# The Economy and the Markets

The Federal Reserve and the Treasury continued to launch extraordinary measures in the fourth quarter to stop the economy's downward slide. The Federal Reserve cut rates to almost zero, the Federal Deposit Insurance Corporation (FDIC) expanded its guarantees, and the Treasury Department adopted a new approach to disbursing rescue plan funds, investing directly in banks instead of buying up troubled assets.

The actions stemmed from the Federal Reserve's commitment to do everything possible to stimulate economic growth. While the impact of those efforts isn't yet clear to the naked eye, credit markets are starting to ease. More visible economic indicators, including unemployment, housing prices and the stock market, have yet to get a lift, and it may be awhile before they do.

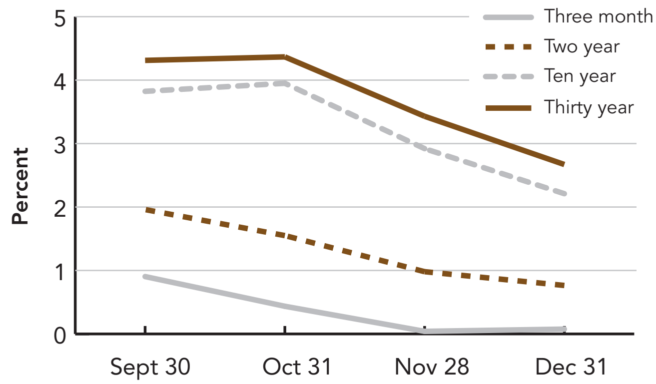
Economic stimulus takes time to work, which is why the benefits are not likely to be felt until summer. We will probably endure one or two more problematic quarters before recovery takes hold. If consumers continue to pull back, the recovery could be slower and take longer than hoped.

## Equities

A negative outlook reinforced by bad unemployment figures and poor retail sales drove the equity markets down sharply in the fourth quarter. The Standard and Poor's 500 Index was -21.94 percent over the quarter and finished -37.0 percent for the year. It was the index's worst one-year performance since 1931. The damage to equities occurred across the globe. The MSCI-EAFE Index, which measures the performance of stocks in developed economies around the world, was -19.9 percent for the quarter and finished -43.1 percent for the year.

While very negative assumptions are behind the market's current level, the decline may not be over. Fourth quarter earnings reports are likely to be very ugly, and could send the markets down further. One future ray of hope for equities comes from their history of turning up well ahead of an economic recovery.

**Treasury Yields – 4th quarter**




*A flight to quality drove Treasury yields down to unusually low levels.*

## Fixed Income

Returns suffered in almost every sector of the fixed income market, with the exception of Treasuries. A flight to quality and efforts to spruce up year-end portfolio holdings drove Treasuries to unusually low levels. The two-year Treasury ended the year yielding 0.8 percent, while the 10-year stood at 2.2 percent and the 30-year at 2.7 percent. For the time being, investors are clearly not concerned about inflation.

Cash returns also dwindled, forcing investors to look further out for better yields. While corporate bond spreads widened meaningfully during the quarter and remain extremely wide, a modest tightening occurred in December, perhaps foreshadowing a broader improvement. High yield issues as measured by the Barclays High Yield Index were hit hard, and were -17.80 percent for the quarter and down -25.5 percent for the year.

## Real Estate

Stability in the residential housing market remains important to turning around the broader economy. While there's not much to indicate the housing market is improving, Federal Reserve action brought mortgage rates down to levels not seen in 40 years, which should help stabilize prices.

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The drop in rates should help people lower their mortgage payments through refinancing and could also bring more new buyers into the market. The high inventory of unsold homes, and a continued rise in foreclosures lowers the likelihood of an immediate turnaround.

Commercial real estate, which had remained somewhat above the gloom, was hit hard in the fourth quarter. Concerns about the availability of commercial real estate financing drove the market down almost 60 percent at one point, as the commercial mortgage-backed securities market froze. Once it became clear that banks would continue to make commercial real estate loans (although on more conservative terms), the market recovered somewhat, with the Wilshire Real Estate Securities Index returning -40.4 percent for the fourth quarter and -39.8 percent for the year.

## Outlook

We believe the financial markets will recover in 2009. The markets typically revive before it's clear that economic fundamentals have turned around. As the stimulus starts to have an effect, we believe markets are likely to respond positively to slower rates of decline in home prices, fewer jobless claims and indicators that conditions aren't worsening.

It won't be a smooth ride, however. While many negatives have been priced into the markets, additional corporate defaults likely to take place in the first quarter will keep the stress level high. But because market prices now reflect such a sour outlook, we believe severe drops are less likely.

We are in the thick of one of the most difficult economic periods in our lifetimes. We can all hope that 2009 brings brighter days to the economy and the markets.

*The S&P 500 Dividend-Adjusted Index is market-value weighted based on 500 common stocks, which are traded on the NYSE, AMEX and Nasdaq. The weightings make each company's influence on the performance of this index directly proportional to that company's market value.*

*The Barclays High Yield Index covers the universe of fixed rate, non-investment grade debt. Pay-in-kind (PIK) bonds, Eurobonds and debt issues from countries designated as emerging markets (e.g., Argentina, Brazil, Venezuela, etc.) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included. Original issue zeroes, step-up coupon structures and 144-As are also included.*

*The Dow Jones Wilshire Real Estate Securities Index is a market capitalization-weighted index of equity securities whose primary business is equity ownership of commercial real estate investment trusts (REITs). The index contains equity and hybrid REITs and real estate operating companies (REOCs) and includes reinvested dividends.*

*The Morgan Stanley Capital International Europe, Australia and Far East Index (MSCI EAFE) is an unmanaged index composed of the stocks of approximately 1,000 companies traded on 20 stock exchanges from around the world, excluding the USA, Canada and Latin America. It assumes the reinvestment of dividends and capital gains and excludes management fees and expenses.*

*You cannot invest directly in an index.*

*Past performance is not indicative of future results.*

*Investment risks associated with investing in a real estate fund/portfolio, in addition to other risks, include rental income fluctuation, depreciation, property tax value changes and differences in real estate market values.*

*The Economy and the Markets has been prepared for information purposes only and is the opinion of Advantus Capital Management, Inc, a registered investment advisor.*

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