



## Fourth Quarter 2008 Investment Commentary

By any measure, 2008 was a catastrophic year for global markets. Equity markets around the world suffered their largest losses since the 1930s. The only place to hide was in government bonds of developed nations. The fallout from the massive de-leveraging of the financial system caused by the American-inspired mortgage crisis was not restricted to the United States. While US equities as represented by the S&P 500 and Dow Jones Industrial indices were down -37.0% and -33.8%, respectively, overseas markets fell even further and faster: the broad based international MSCI Europe Australia Far East (EAFE) Index was down -43.1% for the year. Despite budget surpluses and favorable balance sheets, the emerging markets fared even worse as the collapse of the oil and other commodity markets decimated the volatile BRIC equities. According to MSCI, Brazil was down -58%, Russia -74%, India -65% and China -52%. Clearly, the principal of diversification did not pay off in 2008, nor did the thesis of the de-coupling of the global markets hold true. In addition to pervasive weakness, markets experienced unprecedented market volatility, especially after the bankruptcy of Lehman Brothers. Since January 1, 1950, there have been 68 days when the US market was up or down more than 4% (with slightly more up than down days). Twenty-eight, or 41%, of these extreme trading days occurred in the final four months of 2008!

The US government has responded to the economic crisis with fiscal and monetary stimuli. After the Federal Reserve pledged to use \$600 billion to buy up debt issued or backed by mortgage finance firms (such as Fannie Mae and Freddie Mac) along with another \$200 billion from the Treasury to support consumer lending, frozen credit markets finally began to thaw. Interest rates on bonds issued by Fannie and Freddie, as well as investment grade companies, and municipalities, dropped from extremely elevated levels in November as investors grew more familiar with the government's bailout plan and more comfortable with the credit risk of these issuers. The credit markets preceded the equity markets into this crisis and it is very likely that they will lead the equity markets out of it. Even if this is not the case, the improvement in the fixed income markets is a welcome sign that some aspects of our government's stimulus plan are beginning to have the desired effect.

## Market Outlook

As difficult as 2008 was, there are good reasons to believe that the prospects for the coming year will start to improve. The 30-year fixed rate mortgage rate has fallen to a recent national average of 5.17%, the lowest level since Freddie Mac began surveying rates in 1971. Oil prices, which briefly flirted with \$150 per barrel in mid-July, have retreated to a sub-\$50 per barrel at the time of this writing. The impact of lower oil prices and interest rates is stimulative to our economy as many consumers will benefit from lower energy and housing costs as a result. In addition, equity markets appear to have stabilized somewhat as the VIX volatility index declined from its all-time high of over 80 to readings in the high 30s (19 is the long-term average). The yield on the S&P 500 Index is now greater than that of the 10-year Treasury for the first time since 1962. Further, money market funds make up 42% of the total market capitalization, well above the 12% they normally average and the 28% high reached at the bottom of the 2002 bear market. At some point, as confidence returns to the market, we believe that investors will seek out more lucrative returns than the 1.7% yield of a 5-year Treasury note.

Success in re-establishing the credit function will eventually trigger a rebound in growth, but this will likely be a deeper and longer adjustment period than anything in recent memory. The first half of 2009 is likely to be disproportionately weak, with stability in our credit markets eventually bearing fruit in the later stages of 2009 and early 2010. Liquidity injections engineered by global policy makers are unprecedented and would normally trigger an inflationary response. This liquidity, however, has been put into place to offset the sharp drop in credit availability from other sources and the corresponding evaporation of the velocity of money. As economies and credit markets normalize in 2010 and beyond, policy makers' focus will likely shift toward the balance between inflationary risk and the orderly removal of the liquidity.

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UMFNE Investment Committee  
January 13, 2009

<sup>1</sup>Source: Soleil Perspective, December 2, 2008

<sup>2</sup>Source: Wall Street Journal, Friday, January 2, 2009, page R12.

<sup>3</sup>Source: Strategas Investment Strategy Report January 6, 2009,

<sup>4</sup>Velocity measures the rate at which money supply turns over within the economy

UMFNE's 2008 year-end performance, as well as the complete Market Commentary will be online by Tuesday, 1/27/09 at [www.umfne.org](http://www.umfne.org). If you would like a printed copy, please call our office at 800-595-4347 X100.

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