



Economic & Market Outlook

- The latest estimates from the Commerce Department indicate U.S. GDP declined at an annualized rate of 6.2% in the fourth quarter of 2008. This marked the steepest decline for the economy since 1982. Looking ahead, we expect the global economy to contract over the next several quarters, with U.S. recovery coming in late 2009 or possibly early 2010.
- Due to the slowing economy, unemployment reached 8.1% according to the most recent report. We expect the level of unemployment to rise even higher in the coming months.
- Federal Reserve officials have cut interest rates to historic lows, and are now targeting rates in the range of 0.0%-0.25%. The Fed has indicated rates will continue to stay low for an extended period of time.
- At the most recent meeting, the Fed indicated heightened concerns about the deflationary trends occurring in the U.S. economy. A prolonged downtrend in price levels could stall recovery by making it harder for consumers to pay off debts and banks less likely to lend.
- The Fed expanded its lending facility for consumer debt securities by \$1 trillion to try to lower the cost of credit card, student and other consumer loans.
- Congress passed, and President Obama signed a \$787 billion economic stimulus bill in February. In addition, President Obama unveiled a \$3.6 trillion budget for 2009, the largest in U.S. history.
- Talk of “bank nationalization” ramped up over the past month. The Treasury recently unveiled details of the Capital Assistance Program, a plan designed to stabilize the U.S. banking system. The rescue plan will involve stress-testing the 19 largest U.S. banks to determine if additional public capital will be required to stabilize these firms.
- The U.S. stock market was down significantly in February, as the S&P 500 registered a negative 10.65% return. Stocks were down worldwide as well, with the Morgan Stanley EAFE International Index down 10.26% for the month.
- With Treasury yields falling, the dividend yield on the S&P 500 now exceeds the yield on the 10-year Treasury, a relationship not seen since the late 1950s.
- We believe the equity markets can achieve better returns in the latter part of this year compared to the first half of the year, as investors anticipate an improving economy. Overly optimistic expectations of a quick revival of the U.S. economy starting the year dimmed and expectations will likely remain muted for the next several months.
- Within the equity markets, we remain fully diversified but continue to prefer domestic stocks over international stocks, large cap over small cap and growth over value on a relative basis. Returns year-to-date have followed this hierarchy.



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- We believe stocks of high quality companies with less exposure to problems in the credit markets should do relatively well in a slowing economy. Companies with significant international sales should benefit if the dollar weakens. We remain conservative and defensive in nature.
- With short-term rates reaching a bottom, we expect longer-term yields will decline as well over the next 6-12 months, due to weakness in the U.S. economy. Beyond that, we expect Treasury yields to rise due to additional Treasury borrowing and glimmers of an economic recovery. Meanwhile, money market yields will likely remain near zero for all of 2009. We believe investors are better off purchasing intermediate-term non-Treasury bonds with significantly higher yields than waiting in money market for the Fed to hike rates.
- We expect low single-digit returns from Treasury securities and mid-to-upper single-digit returns from U.S. corporate, municipal and MBS securities in the next 12 months. We favor taxable municipals with A or better underlying credit ratings, agency mortgage-backed securities with premium coupons, and AAA-rated agency bonds with good call protection. While non-financial corporates are also attractive, we believe regulatory and political risk is currently too high for financial bonds.
- Tax-exempt municipal bonds continue to be attractively priced relative to Treasuries and historical average yields. Lately, a shortage of Minnesota municipal bonds has increased prices and lowered yields, especially in shorter maturities.
- We continue to buy and hold municipal bonds with investment grade underlying credit ratings, independent of the bond insurers' status, and see value in the 11-20 year part of the curve, as the 0-10 year segment is crowded with more buyers than sellers.
- We encourage investors to stay focused on their long-term goals in the midst of this current market volatility. It is especially important to stay diversified and to reaffirm that our clients' current asset allocation is consistent with their long-term goals. We advise clients to remain cautious toward risky assets with time horizons less than 3 years.