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Extraordinary Collapse of Credit Markets Triggers a Global Financial Meltdown

In this issue, we provided a recap of the most challenging economic events confronted by the U.S. since the Great Depression. The mass liquidation of financial assets around the globe was breathtaking, and widespread fear and uncertainty reached extreme levels. We discussed new strategies for stock and bond portfolios in the face of disproportionate price declines

The financial crisis that began with the bursting of the house price bubble and the subsequent collapse of sub-prime mortgage and other asset backed security prices almost brought the global financial system to its knees during the fourth quarter of 2008. Economic disaster was averted by massive government intervention by the United States and other countries, but equity investors sustained significant losses. The table below documents the damage, and the paragraphs that follow summarize our current thinking about the economy and our strategy for positioning your assets for recovery in 2009-2010.

STOCK AND BOND MARKET RESULTS : TOTAL RETURNS

	2009 First Quarter	Year 2008	Last Five Quarters
S& P 500 Stock Index	-19.3%	-21.9%	-37.0%
Salomon Medium-Term Treasury Bond Index	4.6%	6.5%	11.4%
Merrill Lynch 5 to 10 Year AA-AAA Corp. Bond Index	-9.0%	7.9%	-1.8%
Merrill Lynch 3 to 7 Year State G. O. Index	1.8%	4.4%	6.3%
Merrill Lynch 12 to 22 Year State G.O. Index	-4.6%	2.5%	-2.3%

THE GLOBAL FINANCIAL SYSTEM CAME UNDER INTENSE PRESSURE IN THE FOURTH QUARTER, BUT NOW IS STARTING TO HEAL

When the problems in the financial sector started to surface and multiply in September, the Secretary of the Treasury, Chairman of the Federal Reserve and, tangentially, the U.S. Congress stepped up and initiated an unprecedented series of transactions and programs to save the credit markets:

1. Fannie Mae and Freddie Mac, two government sponsored agencies that guarantee some 45% of the US mortgage market, were placed in government conservatorship with coincident commitments for significant equity backing.
2. Over one pressure packed weekend, Lehman Brothers was allowed to fail and Merrill Lynch sold to Bank of America.
3. The United States "nationalized" insurer AIG with a rescue package that so far has totaled \$150 billion.
4. Regulators seized Washington Mutual and sold the bulk of its operations to J.P. Morgan.
5. The Treasury engineered the sale of Wachovia/ AG Edwards to Citigroup, but

- the deal was trumped by an offer from Wells Fargo.
6. Congress authorized the first \$350 billion of a \$700 billion Troubled Asset Recovery Program (TARP) which was primarily used to make direct equity investments in American banks.
 7. Goldman Sachs and Morgan Stanley, the last large investment banks left standing, converted to bank charters to avail themselves of government capital injections and access to demand deposits.
 8. The Fed was authorized to buy up to \$800 billion of mortgage and other asset backed securities via a program called the Term Asset-Backed Securities Loan Facility (TALF).
 9. The Fed initiated a series of fed funds rate cuts, one in concert with six foreign central banks and one that brought the domestic target rate to "between zero and one-quarter percent" by mid-December.
 10. The President agreed to lend \$17 billion to Chrysler and GM after Congress rejected the companies' pleas. GMAC converted to a federally backed bank to get a \$6 billion equity infusion of TARP funds.

In a normal quarter, any one of the items enumerated above could have been the most significant news item, but to have them all occur in rapid succession over 90 days defies description. In multiple venues, Hank Paulson, Ben Bernanke and Sheila Bair, Chairman of the FDIC, reiterated the message that they were prepared "to do whatever it takes" to end the crisis, and so far that has been borne out. These public figures have received a lot of criticism for their efforts. Our view is that, given the degree of uncertainty, the rapidity of events and the unprecedented scale of the crisis, these appointees have gotten things more right than wrong. Most importantly, they have scaled the size of their response to the size of the problem, and we feel the initial improvements in the credit markets are due primarily to their efforts.

FINANCIAL STABILITY IS A PRE-REQUISITE FOR ECONOMIC STABILITY

Historians of the Great Depression and of Japan's "lost decade" from 1989-1999 will tell you that those crises subsided once capital was injected directly into the banks (so they could take the necessary losses--see our October 2008 quarterly letter) and when consumer deposits were guaranteed. Recognizing this, the FDIC expanded insurance coverage on deposits from \$100K to \$250K and the Treasury guaranteed over \$3 trillion of money market fund balances in place as of September 19th, 2008.

There are now signs that the credit market is starting to function again. The London Interbank Overnight Rate (Libor) declined from 6.9% on September 30th to 0.1% at year end, and banks are once again willing to lend to each other. With the assistance of government guarantees, new issue volume in the commercial paper market and short-term note market is starting to grow.

One by one, we are seeing extremes and anomalies in the credit and bond markets normalize, and this is important because the economy must have access to viable credit and capital markets in order to recover. We believe the magnitude of government action and the speed with which it was implemented have greatly reduced or eliminated the

possibility of a “great depression scenario” for the United States economy.

CONSUMER DELEVERAGING HAS TRIGGERED A U.S. RECESSION

Having likely dodged a depression, however, does not negate the fact that the “cure” for a real estate bubble is a recession and credit liquidation cycle, and we are in the middle of one right now. Some 70% of U.S. GDP is driven by consumption, which is sharply contracting because of reduced availability of credit, 7.2% unemployment (2.5 million jobs were lost during 2008) and falling asset prices. It is very difficult to forecast the depth and duration of the current downturn, but one key to recovery lies in arresting the price decline in residential real estate, the largest investment on many family balance sheets.

Since their peak in mid-2006, home prices have declined by 23% through October, and the Mortgage Banking Association reports that roughly one in ten home owners with a mortgage is either in foreclosure or delinquent on monthly payments. Clearly, mortgage rates need to come down so that existing owners can refinance to reduce their debt burden and first time buyers who can afford a 20% down payment are motivated to step up and buy a home.

The TALF program alluded to above is committed to buying up to \$500 billion of mortgage backed securities in the open market with the goal of forcing rates down to the 4.5% level. After deploying just 2% of this money in early January, the 30 year fixed mortgage rate is already down to 5%. We think we will see a rise in both refinancing and new mortgage applications in coming months, and with few new homes being built, the inventory of unsold homes should start to decline sometime in late 2009 or early 2010.

THE BOND MARKET WILL LIKELY EXPERIENCE A PERIOD OF DISINFLATION; THEN AN INFLATIONARY IMPULSE MUST BE MANAGED

The table below shows the yields available on the highest quality taxable and tax-exempt bonds at the end of the fourth quarter. The third column shows the relationship between the two markets in percentage terms.

Years to Maturity	U.S. Treasury Securities	AAA Municipal G.O. Bonds	Muni Yield/ Taxable Yield
1	0.3%	1.0%	333%
2	0.8%	1.8%	225%
4	1.5%	2.6%	173%
10	2.2%	3.9%	177%
30	2.7%	5.3%	196%

Source: Bloomberg Inter-market Yield History

The numbers in this table are remarkable in several respects. U.S. Treasury yields are extraordinarily low, having declined by 300 basis points at the short end and 180 basis

points at the long end versus yields at the end of 2007. This dramatic move reflects extreme fear and risk aversion by fixed income investors whose preference for Treasury securities pushed T-Bill rates into negative yield territory for several days this quarter.

Secondly, the relationship between tax-exempt yields and Treasury yields as shown in column four are at unprecedented levels. For example, a ten year AAA rated General Obligation municipal bond now yields 177% of the comparable ten year Treasury yield. In the past 40 years, that ratio has generally fluctuated between 70% and 110%, and today's extreme reading reflects the combination of an elevated demand for Treasuries and concerns about the credit worthiness of state and local governments embroiled in a deep recession whilst tax revenues and housing prices are falling.

TAXABLE BOND STRATEGY FOR 2009

Our view is that straight Treasury bonds are not the optimal investment right now because demand is elevated by a panic mentality, and supply is certainly going to increase in order to finance upcoming budget deficits in the \$1 trillion range. It is also unclear if foreign governments will continue to be large buyers of U.S. debt if the dollar starts to weaken. As a result, we have essentially sold all of our straight Treasuries and reinvested in three high quality sectors of the taxable bond market:

1. Rather than conventional Treasuries, we have bought intermediate maturity Treasury Inflation Protected Securities, known as TIPS. Unless all the recently created liquidity is skillfully withdrawn once the economy turns, higher inflation is inevitable, and we need to be prepared for it. In this same regard we have continued to hold other bonds with inflation adjusted variable coupons, despite recent price declines.
2. We also own Fannie Mae and Freddie Mac mortgage backed securities to take advantage of TALF buying in that sector, as well as senior unsecured debt of the same Agency issuers, some of which we expect to be called. Our view is that the "implicit" guarantee of this paper by the U.S. Government has never been more "explicit" now that the Government is running both companies in conservatorship.
3. We have started to add AAA rated and AA rated intermediate maturity corporate bonds to portfolios when we can buy them on an opportunistic basis. The yield incentive to hold high quality corporate names has never been higher.

TAX-EXEMPT BOND MARKET STRATEGY FOR 2009

In 2008, the \$2.7 trillion municipal market was impacted by several unique factors. In February the \$300 million auction rate securities market "locked up" when dealers that had historically supported the auction process pulled out of the weekly and monthly auctions. Investors who had purchased on the basis of short-term liquidity were now "stuck" in securities that were nearly impossible to sell, and the "failing" auctions drove rates to higher levels for many issuers. The threat of legal sanctions ultimately forced the dealer community to buy back most of these bonds from their clients.

At about the same time, bond insurers, who historically insured about 50% of new mu-

municipal debt, suffered rating downgrades due to their guarantee liabilities on mortgage backed securities. To make matters worse, five of the largest municipal bond underwriters and dealers either exited the business or merged in 2008 and were forced to sell to reduce inventories. Going into 2009, 41 States have budget shortfalls to finance at a time when the market's capacity to market and absorb new bonds has been weakened.

Our strategy is to be both opportunistic and defensive. We think municipal bond yields are attractive, but we are also being extremely careful about risk. We have talked about the virtues of escrowed to maturity (ETM) and pre-refunded (PR) bonds in almost every letter for the past ten years, and we historically have been able to make great buys in that sector because competition for bonds was largely limited to the property and casualty insurance companies. Now that investor risk tolerance is near zero, ETM's and PR's are in high demand because they are backed with U.S. Government securities, and the pickings have been slim. Our current priorities for tax-exempt purchases include:

1. ETM's and PR's with 10 to 20 year maturities whenever we can find them at fair prices.
2. AAA and AA rated general obligation bonds and revenue bonds tied to basic services like water, electricity and transportation especially when hedge funds and other leveraged institutions are forced to sell to meet withdrawal requests. Even in the Great Depression, the default rates on these kinds of bonds were negligible. We believe the last state to actually default on a General Obligation Bond was Mississippi in 1838.
3. We avoid lower rated bonds, especially those backed by sports complexes, port authorities, convention centers and similar projects whose economics are likely to be hurt in a severe economic downturn.
4. We are ascribing little value to credit insurance and looking more at the underlying credit rating and most recent financial statements for all potential purchases.

THE STOCK MARKET--IS IT SAFE TO GO BACK IN THE WATER YET?

2008's negative 37% total return in the S&P 500 Stock Index has been exceeded only once, by the 43% decline in 1931. In the six largest stock market declines since 1900, only 1931's was followed by another down leg in the following year. In the other five cases, the market had actually recovered 75% of the decline within 18 months of hitting its low. In retrospect, the unique characteristic of this cycle is that the financial system turned out to be far more fragile than anyone imagined, and the key going forward will be how the real economy responds now that the financial system has started to stabilize.

There is no way to sugar coat the economic outlook for 2009. It looks like real GDP will record negative growth of 6% to 8% in the fourth quarter of 2008, and we know the employment picture, consumer psychology and retail sales all point to a tough year ahead. On the other hand, the equity market has discounted a lot of future pain, and the seeds of opportunity are often planted in a crisis. The financial press has done a fine job painting the potential negative scenarios ahead, but we can see some positive counterpoints:

1. Falling energy prices have acted like an immediate tax rebate for consumers on the order of \$250 billion.
2. President elect Obama's fiscal stimulus package is likely to include additional tax cuts for individuals and businesses rather than the tax increases expected from a Democratic administration three months ago; block grants to states could moderate their budget woes.
3. There is an estimated \$8.9 trillion of potential buying power on the sidelines in the form of cash equivalents, bank deposits (earning 0.1%) and money market funds. \$8.9 trillion is about 3/4 of the value of all stocks in the U.S. market, the highest percentage of cash reserves since the savings and loan crisis of 1990.
4. The yield on the S&P 500 is now above 3%, handily above the yield on Treasury securities, and the price to book value ratio is now 1.8 times versus a 30 year average of 2.4 times. Equity valuations are not excessive by these measures.
5. In the short-term, inflation is not expected to be a threat to the capital markets.

STOCK MARKET STRATEGY FOR 2009-2010

As Warren Buffet says, "Investing is like dieting; it is simple but not easy". Our advice is to maintain equity allocations within a diversified portfolio strategy and use the current uncertain environment to fine tune individual positions. To that end, we made a number of portfolio changes in the fourth quarter to take advantage of attractive values created by the extreme volatility.

We have tried to pay particular attention to the balance sheet structures of our portfolio companies in light of investor aversion to leverage and concerns about the ability to roll over large amounts of debt in a risk averse climate. We are limiting exposure to companies with aggressive balance sheet postures to less than 10% of portfolios while continually monitoring credit developments for those holdings. It is tempting in this environment to completely avoid companies using meaningful leverage, but we feel a small exposure is appropriate because these stocks offer the most upside if credit markets continue to heal and the economy eventually turns up.

ADDITIONAL THOUGHTS

The Securities and Exchange Commission requires that we annually offer to send you an updated copy of our form ADV like the one that was given to you before the inception of our business relationship. If you would like one, please send us a written note to that effect because the SEC requires two-way documentation of all requests.

2008 was a terrible year for equity investors and managers alike and we are committed to do everything we can to help our clients manage through this cycle and move forward. We appreciate all of your supportive comments last year and welcome any questions you may have.