2008 Capital Market Commentary

The S&P 500 Index finished the year down 37%, the worse calendar year return since 1931 when stocks fell 43%. Bond returns were positive, but only because a "flight to quality" sparked a 20% rally in Treasury bonds (10-year). The investment grade Barclays (formerly Lehman) Aggregate Bond Index returned a much more modest 5% for the year, weighed down by a 6% loss on its components that don't carry a government guarantee. High yield bond and bank loan securities were pounded, trading at 65 cents on the dollar at year end versus prices close to par a year earlier. Commodities skyrocketed during the first half of the year but plummeted through the second half, finishing down 36% for the year. Our review of 2008 could not, of course, be complete without mentioning where it all began, in the U.S. residential housing market. Housing values nationwide are down 18%, and, when you consider that the average homeowner was almost 50% mortgaged going into the year, losses on home equity are approaching 40% for 2008. Not a pretty picture for institutions or individuals alike. Exhibit 1 shows calendar 2008 returns for the major market indices.

Exhibit 1: 2008 Market Performance

Index	December	FYTD*	Calendar 2008
Equity			
DJ Wilshire 5000	1.7%	-29.5%	-37.2%
S&P 500	1.1%	-28.5%	-37.0%
Russell 2000	5.8%	-26.9%	-33.8%
MSCI EAFE	6.0%	-36.6%	-43.1%
MSCI Emerging Mkts	7.7%	-47.3%	-53.5%
DJ Wilshire REIT	17.7%	-28.2%	-39.2%
S&P 500 Financials	-3.1%	-38.2%	-56.6%
Fixed Income			
Barclays Aggregate	3.7%	4.1%	5.2%
Barclays Treasuries	6.3%	17.7%	20.1%
Barclays TIPS	5.0%	-6.9%	-2.4%
Barclays High Yield	7.7%	-25.2%	-26.2%
Barclays Bank Loan	-3.0%	-29.1%	-29.5%
AAA ABX (Subprime)	3.6%	-28.8%	-43.2%
Barclays Municipals	1.5%	-2.5%	-2.5%
3 mo.Libor	0.2%	-1.4%	0.2%
Alternative			
DJ AIG Commodity	-4.5%	-49.4%	-35.7%
HFRI Fund of Funds**	-0.2%	-18.0%	-20.0%
HFRI Fund Weighted**	0.4%	-17.0%	-18.3%

* Fiscal YTD from June 30

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Other noteworthy developments during 2008 include:

1. *Hedge Funds*. Hedge funds had record losses in 2008. The HFRI Fund Weighted Index lost 18.3% for the year and the HFRI Fund of Funds Index, which probably is a better indicator of actual investor returns, was down 20.0%. We have written in earlier commentaries about the significant deleveraging and redemption pressure on hedge funds, undoubtedly making losses worse. While we see deleveraging abating, redemptions should continue for the foreseeable future as year-end "gating" prolongs liquidation requests.

2. *Libor*. The good news is that the government may be getting the credit crisis slowly under control through Treasury and Fed actions. We indicated in past reports that the Libor spread to short term Treasuries is a key indicator of the health of the financial markets. The Libor rate spread has historically averaged 0.25% but skyrocketed to 4.50% after the Lehman bankruptcy. The spread continues to decline and ended the year at 1.34%.

3. *CPI*. Inflation has been negative for four consecutive months and equals 1.0% for the one year ending November. (December CPI is not available.) We expect CPI to continue to fall for the short term, as does the market. For the first time, TIPS are yielding more than Treasuries for maturities up to 10 years. The only rational explanation is that the markets are expecting deflation, at least for the next few years. TIPS returns had been tracking Treasury returns until this year when they began moving in opposite directions.

4. *Diversification.* Most markets moved significantly downward in 2008, frustrating investors who hoped that asset class diversification would protect them, or at least dampen losses. The non-U.S. stock markets lost more than the U.S. markets, due in large part to a recovering dollar and foreign investors saw the U.S. as a safer haven than their local markets.

5. *Equity REITs.* This was one of the worst performing market sectors in 2008, down 39%. REIT dividend yields, which usually trade at a slight premium to Treasury bonds, climbed to over 8%.

6. *Private Equity and Real Estate.* Returns for these asset classes are reported with at least a three month lag so we do not know what effect the fourth market drop will have on valuations. Our suspicion is that writedowns will come swifter than in 2000 as FAS 157 will bring greater scrutiny to how GPs value their portfolio companies. Nonetheless, we anticipate a softer landing (fewer losses) than witnessed in the public markets.

We end with an abbreviated review of what is now accepted as the worst *financial* crisis since the Great Depression. Yet unsettled is whether we are also witnessing the worst *economic* crisis since the Great Depression. Appendix A offers a graphic chronology of events, beginning with the first market recognition of the subprime mortgage problem over 18 months ago in June 2007 and that continues to this day. While not understood at the time, we now know that an economic recession began in November 2007. Nine months later, the events of September 2008, particularly the Lehman bankruptcy, appear to have triggered an investor and consumer *panic* that immediately created a worsening financial crisis and deepening recession. Quick governmental action, through TARP and Fed purchases, may have contained the financial crisis, but it remains unknown how deep and how long the recession will be, with a depression scenario now a non-trivial possibility.

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January 12, 2009

Appendix A: 2007-2009 Financial Crisis Timeline

2007

APRIL
S M T W T F S

MAY
S M T W T F S
Mortgage Lenders
Early bailouts begin

JUNE
S M T W T F S
Subprime Mortgages & CDOs
Loose lending standards stoke sharp declines in levered tranches of subprime ABS.

JULY
M T W T F S S
Bank Loans
CLOs drop out of market due to losses in subprime. Banks get stuck with excess supply from LBO financing.

AUGUST
M T W T F S S
Libor and Quant Funds
Banks reserve capital, causing LIBOR/T-Bill spread to surge. Quant models fail amidst massive deleveraging.

SEPTEMBER
M T W T F S S
SIVs
Structured Investment Vehicles that issued short term paper to finance mortgage investments face liquidation.

OCTOBER
M T W T F S S
Money Market Funds
Yield-hungry investors ignored risk in "cash" investments with exposure to subprime

NOVEMBER
M T W T F S S
Bond Insurers
MBIA, Ambac, FGIC prove undercapitalized to handle mounting insured losses in structured credit mortgage securities.

DECEMBER
M T W T F S S
Municipal Bonds
Municipal bond investors react to instability of insurers subject to subprime liabilities. Municipalities face higher financing costs.

2008

JANUARY
S M T W T F S
Stocks, ABS, Bank Loans II
Recession fears cause stocks to tumble. Falling LIBOR chases yield investors out of bank loans.

FEBRUARY
S M T W T F S
Auction Rate Securities, CMBS
Auctions on securities funding everything from student loans to closed-end funds fail as insurance appears worthless and banks refuse to act as buyers of last resort.

MARCH
S M T W T F S
Fed Bailout of Bear Stearns
Cash depleted as repo market no longer available, forcing Fed to broker JPM acquisition and direct assistance.

APRIL
S M T W T F S
European Central Banks Act
The EU and Bank of England rescue WestLB, RBS, other financial institutions. TPG injects $7 billion into WaMu.

MAY
S M T W T F S
Prime Mortgages
Mortgage deliquency rates rise, bringing down prices of Alt-A and prime mortgage securities

JUNE
S M T W T F S
Recaps Continue
Merril Lynch and Lehman raise captial from institutional investors

JULY
S M T W T F S
Bank Seizures
FDIC seizes IndyMac and Treasury discusses options for Fannie Mae and Freddie Mac

AUG
S M T W T F S
Storm Clouds Gather
Stocks of financial instituitons and credit instruments reflect turmoil in market.

SEPT
S M T W T F S
Near Financial Collapse
Lehman files for bankruptcy. Fannie Mae, Freddie Mac, WaMu, AIG, B&B, Giltnir, Merrill Lynch seized or merged.

October
S M T W T F S
Massive Govt Action -- TARP
Governments and central banks announce bailout packages, inject liquidity in credit markets and take stakes in financial institutions.

November
S M T W T F S
Panic Subsides but Recession Mounts
Wave of dismal economic data spurs need for fiscal stimulus, mortgage modification. Citibank rescued.

December
S M T W T F S
Auto Bailout, Madoff
TARP monies for auto industry; Bank status for auto finance companies; hedge fund redemptions expose Madoff.

2009

JANUARY
S M T W T F S
Trillion Dollar Stimulus Package
Unemployment jumps to 7.2%; Obama promises historic stimulus package.

FEBRUARY
S M T W T F S

MARCH
S M T W T F S

Source: Cliffwater LLC