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2009 Outlook: Choosing Which Horse to Ride

- Looking Ahead
- Challenges Confronting Policymakers
- The Fed to the Rescue
- Assessing the Economic Impact
- Will Housing Stabilize?
- Can Aggregate Demand Be Bolstered?
- What Could Go Wrong (Again)?
- Formulating an Investment Strategy

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Our New Year's greeting: 2008 is finally over! That's the good news. The bad news is the spillover from the housing and credit market bubbles is still very evident in the United States and around the world. Even so, it will be hard for 2009 to match last year's horrid investment results (see Figure 1), which will go down as the period of greatest wealth destruction on record for U.S. households: Cumulative losses on equity, fixed income and real estate holdings are estimated to exceed \$10 trillion.

Figure 1

	1st Half	2nd Half ¹	YTD ¹
Equities			
S&P 500	- 11.9%	- 28.3%	- 36.5%
EAFE (\$)	- 10.5%	- 36.3%	- 42.0%
EM (\$)	- 11.7%	- 46.9%	- 52.7%
Bonds			
Treasuries	2.2%	11.2%	- 13.7%
Corporate	- 0.8%	- 4.1%	- 4.9%
High Yield	- 1.2%	- 25.3%	- 26.1%
Commodities			
Oil (WTI)	45.8%	- 59.6%	- 55.6%
CRB (all)	29.0%	- 50.4%	36.0%
Gold	11.0%	- 5.0%	4.6%

¹Returns for equity indices include dividend except emerging markets, which are price changes. Source: Bloomberg

The toll on the U.S. and overseas economies is the worst global recession in three decades. According to the National Bureau of Economic Research (NBER), the U.S. economy has been in recession for just over a year, already surpassing the two previous recessions. Moreover, the depths of the current recession, measured from peak to trough of real GDP and also in job losses, now rival the downturns of the mid 1970s and early 1980s, and the recession could become the most severe in post-war history.

U.S. policymakers now find themselves scrambling to limit the economic deterioration and to restore financial stability. After underestimating the problem for more than a year, they are now embarking bold new programs. The Federal Reserve is pursuing unorthodox policies to reignite credit markets and to lower mortgage rates while setting short term interest rates near zero. In addition, the Obama Administration is preparing a record U.S. fiscal stimulus package that could reach \$1 trillion over the next two years. These actions will play a key role in shaping the course of the economy and financial markets this year and next.

Looking Ahead

As we begin 2009, the consensus forecast sees the economy contracting further in the first half of the year, and then stabilizing in the second half as policies begin to take hold. While this scenario is plausible, we are also cognizant that it is similar to the consensus view for 2008, which proved to be wrong. Forecasters a year ago did not envision the multitude of problems in the financial sector, and this could happen again. Accordingly, we are paying close attention to what bearish forecasters are saying, and we are establishing markers to discern which view is right.

What investment strategy makes sense in this environment? Current conditions are the most turbulent ever experienced, and a quick improvement in the economy or return to normal market volatility is unlikely. We also believe a re-opening of credit markets is critical for recovery of the economy and risky assets. Consequently, our strategy is to explore opportunities in fixed income markets first, beginning with investment grade corporate bonds. Over time, as credit markets thaw, riskier instruments including high yield bonds and equities are likely to improve, as well. Finally, the asset that appears most overpriced is U.S. treasuries; yields are likely to rise as the economy stabilizes.

Challenges Confronting Policymakers

In many respects, the challenges confronting governments today are the biggest since the Great Depression. While the magnitude of the current problem does not compare with the 1930s experience, policymakers have found they cannot rely on orthodox policies to counter the myriad of forces that have propelled the global economy into recession, including the bursting of the housing and credit bubbles, excess leverage in the financial system and a dearth of saving by U.S. households.



Faced with this situation, policymakers must now stabilize the housing market, put financial institutions on sound footing, and boost aggregate demand. One of their biggest challenges is to restore confidence that was shattered by the collapse of Lehman Brothers and the forced rescues of other prominent financial institutions. These developments, and disillusionment with the TARP program, spawned a huge sell-off in financial markets from September through November. While markets have rallied off their lows since then as panic selling has subsided, investor confidence is still fragile.

The Fed to the Rescue

For its part, the Federal Reserve has responded by embarking on an ambitious plan to rescue the financial system. The Fed's goal is to combat deflation and shore up confidence in the financial system by providing ample liquidity and by effectively becoming the lender of first resort. This marks an historic change in which the Fed is now making decisions that directly affect the overall allocation of credit, as well as the quantity of money.

In implementing its new strategy, it has taken a series of actions including:

- More than doubling the size of its balance sheet since September,
- Announcing planned purchases of mortgage-backed securities and agency debt totaling \$600 billion,
- Lowering short term interest rates effectively to zero, and
- Indicating willingness to purchase longer-dated treasuries to reduce long-term interest rates.

The unprecedented nature of these actions has generated considerable debate about their effectiveness and desirability. Some observers, for example, contend that the Federal Reserve will not be able to re-open credit markets as long as balance sheets of financial institutions remain strained. They note that banks still are reluctant to make new loans and are holding considerable excess reserves. Others are worried that the Fed's actions are ultimately inflationary and could backfire if they undermine confidence in the U.S. dollar. While there is some merit to these arguments, we believe the Fed's actions are justified, considering the severity of the problems today. In fact, inflation expectations as observed by Treasury Inflation Protected Securities (TIPS) markets show the risk of deflation to be the dominant concern now.

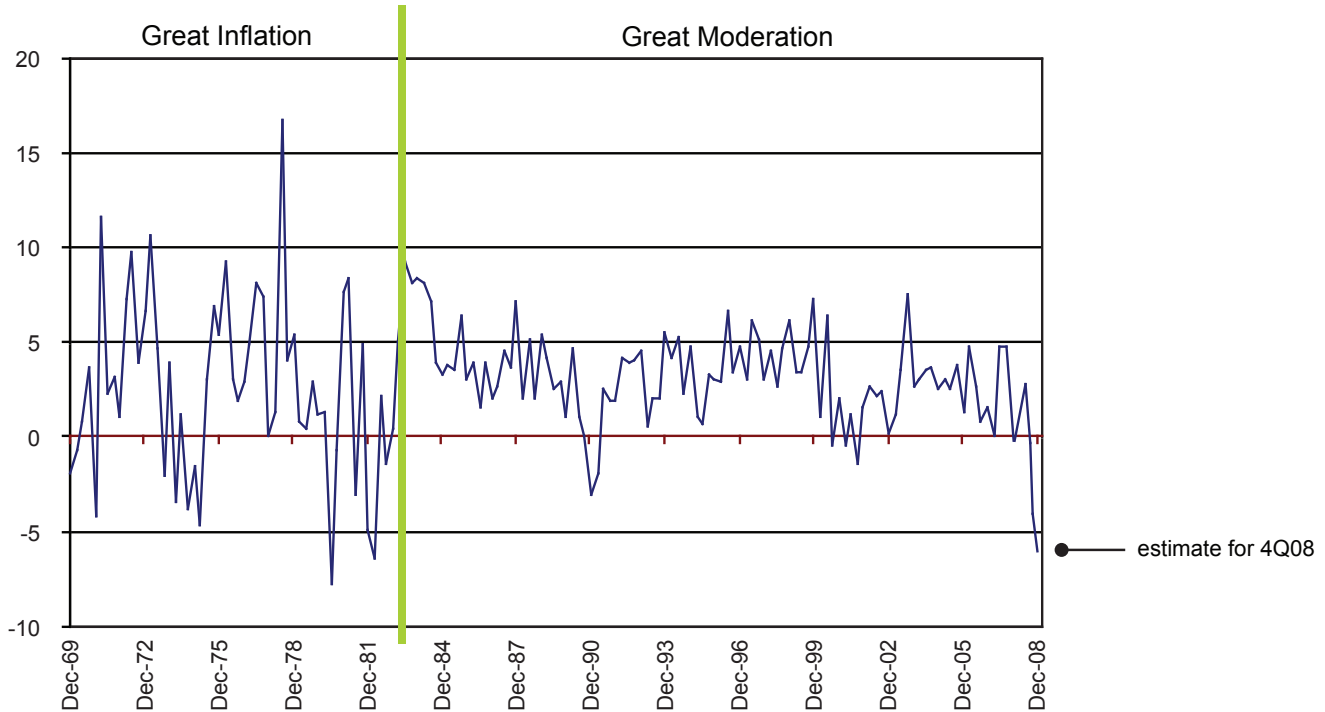
Instead of prejudging these actions, we are monitoring interest rate spreads and other indicators closely to see if credit market conditions are improving. Based on this data, there are several encouraging developments. First, the Fed's actions to date clearly are having the desired effect of lowering short-term interest rates and re-opening some short-term markets. Three-month LIBOR, for example, has declined from 4 ½% in mid November to nearly 1% recently, and activity in the commercial paper market, which had halted in the autumn, has resumed. Second, the rate on conventional 30-year mortgages has fallen by nearly 100 basis points since November and is currently just above 5.0%, with the Fed reportedly hoping to reduce it to 4.5%. Third, investment grade credit spreads have begun to narrow over the past month after having widened to more than 500 basis points, and new issuance activity has picked up. Nonetheless, while these developments are favorable, further progress is necessary to restore the normal functioning of credit markets.

Assessing the Economic Impact

In assessing the potential impact of these actions on the economy, investors should not expect a quick economic turnaround. If anything, the latest readings suggest the pace of economic decline has accelerated and is the steepest in decades (see Figure 2). Real GDP in the fourth quarter may have contracted at a 5%-6% annual rate, and the first quarter is likely to show a further sizable decline. Also, job losses in the final four months of 2008 have totaled nearly two million workers, and the tally is expected to continue climbing throughout 2009. The weakness in the United States, moreover, has spread throughout the industrial world and the emerging economies, including China and others that were once thought to be immune from a U.S. recession. Consequently, U.S. exports, which had underpinned the economy, have plummeted recently.



Figure 2
Real GDP (% Changed Annualized)



Source: Bloomberg

While economic forecasters have largely written off the first half of 2009, there is a significant divergence in views about the second half. Specifically, the consensus or mainstream view is that the economy will stabilize later this year, whereas pessimists expect the economy to continue contracting throughout the year. The key differences in forecasts between these two camps (shown in Figure 3) mainly reflect varying assessments about key sectors of the economy such as housing and consumption, as well as differing judgments about economic policies.

Figure 3
The Bears versus The Mainstream

	Consensus	N. Roubini
Real GDP (peak – trough)	(3 – 4%)	(5%)
Personal Saving Rate	3% – 5%	5% – 6%
Peak Unemployment	8%+	9%
Housing Prices	(10%)	(20%)
Credit Losses	\$1.5 Trillion	\$2 Trillion
Implied Default Rate	10%	13%
S&P 500 EPS	\$65	\$50 – \$60
S&P 500 Index	8% – 20%	(25%)

Source: RGE Monitor, various publications from consensus views

Will Housing Stabilize?

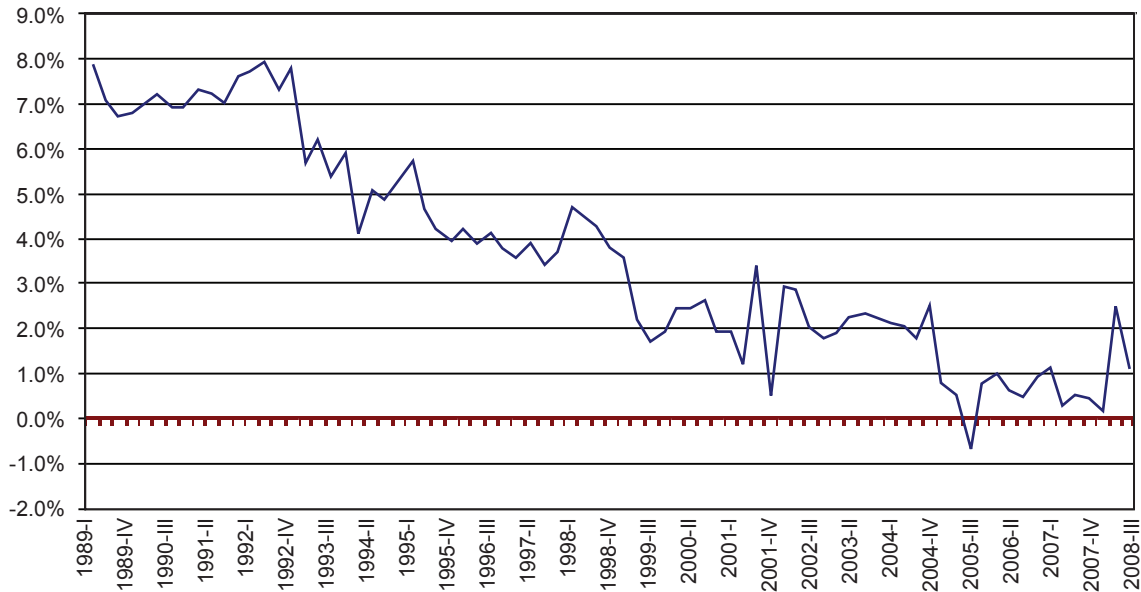
One of the main differences among forecasters pertains to residential housing, the sector that has been the primary drag on the economy over the past three years. The consensus view is that housing activity is likely to stabilize later this year, albeit at depressed levels, owing to a significant improvement in housing affordability and the Fed's efforts to expand mortgage availability. By comparison, the bearish case is that the overhang of inventories will remain unusually high due to rising foreclosures, and this will depress housing prices further by as much as 20%, bringing the cumulative decline to about 40%.

Can Aggregate Demand Be Bolstered?

Another key difference in forecasts relates to household spending, which has been the primary depressant to the economy recently. Purchases of autos, home furnishings and other big ticket items are estimated to have plummeted at an 18% annual rate in the fourth quarter. This has been the key factor behind the deepening of the U.S. recession, as consumer spending accounts for 70% of total spending in the United States. Declines in these areas, moreover, have caused U.S. businesses to pare back capital spending and employment, while also affecting businesses abroad.

There is general agreement among forecasters that a quick turnaround in consumer spending is unlikely, because households need to replenish savings at a time when personal income growth has slowed, wealth has been destroyed and jobs are scarce. The debate among the forecasters largely centers around how high the saving rate will rise this year (see Figure 4), with the consensus expecting a doubling to 4%-5%, while pessimists expect a bigger increase (6% or more).

Figure 4
Personal Saving Rate



Source: B.E.A., Department of Commerce

To a large extent, mainstream forecasters are banking on monetary policy initiatives and other sources of stimulus to help stabilize the economy. One source of added stimulus will come from a steep decline in oil prices, which effectively act as a tax cut for consumers and businesses. Assuming oil prices remain around \$50 per barrel or less in the coming year, for instance, the increase in purchasing power is estimated to be in the vicinity of \$300 - \$350 billion annually, or roughly twice the size of the tax rebate program enacted in 2008.

Another consideration is that the federal government is expected to take unprecedented action to fill the void in aggregate demand. The Obama Administration reportedly will ask Congress to pass legislation that could reach \$1 trillion over the next two years, which would be the biggest stimulus package in U.S. history. While details of the plan have yet to be announced, it is expected to be comprehensive and include \$300 billion in tax cuts for the middle class and businesses, increased assistance to state and local governments, and federal spending on infrastructure and energy initiatives.

What Could Go Wrong (Again)?

While the consensus view is plausible, we are also mindful that it is similar to the consensus in 2008, which turned out to be wrong, because forecasters under-estimated problems in the financial sector. Indeed, this has been the tendency since early 2007, when the Federal Reserve initially estimated that losses on sub-prime loans could reach \$100 billion. While there is greater appreciation of the complexity of the problem today, with cumulative write-downs by financial institutions approaching one trillion dollars, no one knows what the final tally will be and how readily financial institutions can raise the necessary capital. The mainstream view now is that the tally could reach \$1.5 trillion, but pessimists contend it may double to \$2 trillion, because systemic problems in the financial system have not been dealt with adequately.

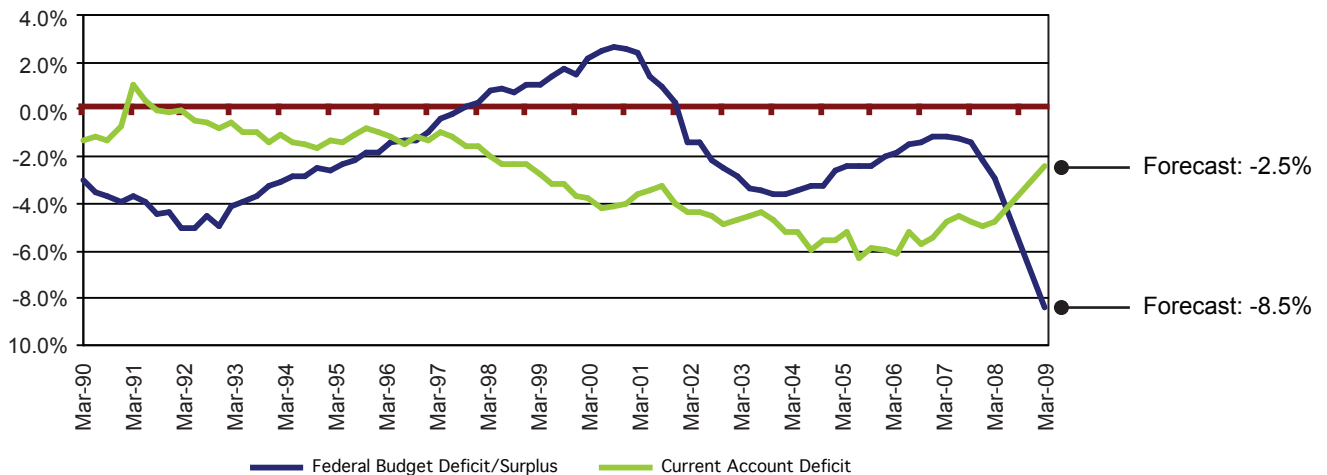
Another risk is that investors could lose confidence in U.S. policymakers and the dollar if the money supply and federal budget deficit continue to mushroom. Market bears, for example, contend U.S. policymakers may not have the latitude to pursue unorthodox monetary policies and massive fiscal stimulus should foreign investors become reluctant about financing the U.S. current account deficit.

Our own assessment is that the risk of a dollar crisis is a long-term issue but not an immediate threat. One reason is that economic conditions abroad are also deteriorating rapidly, and policymakers in Europe and other parts of the world have responded much slower than in the United States. Consequently, we expect the United States to recover ahead of the rest of world, which should underpin the dollar.

A second reason is that the U.S. current account deficit is likely to shrink significantly in the coming year owing primarily to reduced imports of oil, raw materials and goods from abroad. If so, this will lower the U.S. external financing requirement significantly, even though the U.S. budget deficit is projected to reach \$1.2 trillion (8.5% of GDP) (see Figure 5.) Our conclusion, therefore, is that there is greater risk this year of treasury yields rising than of the dollar plummeting.

Figure 5

Federal Budget and Current Account Deficits as percentage of GDP



Source: B.E.A. Bureau of Economics Analysis



Formulating an Investment Strategy

Weighing these considerations, we are open-minded in formulating our investment strategy. On balance, we are sanguine that the extraordinary policy actions will stabilize the economy and financial markets, but we are unsure about timing and also mindful of unforeseen contingencies that could arise. With the economy likely to be contracting through midyear at least, we expect markets to remain volatile for a while longer, rallying in advance of a turn in the economy and, will also be prone to pullbacks when news is disappointing.

In these circumstances, we are cautious in adding to risky assets such as stocks and lower-quality debt instruments at this time. While they are very cheap from a long-term perspective, we believe further improvement in credit market conditions is essential for them to sustain rallies. We are prepared to add to equity positions or high yield debt, however, amid clearer signs of a thaw in credit markets. Meanwhile, investment-grade corporate bonds (and municipals for taxable accounts) offer the best risk reward tradeoff. One asset class that we think is over-priced is U.S. treasuries, where yields are near record lows even as gross issuance may be headed to \$2 trillion dollars this year. While it was the asset of choice in 2008, we believe it will underperform as the economy stabilizes.



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