

## Window to the Market

By Mark Luschini, Chief Investment Strategist



The dislocations that have transpired in recent history, driven by credit-related or economic forces, combined to make 2008 a challenging year for most investors. Equity investors sadly discovered there was no safe place to hide. Companies of all size, sector and domicile lost value making the prudence of diversification seemingly a lost art.

The U.S. has the biggest and arguably most diverse economy in the world. Many investors benchmark their equity activities to the S&P 500, which is a market capitalization-based index comprised of 500 companies. The companies in this index represent ten primary categories or sectors defined by Standard & Poor's, one of the world's foremost providers of index data. Perhaps what is exemplified by these sectors can be best illustrated in the accompanying periodic table, which shows the weighting of each of the ten industry sectors that comprise the U.S. stock market, as represented by the S&P 500. This table is indicative of the market capitalization of the combined companies within each sector. Generally speaking, as the performance of one sector does measurably better or worse than the others a noticeable change in weighting will occur, otherwise the weighting may stay fairly stable over time.

Certain sectors are remarkably consistent while others have assumed substantially more or less prominent roles in influencing the direction of the stock market. The Financial sector reached its zenith in 2006 as investment banks and other financial service companies were using financial alchemy and leverage to generate outsized profits pushing their share prices, and thus the Financial sector weighting in the market, increasingly higher. The 22.3% weighting that Financials commanded within the S&P 500 in 2006 should have served as a red flag, particularly to the "mean reversion theorists." The two previous times a sector eclipsed the 20% weight, energy in the early 1980's and technology in the late 1990's, the stories ended badly for investors that did not trim exposure before each collapsed. Consumer Discretionary companies (these include retailers, restaurants, and autos) have seen a correction in their representation from 11.9% of the market in 2004 to 8.5% in 2007, a decline of almost 30%. This can be attributed to the decline in

consumer spending which was sniffed out by the market even before the economic infirmity we experienced last year became obvious.

The classic defensive sectors such as Consumer Staples, Healthcare and Utilities did not show particularly impressive results in the first half of 2008. However, as the market decline intensified into the fourth quarter those areas largely deemed economically insensitive held up relatively well. For the year, Consumer Staples, which are usually large multinational companies making products like food stuffs and tooth paste, was the best performing category declining 15.4%. Healthcare, an industry where spending by businesses and households represents about 16% of the U.S. GDP, dropped 22.8%. The third best performing category, Utilities, mounted a late-year comeback falling less than half of the market's loss in the fourth quarter to finish down 29.0%. While any decline is not comforting, one can see that a healthy dose of exposure to these three areas would have mitigated the blow to portfolios that might have declined in value equivalent to or worse than the 37.0% loss in the S&P 500.

Obviously, it is extremely difficult—if not impossible—to effectively time holding only one or two sectors hoping they are the winners while avoiding those one or two that turn out to be the laggards. Yet at various points in time across cycles in the economy and the stock market's

	2004	2005	2006	2007	2008
Financials	20.6	21.3	22.3	17.6	Technology 15.3
Technology	16.1	15.1	15.1	16.7	Health Care 14.8
Health Care	12.7	13.3	12.0	Energy 12.9	Energy 13.3
Consumer Discretionary	11.9	Industrials 11.3	Industrials 10.8	Health Care 12.0	Financials 13.3
Industrials	11.8	Consumer Discretionary 10.8	Consumer Discretionary 10.6	Industrials 11.5	Consumer Staples 12.9
Consumer Staples	10.5	Consumer Staples 9.5	Energy 9.8	Consumer Staples 10.2	Industrials 11.1
Energy	7.2	Energy 9.3	Consumer Staples 9.3	Consumer Discretionary 8.5	Consumer Discretionary 8.4
Telecom	3.3	Utilities 3.4	Utilities 3.6	Telecom 3.6	Utilities 4.2
Materials	3.1	Telecom 3.0	Telecom 3.5	Utilities 3.6	Telecom 3.8
Utilities	2.9	Materials 3.0	Materials 3.0	Materials 3.3	Materials 2.9

Source: Factset

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calibration to it, certain patterns develop that can be exploitable. Since this time of the year often invites retrospection upon predictions made right or wrong we will share a few as well. Our Investment Strategy Group recommended overweighting two of the three afore-mentioned sectors, Consumer Staples and Healthcare during 2008. We believed the economy was in the midst of a slowdown without then realizing that it would be one of near epic proportion. We turned positive on Utilities in October after share prices of companies in this sector fell with the overall market to the point where valuations and their elevated yields seemed to offer a cushion against further erosion. Against the S&P 500's decline of 21.9% in the fourth quarter, the Utility sector's performance of -10.9% does not look so bad. We lagged the overall stock market with calls to overweight Technology (-43.1%), and our underweight to Consumer Discretionary, which declined about 3.5% less than the S&P 500, surprised us given the headwinds that consumers have faced and we expect will continue to well into 2009. Of final note, we had been cautious about Financials, maintaining a neutral weight but warning that it was a sector that required deliberate selection. That sector was by far the worst performer of the ten falling by 55.3%, with 36.9% of that coming in just the last three months of the year.

Broad diversification across a variety of industries is the most effective way to dilute the prospects of being really wrong. Often, limiting the catastrophic losers is more important than chasing the identity of the next big winner. Looking at the market with a greater degree of granularity, especially since it is a publicly traded reflection of the overall economy, may help in understanding where risks are elevated.



## 2009—A new broom sweeps clean

By Gregory M. Drahuschak, Vice President

Due to a detailed prospective report that will be released later this month, this section of Investment Perspectives focuses largely on a short recap of 2008. Anything short of a doctoral dissertation can not do justice to a year like 2008 that was crammed with market-impacting elements.

In our 2008 outlook we noted that, "GDP growth early in 2008 could be lackluster due to several factors including ongoing loan issues and generally slower consumer spending." It took time but GDP growth certainly slowed. The extent of the slowdown, however, was far beyond our expectations. The ISM Index highlighted the economic slide. As table A shows, the Index approached its all-time low in December.

Growth in the U.S. economy certainly was impacted negatively by the rapid development of the credit market disarray. So severe were some of the developments that investor fear at times was palpable. The Federal Reserve and Treasury Department moves to tackle the problems head on undoubtedly helped ease the situation, although we would add that the jury is still out on the eventual effectiveness of some of the Treasury Department's actions. As table B illustrates, aside from the slide in June, the Dow and S&P 500 resisted reacting to the developing crisis until October when the market finally succumbed to a nearly daily onslaught of negative news. The negative news flow continued well into November when the S&P 500 posted its fourth biggest loss for the month on record. There was no place to hide other than cash. No S&P 500 sector escaped the ravages of the market decline. Energy bucked the overall trend for a time, but even that sector eventually succumbed as the price of crude oil precipitously fell from its all-time high around \$147 a barrel.

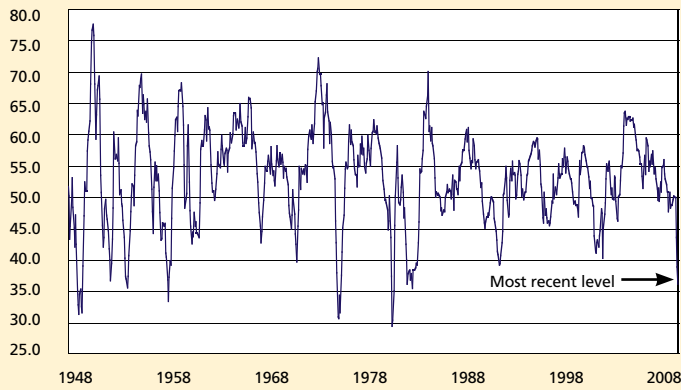
In our view the demarcation point for the market came in August when the Dow Jones Industrial Average and the S&P 500 broke significant short-term technical support. Although for a time ballooning volume in October and the spike low reached on the tenth day of the month suggested that the market was washed out and prepped for a significant rebound, the bounce off the low was short-lived as the major averages took another significant step down late in November. Numerous events highlighted by precedent-setting amounts of cash made available to banks and other financial institutions produced a sense of drama during nearly every trading session in October and November. While the decline produced some compelling equity values, stepping into most of them proved to be a mistake.

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2008 Market Data		Prior Close	Last	Change	% Daily	% YTD	% Jan	% Feb	% Mar	% Apr	% May	% June	% July	% Aug	% Sept	% Oct	% Nov	% Dec	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter
DJ Industries	.DIA	8668.39	8776.39	108.00	1.25	(33.84)	(4.63)	(3.04)	(0.03)	4.54	(1.42)	(10.19)	0.25	1.45	(6.00)	(14.20)	(5.32)	(0.60)	(7.55)	(7.44)	(4.40)	(19.12)
S&P 500	SPX	890.64	903.25	12.61	1.42	(38.49)	(6.12)	(3.48)	(0.60)	4.75	1.07	(8.60)	(0.99)	1.22	(9.21)	(17.15)	(7.48)	0.78	(9.92)	(3.23)	(9.00)	(22.45)
NASDAQ Comp	COMP	1550.70	1577.00	26.30	1.70	(40.54)	(9.89)	(4.95)	0.33	5.87	4.55	(9.11)	1.42	1.80	(12.05)	(17.03)	(10.77)	2.70	(14.07)	0.61	(9.19)	(24.27)
SOX Index	SOX	211.26	212.17	0.91	0.43	(48.25)	(12.48)	(0.28)	(5.18)	15.26	4.04	(9.28)	(7.36)	6.45	(19.16)	(18.36)	(14.36)	5.40	(17.25)	8.79	(20.53)	(27.66)
Biotech Index	BTK	633.99	647.17	13.18	2.08	(17.72)	(4.72)	(3.66)	2.14	1.10	1.78	(2.76)	17.12	(3.81)	(5.66)	(12.78)	(11.63)	8.59	(6.24)	0.05	6.28	(17.47)
DJ Transports	.TRANS	3438.64	3537.15	98.51	2.86	(22.61)	3.97	(4.24)	5.13	8.03	5.21	(9.00)	2.50	0.62	(9.55)	(15.51)	(9.62)	0.71	4.67	3.43	(6.71)	(23.37)
DJ Utilities	.UTIL	363.83	370.76	6.93	1.90	(30.38)	(5.61)	(5.01)	0.31	6.58	2.18	(0.15)	(6.91)	(1.52)	(10.28)	(11.73)	1.01	(3.00)	(10.05)	8.74	(17.74)	(13.46)
Volatility Index	VIX	41.63	40.00	(1.63)	(3.92)	77.78	16.44	1.30	(3.50)	(18.82)	(14.24)	34.32	(4.22)	(9.98)	90.75	40.44	(6.76)	(28.37)	13.82	(6.48)	64.47	1.55
S&P Midcap 400	MID	524.62	538.28	13.66	2.60	(37.28)	(6.24)	(2.00)	(1.14)	7.61	5.14	(7.14)	(1.95)	1.57	(10.83)	(21.98)	(9.49)	4.61	(9.17)	5.06	(11.20)	(25.99)
S&P 100	.OEX	426.47	431.54	5.07	1.19	(37.06)	(6.21)	(4.58)	0.01	4.45	(0.29)	(9.08)	0.49	1.19	(8.01)	(14.72)	(6.74)	(0.31)	(10.49)	(5.32)	(6.47)	(20.60)
Gold ETF	GLD	85.90	86.52	0.62	0.72	4.92	10.84	5.23	(6.00)	(4.16)	0.92	4.52	(1.44)	(9.29)	4.11	(15.99)	12.57	7.73	9.64	1.10	(6.93)	1.70
Russell 1000 Index	.RUI	480.38	487.77	7.39	1.54	(39.02)	(6.11)	(3.27)	(0.84)	4.96	1.62	(8.47)	(1.30)	1.17	(9.81)	(17.82)	(7.85)	1.32	(9.94)	(2.37)	(9.94)	(22.98)
Russell 2000 Index	.RUT	482.77	499.45	16.68	3.46	(34.80)	(6.88)	(3.80)	0.26	4.10	4.48	(7.83)	3.60	3.50	(8.10)	(20.79)	(11.98)	5.56	(10.19)	0.25	(1.46)	(26.51)

Source: Standard & Poor's

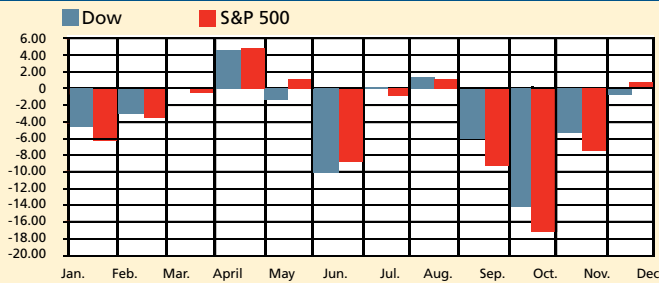
**Table A: All-Time ISM Index**



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The word unprecedented was used and probably overly used often last year to describe economic and market events. There, however, is no denying that from a market standpoint there have not been many years that produced the breadth of price decline that the 2008 market did.

**Table B: 2008 by the Months**



Of the 497 S&P 500 stocks that were in the index for the entire year, only 34 posted gains. The ten stocks with the largest declines suffered an average 86.29 percent

loss. Somewhat surprisingly, four of the ten biggest losers were not financial stocks.

It is equally surprising that with all the worry about consumer spending that a retailer, Family Dollar Stores (FDO\$28.40) was the best performing S&P 500 stock. Another retailer, Wal-Mart (WMT \$51.38), was the top Dow stock (price quoted as of close of business 1-08-09). Only two Dow issues ended 2008 with gains.

2008 ended with an unusually strong holiday rally that gave the Dow, S&P 500, NASDAQ and Russell 2000 gains of more than six percent each. New cash that typically comes into the market at the start of a new month, particularly when that month also kicks off a new year, had a significant hand in generating the upside.

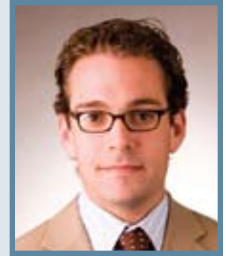
We had noted in our Market View Daily publication late in December the market was poised at least for a short-term rally. As the holiday period ended and considering the late-year rally, the market still looked like it could extend the rally that could take the S&P 500 to 1000 and the Dow to 9500 in a relatively short period. As noted at the start of this report we will have a significantly detailed 2009 outlook report available early in January. Check with your JMS representative for the availability of that report.

S&P 500 sectors	End of June	End of 2008
S&P 500	-12.83%	-38.49%
Energy	8.12%	-35.93%
Materials	0.19%	-47.05%
Industrials	-14.59%	-41.52%
Consumer Discretionary	-13.86%	-34.73%
Consumer Staples	-8.54%	-17.66%
Health Care	-13.47%	-24.48%
Financials	-30.89%	-56.95%
Information Technology	-13.43%	-43.68%
Telecommunications Services	-18.90%	-33.62%
Utilities	-4.34%	-31.55%

The chart, 2008 Market Data, contains some closing data that wraps up a year that by many measures most investors would like to forget. We suspect that the early part of January will offer some improved sentiment as the market looks toward President-elect Obama's inauguration and the hope that a new administration will sweep out some of the economy's ills. The prospect of a major stimulus plan that reportedly could include some business tax cuts is likely to be the focal point of the optimism. We, however, would caution investors not to expect a major turn in economic data until we are well into 2009.

## 2009 Outlook

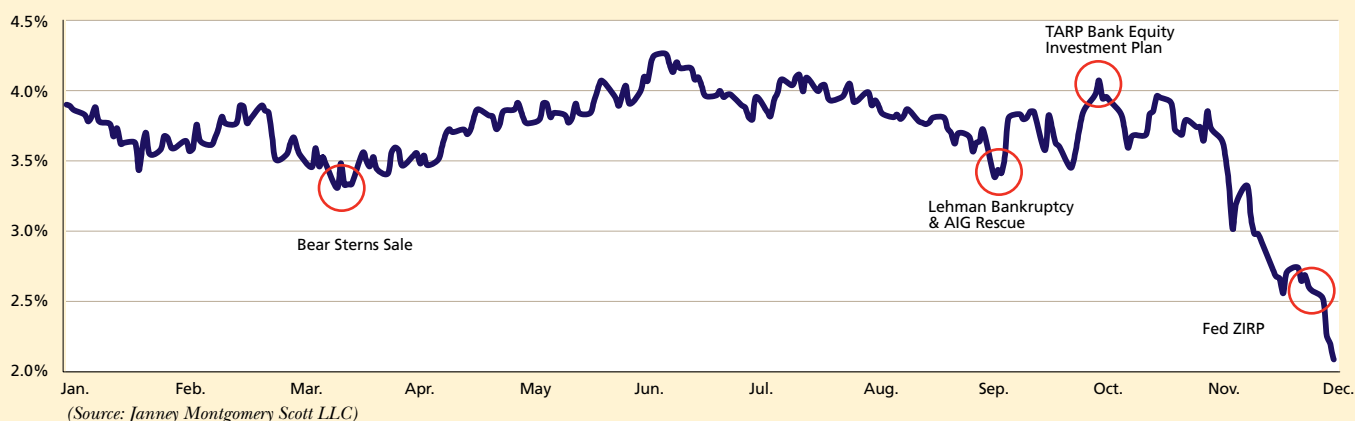
*By Guy LeBas, Vice President*



It's no exaggeration to say that 2008 brought with it the toughest economic times since at least the 1980 – 1982 slowdown, and perhaps even the last half-century. There's plenty of data, and even more in the way of anecdotal evidence, to point out the degree of slowing in consumer spending and corporate investment that will impact the domestic economy for, at a minimum, several years to come. We have come to believe, however, in a bit of a more dire prediction about long-term economic trends—not that the U.S. economy is headed for the depression that many have predicted, but rather that we're entering into an era of reduced consumer and corporate spending growth. The debt-fueled boom that's supported elevated growth rates for literally the last two decades has come to a rather painful conclusion, and the fallout from the collapse isn't the sort of event that's easily forgotten. As a result, credit availability and leverage is likely to settle out at levels significantly tighter than what's been experienced in the 1992 – 2007 timeframe, even once the current rather dramatic pullback in credit eases. That lower credit availability and reduced leverage in turn will eliminate a major engine for economic growth. In 2008, we didn't just set the economic trends for a few quarters, we established a framework that looks set to guide the U.S. towards an era of reduced growth.

The 2009 year is shaping up as an epic battle between the economic forces of good and evil, or, in this case, the forces of government intervention, and the continued credit and liquidity-driven destructive influence. From a 10,000 foot perspective, that's not exactly an encouraging situation: the only hope of support for our economy and financial system lies in a government which, throughout American history, the people have tried to prevent from becoming too powerful. But to borrow the words of short-timer Treasury Secretary Henry Paulson, the alternative is unacceptable. In

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charting a course for the next calendar year, we'll focus on this Lord of the Rings-sized conflict, first in evaluating the organic influences coursing through the system, and then in estimating the size and success of exogenous support. So how does this epic battle play out? Ultimately we're optimistic that the range of fiscal and monetary stimulus crossing the tape will be sufficient to pull the U.S. economy out of the deep and rather long recession we're clearly facing. At the same time, no amount of government spending can truly reverse the pullback in leverage from the private markets, and certainly not in an efficient manner. Since this leverage and liquidity is a crucial component of the factors driving long-term economic growth, the truth is that 2008 is a banner year, not just for its own weakness and the remarkable disruption in the capital markets, but as a harbinger for an era of reduced consumer and corporate spending growth.

While the economic scenario unfolded with a certain order, the same can't be said for action in the capital markets. Chaotic would be a generous way to characterize the over all market volatility and extreme event risk that emerged during the course of 2008 and whose effects will clearly be felt well into the next several years. Amid this chaos, one phrase has come to the forefront time and again: "In a crisis, all the correlations go to one." Roger Lowenstein, author of the financial epic *When Genius Failed* deserves credit for that one, but it's even more pointed and painfully poetic today than it was in the Long Term Capital Management implosion in 1998, not only because the correlations are closer to one than they've ever been, but because the original source of these issues, the subprime mortgage disaster, was arguably perpetuated by a set of erroneous correlation assumptions. When the "correlations go to one," the prices of seemingly unrelated assets behave as if they were suddenly in fact very much related. Perhaps the most poignant example comes from the relationship between AIG's stock price and the value of a triple A rated municipal bond. While the two securities are very much unrelated in theoretical terms, the fact that AIG owned a \$47 billion portfolio of munis meant that distress at AIG resulted in distress in the municipal markets. Those sorts of relationships are precisely the type that surface only in a true financial crisis.

Consider this: 6 out of the 8 major fixed income sectors posted their worst return relative to Treasuries in 2008. In that sense, calling 2008 a challenging year for the debt markets would be an understatement of epic proportion. We remain cautiously optimistic about future conditions, however, and have a focus on four major overarching themes that are likely to continue shaping the debt markets for years to come: the Fed's zero interest rate policy, the replacement of private capital with government capital, the growing importance of liquidity, and the erosion of traditional bondholder protections. While these aren't exactly positive forces, a thorough understanding can nonetheless aid in identifying the most attractive risk/return tradeoffs in what's an increasingly low interest rate environment. On the whole, however, it appears that lower risk asset classes are set to outperform higher risk ones in 2009 as investors continue to come to terms with a lower return future.

For more details, see our Fixed Income 2008 Review/2009 Outlook.

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