROM THE \$30 LOWS OF DECEMBER, BUT A REDUCTION IN INVENTORY LEVELS IS NEEDED TO SUSTAIN HIGHER OIL PRICES.
- INFORMATION TECHNOLOGY WAS THE ONLY SECTOR TO SHOW A POSITIVE PERFORMANCE IN THE FIRST QUARTER OF 2009, WHILE THE FINANCIAL AND INDUSTRIAL SECTORS PERFORMED THE WORST.
- STABILIZATION OF THE HOUSING MARKET AND AN IMPROVEMENT IN THE EMPLOYMENT SITUATION ARE NECESSARY TO STIMULATE CONSUMER SPENDING.
- THE MANUFACTURING/INDUSTRIAL SECTOR SHOULD REMAIN WEAK, BUT LOW INVENTORY LEVELS AND THE GOVERNMENT'S STIMULUS PROGRAM COULD SPUR DEMAND.
- THE FINANCIAL SECTOR WILL REMAIN VOLATILE AS INVESTORS DIGEST THE MULTITUDE OF GOVERNMENT PROGRAMS AND THEIR EFFECTIVENESS IN STABILIZING THE FINANCIAL SYSTEM.
- INVESTORS SHOULD REMAIN CAUTIOUS WHILE STAYING FOCUSED ON THEIR LONG TERM GOALS!

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