Godsey & Gibb Associates
Investment Watch
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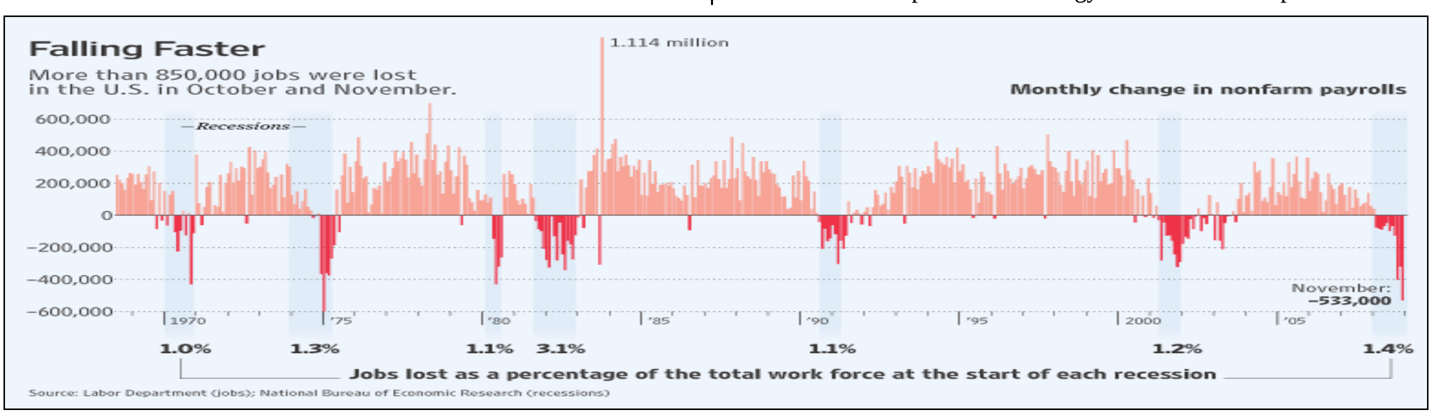
Recession Deepens As Tight Credit, Rising Unemployment, Falling House Prices, and Asset Deflation Pressure U.S. Consumer Spending and Global Economic Growth

The profound problems in the financial markets are taking a rising toll on the real economy. Recession conditions in the U.S. and global developed economies continued in the third and fourth quarters of 2008, driving an unprecedented policy response from the federal government. Broad stock indices declined over 40%, sending all ten-industry sectors significantly lower for the year. The financial market and economic turmoil continued to drive record levels of stock price volatility. The Chicago Board Option Exchange's Market Volatility Index (VIX) set an all-time closing high in November, surpassing realized levels of volatility experienced in 1987. The decline in stocks sent the dividend yield for the S&P 500 Index higher than the yield on the 10-year U.S. Treasury note for the first time since the 1950s. The 10-year U.S. Treasury note rallied, sending the yield to near 2% (the lowest in at least 31 years) from 5% just over a year ago. Non-investment grade credit spreads widened to over 20% (2000 basis points) over comparable U.S. Treasury notes. Even the cash markets, perceived by many as the safest, were negatively impacted by losses on asset-backed corporate paper.

Banks tightened lending standards and terms on all major loan categories according to the October 2008 Senior Loan Officer Opinion Survey on Bank Lending Practices conducted by the Federal Reserve. The financial crisis that started with troubles related to the housing bubble migrated into an eventual credit bubble and now the economy is suffering through a negative wealth effect due to the related equity shock. After rising 1.2% in the second quarter, third quarter consumer spending fell 3.7%, the largest decline in 25 years. Gross domestic product (GDP) in the third quarter declined 0.5% and is estimated to be more severely negative in both the fourth quarter of 2008 and the first quarter of 2009. The International Monetary Fund predicts that economic growth in 31 advanced economies, including the U.S., Japan, and Western Europe, will contract in 2009 in the aggregate for the first time since World War II.

Other economic measures also reached recession levels. The U.S. economy has lost jobs in every month in 2008 through November. The four-week moving average of new claims for unemployment benefits recently surpassed a 26-year high. November's job losses were the worst since 1974. The unemployment rate, which is currently 6.7% (the highest in 15 years), could rise to 8% or even 9% in 2009, by some estimates. Home prices declined 18.0% year-over-over in the 12 months ending in October 2008 according to the S&P Case-Shiller 20 home prices index. The FDIC announced its list of "problem" banks increased to 171 in the third quarter from 117 in the second quarter. Rising losses on mortgage and construction loans and rising delinquencies on credit card and other consumer loans continue to worsen the operating environment for banks. Nationally, bank reserves are not keeping pace with the growth of troubled loans, leading to lower coverage ratios (calculated as the dollar value of bad loans divided by the reserves for those loans).

In the most aggressive policy response in a generation, the Federal Reserve cut its Fed funds target rate to near 0%. In addition, combined with announcements from the U.S. Treasury and the Federal Deposit Insurance Corporation, the federal government outlined an unprecedented response to the financial crisis and recession. While there are limits to how low short-term interest rates can go, the Fed has shown little restraint on how large its balance sheet can grow. Growth in the Fed's balance sheet is known as "quantitative easing" as it increases the quantity of money in the broad economy, essentially creating cash to be used for its recently announced lending facilities. Since late August 2008, the Fed has grown its balance sheet to over $2 trillion, from a little less than $900 billion. While this increase will hopefully stimulate and stabilize multiple areas of the financial markets, quantitative easing comes with risks such as a credit market that becomes dependant on government involvement, as well as the implementation of an appropriate and non-disruptive exit strategy once markets improve.



Source: The Wall Street Journal

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In Washington, the new administration's economic team is taking shape (Treasury Secretary-designate Timothy Geithner, director of the National Economic Council Lawrence Summers and Council of Economic Advisors head Christina Romer) and we would describe it as neo-Keynesian (pro short-run stimulus, but anti long-run persistent deficits). Therefore, we believe a second economic stimulus is likely. Its focus is expected to be "infrastructure spending" to build roads, modernize schools, expand internet access, improve buildings' energy efficiency and enhance hospital technology. However, as the massive fiscal and monetary policy response to date has shown, there are no quick fixes for the recession. While the programs and policies implemented so far have helped to increase liquidity and to partially recapitalize the banking system, returning financial markets to normal and improving credit conditions will take time. Longer-term, we would expect to see an overhaul of the regulatory system in Washington, with a focus on improving financial sector transparency and accountability.

Recessions are unfortunately normal and unavoidable. During downturns it often feels like each is the worst since the Great Depression and the current environment is certainly no different. Although we will continue to monitor the available data closely for future potential risks, we believe that the unprecedented level of stimulus will begin to take hold and combined with lower commodity prices, it should deliver a modest economic recovery beginning in the second half of 2009. However, we expect the recovery to be subdued relative to historical standards. The "Great Moderation" should be modest due to the negative wealth effect from lower home and equity prices and a more restrained, and hopefully more responsible, use of leverage. This transition in the use of debt should lead to increased savings rates in the U.S. and therefore a lower than normal level of consumer spending and overall economic growth.

We will continue to monitor the incoming data for signs of an eventual economic recovery. Positive signs to date include the precipitous decline in crude oil prices, which led to a related 62% decrease in gasoline prices to approximately $1.50/gallon, which works like a tax cut for U.S. consumers. In addition, benchmark 30-year mortgage rates fell to near 5.17% in late December. This marks the lowest level since Fannie Mae began its weekly rate survey in 1971. A year ago, a 30-year mortgage averaged 6.14%. Moreover, there is more cash available "on the sidelines" than at any time since 1990. Balances held in cash, bank deposits and money market funds recently totaled $8.85 trillion, a number equal to 74% of the market value of U.S. companies, according to data from the Federal Reserve, compiled by Leuthold Group and Bloomberg. However, until we see moderation in the level of house price declines, stabilization in the labor markets, and a diminished level of losses at financial institutions, we will remain defensive with regard to the financial markets and the economy.

We continue to believe that successful investing takes time, patience and flexibility. While we can't directly control the economy or the financial markets, we can: keep our emotions in check, prioritize goals and objectives, and review portfolio positioning in light of the relevant goals, objectives, and risks. Given the current uncertain environment, we have proactively positioned portfolios for a longer than average economic recession through an evolution in asset allocation. We have underweight positions (and even zero weights) to higher risk, higher beta asset classes. This diversification away from volatility has added value. We continue to focus on high-quality equities with the most visible long-term growth prospects, resilient cash flows, sound balance sheets and secure, and often growing, dividends. By investing in a diversified portfolio of high-quality, mostly dividend paying companies, we believe we can enhance total return through growing dividend income now, until growth in earnings and the broad economy resumes. Our defensive positioning also carries over to the fixed-income markets. We have avoided adding to U.S. Treasury positions due to historically low yields, record levels of issuance and the prospects for future inflation, all of which diminish the appeal of direct U.S. obligations. We continue to focus on both highly-rated municipal notes and highly-rated corporate securities. We have increased our use of FDIC-insured certificates of deposit for income generation, and we maintain above–average cash levels for preservation and flexibility.

U.S. Business Cycles Since World War II

		Duration in Months		Peak to Trough % Change		Jobless Rate		
Peak	**Trough**	**Recession Peak to Trough**	**Expansion Peak to Trough**	**Real GDP**	**Nonfarm Employment**	**Low**	**High**	**Change, ppt**
Dec 2007	**Sept 2009 ***	**21 ***	**--**	**-2.8 ***	**-3.7 ***	**4.4**	**9.0 ***	**4.6 ***
Mar 2001	Nov 2001	8	120	-0.4	-2.0	3.8	6.3	2.5
Jul 1990	Mar 1991	8	92	-1.3	-1.5	5.0	7.8	2.8
Jul 1981	Nov 1982	16	12	-2.9	-3.1	7.2	10.8	3.6
Jan 1980	Jul 1980	6	58	-2.2	-1.3	5.6	7.8	2.2
Nov 1973	Mar 1975	16	36	-3.1	-2.7	4.6	9.0	4.4
Dec 1969	Nov 1970	11	106	-1.0	-1.4	3.4	6.1	2.7
Apr 1960	Feb 1961	10	24	-1.3	-2.3	4.8	7.1	2.3
Aug 1957	Apr 1958	8	39	-3.8	-4.4	3.7	7.5	3.8
Jul 1953	May 1954	10	45	-2.7	-3.3	2.5	6.1	3.6
Nov 1948	Oct 1949	11	37	-1.7	-5.1	3.4	7.9	4.5
Average for recessions		10	--	-2.0	-2.7	4.4	7.6	3.2

Sources: NBER, BEA, FRB, BLS, Moody's Economy.com

* Estimated

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