ROOF ADVISORY GROUP, INC.®
INVESTMENT ADVISORY & FINANCIAL PLANNING SERVICES

INVESTMENT UPDATE

December 11, 2008

Economic Conditions & Market Outlook

'Disastrous.' 'Horrendous.' 'Almost Indescribably Terrible'. No, these adjectives were not excerpted from some over-the-top headline on the cover of the New York Post. Instead, the words were extracted from the recently published remarks of a group not typically known for their use of hyperbole…economists. What the writers were grimly referencing was Friday's release of the most recent U.S. jobs data which showed a November monthly decline in nonfarm payrolls of 533,000, the worst single month drop since 1974.

Equally dreary was the U.S. Labor Department's monthly unemployment number which climbed to 6.7% and reached a fifteen year jobless rate high. November's overall ISM manufacturing index hit a 26 year low and nine of the eleven major categories in the report were labeled as 'contracting', or its negative equivalent, for the period. U.S. exports undershot quarterly estimates but still remained in positive territory, although the growth rate was less than one-third of what it had been the prior quarter; illustrating that overseas buyers are also feeling the pinch from this global slowdown.

Here at home, consumer spending faltered during the third quarter, dropping at an annualized rate of -3.7%, and registering the biggest reduction in the measure since the second quarter of 1980. Home builders again cut spending and housing prices continued to fall but most potential buyers remained cautiously on the sideline. On average, auto sales for November were down 30-40% and U.S. retailers were preparing for a Scrooge-like season of holiday sales.

Not surprisingly, revised data from the Commerce Department indicated that the economy performed worse than expected during the third quarter of 2008, with gross domestic product (GDP) shrinking at an annual rate of -0.5% for the period. This was the most negative showing for an annualized GDP number since it contracted at a -1.4% rate during the third quarter of 2001, when the U.S. was toward the end of its last recession. Comparatively speaking, the third quarter 2008 decline may look relatively mild versus the 2001 number but it is generally expected that the fourth quarter 2008 GDP figure will be downright abysmal.

Most discussions about GDP during the year led to the question of whether or not the U.S. economy was in a recession, a topic that has been endlessly debated by economists, academics, financial observers, media pundits, and politicians since the beginning of 2008. As early as our January *Investment Update* (see www.roofadvisory.com - *Articles* tab, for all referenced *Investment Updates*), it was noted that Federal Reserve Chairman Ben Bernanke was acknowledging a 'worsening of economic activity and more pronounced downside risk to growth' but that the Fed was 'not forecasting an impending economic recession'.

Mixed economic data, combined with incessant political posturing regarding the state of the U.S. economy, continued to fuel the debate in the months ahead. While a recession is traditionally defined as two consecutive quarters of negative economic growth, the quarterly GDP readings throughout the year stubbornly refused to cooperate with this general rule of thumb. So much so that at the end of July, U.S. economists were even contemplating the possibility of declaring a 'recession' despite financial growth indicators remaining positive…a seemingly contradictory declaration and indeed the first time that a U.S. recession would not have been accompanied by a decline in economic output.

As recently as October, the National Bureau of Economic Research - final arbiter of all business cycle debates - posited that it was "very unlikely" that a third quarter GDP decline would be substantial enough to identify the start of a recession. However, the suspense ended on December 1 when the NBER formally declared that the U.S. was indeed in the throes of a recession and that it had started in December 2007…a full year prior.

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From an investor's point of view, what does this economic pronouncement mean? Not as much as you might expect. May 2008's *Investment Update* noted that by the time such labels are affixed, the proverbial horse is already out of the barn. Focusing on fundamental data shifts and incremental market moves will provide far more insight as to potential forthcoming investment trends.

Additionally, we have long cautioned investors that the economy and the stock market do not move in lock step. The January 2008 *Investment Update* referenced previously details that even when it has been clearly determined that the U.S. economy has been in a recession, there is less-than-perfect correlation between the negative economy and the stock market's performance during such periods.

Finally, both the equity and fixed income markets have continued to be negatively impacted by atypical events and issues from far outside the standard influence of economic growth/contraction, business cycle movement, corporate earnings, etc. Many of these unique, extraneous factors were discussed at length in the September and October distributions of the firm's *Investment Update* but examples include: a global credit/liquidity crisis, unexpected bankruptcies that sank financial giants, corporate shotgun marriages that sacrificed shareholder value, and extreme day-to-day market volatility, just to name a few.

All of this upheaval obviously had a deleterious effect on investor confidence and justifiably so. As October wrapped up and November rolled on; concern continued to fester in the markets as many investors understandably feared that the U.S. Government's newly acquired role as financier-of-last-resort would have long term negative consequences. Nor was investor sentiment buoyed by the Treasury Department's unilateral redefinition of the mission for the recently approved Trouble Asset Rescue Plan (T.A.R.P.) or watching the C.E.O.s of the Big Three automakers arrive hat in hand on Capitol Hill with nary a plan as to how they might permanently solve their financial mess.

Not surprisingly, the equity markets suffered during the month of October, with the S&P 500 and the Dow Jones Industrial Average logging losses of -16.83% and -14.06% respectively. In November, the two major indices saw some slowing in their downward price spiral but still ended the month solidly negative, with additional declines of -7.48% and -5.32%. After maintaining portfolios at minimum equity target levels for most of September, the firm further slashed equity exposure during the last week of that month and again the first week of October; thus protecting our clientele from the worst of the carnage.

Even the normally safe haven of bonds was rocked by the financial fallout of the credit crunch. Normal concerns about the risk of issuer default were accentuated by the pervasive uncertainty and, for a time, trading in most fixed income securities ground to a near halt. Given some of the fixed income market's idiosyncrasies in establishing bond value, this limited trading volume has created some outlandish bond pricing distortions that will likely continue to be the norm well into 2009. While interim price fluctuation is immaterial if a bond is held until maturity, these abnormal pricing swings only exacerbated the portfolio volatility felt by investors.

However, there are some notable bright spots as well. Except for those selling on-air advertising, the country breathed a collective sigh of relief when the presidential campaign marathon finally ended and one notable uncertainty was clearly resolved. As with any party change, long-ranging fiscal and philosophical differences will need to be wrestled with going forward. But putting the election behind us, and the appointment of several financially savvy cabinet members, has helped assuage one set of market concerns.

Likewise, the multiple initiatives of the Federal government to inject liquidity into the credit markets, financially backstop troubled companies/assets, and expand guarantees on certain deposits and money market funds has started to take hold. This has helped calm investor queasiness regarding the possibility of ongoing, out-of-left-field defaults that so rattled both the equity and fixed income markets several months ago.

Similarly, it is clear that there is, and will continue to be, a concerted effort by the Federal government to stimulate the economy with whatever tools it can muster. Will this be costly? Yes. Will this aggravate the deficit? Yes. Will we overspend? Yes. Will there be waste and pork? Yes. But will it work? Yes. As always, it will be difficult to turn off the spending faucet once started and there may indeed be inflationary pressures to deal with down the road but those are problems for another day.

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Recently, trading volume in most of the fixed income market remains extraordinarily thin with one exception. There is currently an insatiable worldwide demand for U.S. Treasury bills, notes, and bonds that has been propelled by global economic uncertainty. This glut of buyers has caused yields on U.S. Treasury paper to drop to unheard of levels; with 30-year T-bond yields barely topping 3.00%, 5-year T-notes near 1.5%, and 3-month T-bills recently priced to generate an effective yield of 0.0%...adding new meaning to the term 'zero-coupon bond'. Both of these fixed income market anomalies will correct as calamitous concerns moderate and the appetite for more appropriate and normative yields, along with the accompanying risk, return.

Stock market price movement continues to be volatile, although the daily swings can seem rather tame when compared to the gut-wrenching lurches of the past few months. Perhaps we are just acclimating. Although the firm does not make macro investment decisions based on suspected technical market tops or bottoms, many equities have been trading within a defined pricing range and we have been selectively adding/enhancing certain stock positions we view as fundamentally sound when they tick toward the lower end of that parameter.

As expected in the currently strained economic environment, recent corporate earnings announcements have leaned toward lackluster at best, with many companies significantly lowering estimates for the upcoming period. Consequently, current price to earnings (P/E) ratios based on historic earnings need to be viewed with a jaundiced eye and do not necessarily indicate a bargain in this market. Factors such as low debt, high free cash flow, a stable dividend, etc. have been receiving greater emphasis in our ongoing equity evaluations. With dividend yields on many quality companies reaching record high levels, one can be paid well to wait.

We also suspect that hindsight may eventually show that the U.S. equity market at its present level is notably oversold. Basement level short term fixed income yields and a quixotic bond market also contribute to making equities more appealing on a relative risk versus return basis than they were at the beginning of October and we continue to prudently look for long term investment opportunities. However, given the fragility of the markets, the uncertainty of the economy, and the impending transition of the federal government, there is no rush for a broad increase in overall equity exposure. Caution, patience, and selectivity remain our watchwords.

Our Tactical Investment Stance

Roof Advisory Group's disciplined investment approach emphasizes adding value to client portfolios while controlling downside risk. Strategies include clearly defining investment policy ranges based on each client's specific investment objectives/risk tolerance, monitoring portfolio adherence to established benchmark parameters, and the ongoing evaluation of relative portfolio return.

Within this strategic context, the firm makes tactical shifts with changing market conditions to optimize client portfolio performance. While every client situation is unique, outlined below are a few of the tactics we are using in the current market:

• After maintaining a ***minimum equity*** allocation for most of September, portfolio target weightings were reduced outside the normal range to a level during the last week of that month. This portfolio move was in response to unstable market conditions. Stocks were ***further reduced*** the very next week to ***40-50% below minimum equity*** in the very unsettled market. This fallback strategy was anticipated in advance and taken as an ***extraordinary and temporary*** position to ***preserve client capital***.

Beginning in the last week of October, certain equity positions started to be ***slowly and selectively rebuilt***, if deemed appropriate, although the firm remained well ***below minimum equity*** target levels until earlier this week when we again neared the minimum equity levels targeted by individual investment policies.

• ***Diversification is always a priority*** but stock and bond positions in ***sectors most at risk*** were ***pared more aggressively*** during the market upheaval. Position rebuilding will again focus on spreading risk via adequate portfolio diversification, while not overlooking ***unique opportunities*** that may be available via specific securities or sectors.

• ***Short-term fixed income*** investment levels are ***temporarily higher*** than norm because of the tactical shifts above but ***will return to target levels*** as assets are ***gradually redeployed*** to appropriate long term investments. Money market funds used by the firm continue to be ***reviewed at the holding level.***

E. Jeffrey Roof