



CAPITAL MANAGEMENT, LLC

www.smscap.com

6575 West Loop South, Suite 603 • Bellaire, Texas 77401
Phone 713-623-1534 • Fax 713-589-9496 • Email info@smscap.com

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By Steven M. Sheldon, CFA

About SMS Capital Management

SMS provides investment management services to individual investors desiring to preserve and build long-term wealth. As a fee-based firm, SMS has an independent, objective and sound approach to portfolio management. The firm is a Registered Investment Adviser.



About the Author

Steven Sheldon has more than thirteen years of professional experience analyzing and managing investments. Prior to founding SMS, Mr. Sheldon worked as a senior member of a corporate principal investments group. Mr. Sheldon has an MBA from Tulane University and a BBA from The University of Texas. In addition, he is a CFA charterholder and a member of both the CFA Institute and the Houston Society of Financial Analysts (HSFA).

2009 – Market Outlook

There were lots of extraordinary things that happened in 2008. Unfortunately, from an investor's standpoint, they were all extraordinarily bad. It was a year that started off in the wrong direction and only got inconceivably worse. It was a year you found yourself saying, "You've got to be kidding me" over and over again in utter disbelief. And almost fittingly, the year in which we witnessed the tragic demise of so many of the world's largest financial institutions ended with the uncovering of perhaps the biggest and most disturbing investment fraud of all time. Yes, it was a year to be remembered and a year to be forgotten.

As we head into 2009 in the midst of arguably the deepest recession since WWII, it is unclear as to whether the stock market hit "bottom" in November or whether or not further declines lie ahead. **Even though current stock prices are already reflecting a very serious economic downturn, there is no doubt that corporate earnings will continue to slide in 2009. Thus, even though stocks are attractive at current valuation levels, they remain a precarious investment in the short run.**

At its lowest point on November 20th, the S&P 500 index closed at 752, marking a 52% decline from its value peak of 1565 set on October 9, 2007 (just a little over a year earlier). At that low level, all gains from the previous five-year bull market from 2002-2007 were wiped out. The market has since bounced back somewhat from its November lows, but still finished the year deep in negative territory.

Low inflation, falling interest rates, expansionary Fed policy, and a new White House administration that is eager to provide significant fiscal stimulus should help the economy get back on a growth track over time. However, the stock market might have to wait until 2010 to be "out of the woods" and set up to register more meaningful and sustainable returns. That does not mean that we won't have several rallies (perhaps very significant ones) during the next year, they just might fade away as reality sets in that there are no quick fixes for this economy.

With all the uncertainty still surrounding the state of the global economy, investors should maintain a more conservative stance with regard to equities, as better risk-adjusted opportunities are presently in the bond market.

The Hundred Year Flood and Then Some

In 2008, virtually all asset classes, except cash and U.S. Treasury bonds, were bludgeoned by the deepening credit crisis and the ensuing onset of a global recession. The steepest losses were in the months of September through November, as the global sell-off reached a panicked frenzy. Investors' reaction to the sudden collapse, bailout, or forced merger of AIG, Lehman, Fannie Mae, Freddie Mac, Washington Mutual, Merrill Lynch, Wachovia (just to name a few) was to sell anything that had risk associated with it. Selling by hedge funds and mutual funds exacerbated the downside spiral as fund managers were forced to sell their most liquid holdings just to raise cash to meet investor redemptions.



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With nowhere to hide, equities got slaughtered across all capitalizations and sectors. Financials were the worst performing sector for the second year in a row, losing 57%, while consumer staples performed the best (or lost the least), declining 17.66%, as investors flocked to the shares of companies providing basic goods and necessities. Despite all the problems in the U.S., international developed markets did worse, and emerging markets suffered even more. For U.S. dollar-based investors, Japan had the best return (thanks to a strengthened yen) and Russia had the worst (due to the collapsing ruble).

For the Year Ended December, 31, 2008 (Total Returns - Including Dividends)

Index	Total Return (%)*
S&P 500	-37.00%
DJIA	-31.93%
Russell 2000 (Small Cap)	-33.79%
International	-42.80%
U.S. Bond Aggregate	5.7%

The performance of fixed income investments in 2008 depended on whether or not the U.S. government stood behind the obligation. If the income stream was backed by the government it went up in value, all other fixed income investments including REIT's, Master Limited Partnerships (MLP's), and corporate bonds had negative returns for the year. High yield (junk) bonds got pummeled as fears of massive future defaults took a toll. Investment grade bonds, normally a safe haven, also performed terribly, having the worst year since the great depression era as investors dumped everything that didn't have a U.S. government guarantee.

More Mattress Stuffing?

Shell-shocked retail and institutional investors responded in a predictable fashion to the market crash and extreme volatility by stampeding out of their stock and bond holdings at a record pace. Understandably, money market fund balances (now being back-stopped by government guarantees) and FDIC insured bank certificates of deposit have surged. As of mid December there was approximately \$3.8 trillion in money market funds, up from \$3.1 trillion a year ago. **Essentially, an astounding \$700 billion has been added to these savings vehicles in the last several months.**

With the yield paid on these theoretically "riskless" investment vehicles dwindling by the day, it is only a matter of time until these same investors will be looking to earn a better return on their money. By lowering rates to such a low level (the target for Fed funds is rate is now 0% to 1/4%), the Fed is improving the profitability of financial institutions as well as encouraging investment in "risk" assets; thereby, providing the essential capital for the economy to grow. Banks should be more willing to borrow cheaply and make loans at much higher rates while investors will likely start moving out of money market funds to invest in stocks and bonds.



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Portfolio Positioning

In 2009, it's not a question of whether or not corporate profits will be lower than in 2008; it's a question of by how much? **Slack demand for goods and services due to the recession, a stronger dollar, and higher borrowing costs will all weigh heavily on corporate earnings in 2009.** While the 52% drop in the S&P 500 (from peak to November low) obviously foretells much of the decline in future earnings, it is yet to be determined just how much.

A good case can be made that the stock market hit bottom in November and will move significantly higher next year as the economic recovery starts to take hold in late 2009 and stock prices move in advance of that recovery. In fact, in many past recessions, the market starts to recover midway through the recession. Assuming this recession lasts a very long two years (and we are just over one year through it), the market might start advancing early in 2009. On the other hand, since this recession is so deep and global in nature, the market might set new lows next year before finally recovering. As earnings plunge with the deepening of the recession, investors may decide to sell at any price just to stop the pain. Lastly, it is also plausible that stocks neither plunge nor skyrocket, but stay in a fairly narrow trading range. As investors digest both the good and bad news about economy little headway will be made.

The bottom line is that it is still too early to have conviction as to how this particular recession and recovery will play out. Stock prices are attractively priced, but that does not mean they will go up and stay up in the near term.

Investors looking to move cash off the sidelines should consider investing in the debt of high grade companies (investment grade bonds) rather than buying stocks. Currently, an intermediate term investment grade bond fund is yielding roughly 7%. Historically, investment grade bonds pay approximately 1.50% to 2% more than the equivalent term U.S. Treasury bond. This additional yield is known as the "credit spread". In September, as the economy imploded, the credit spread surged from 3% to more than 6%. At those record high levels, investors are finally getting compensated for the risk of default they are taking. In addition, investment grade bonds are going to be a tell-tale sign for the market since the bond market tends to lead the stock market. In other words, for the stock market to start behaving better, the corporate bond market will have to do better first.

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