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GENERAL MARKET OBSERVATIONS

A Long-awaited Global Response Gave Some Relief to World Markets

- At the close of the third quarter, U.S. bond and equity market selling showed no signs of abating, despite the already steep decline in stock and bond prices experienced in the prior quarters since the fall of 2007. The global markets accelerated their downward pace in September as well, once the collateral damage of the U.S. banking crisis bled into the world's major central banking system. Just as the panic selling appeared to reach a climax, not too dissimilar to the bottom experienced in the 1974 bear market, on October 10th the central bankers of the G7 nations announced a dramatic action of a coordinated rate cut and partial nationalization of the banking system. Despite the central European banks tendency, in the post war periods to fear inflation rather than deflation, this long awaited response reassured financial markets that global policy makers have finally taken decisive steps toward repairing the rapidly deteriorating banking system abroad and consistent with U.S. policy initiatives. This policy reversal appeared to be the cooperative action investors required to insure confidence and defer portfolio liquidations that has persisted unabated all year. However, the global response has been more tempered as markets outside the U.S. continued to operate under a negative cloud into the month of October with credit spreads widening and debt markets remaining clogged against a rising U.S. dollar.
- During the third quarter, amid growing fears that the world economies were embarking on a protracted recession, investors continued to demonstrate little patience indiscriminately selling long duration investments. Despite any positive news associated with current fundamental earnings reports, the "risk premium" to hold longer duration instruments soared as a result of investor fear. History shows us that investments made in times of greatest distress offer the most rewarding periods to build wealth for the long term.

An Optimistic Perspective on Today's Financial Markets

- In retrospect, it appears that the U.S. authorities' decision to allow Lehman Brothers to collapse was a grave mistake. As we are acutely aware, the decision profoundly shook confidence in the U.S. banking system, leading to the complete shut down of the interbank market. We would also add that allowing Fannie and Freddie Mac's preferred share prices to collapse, effectively wiping out large portions of tier one capital for many financial institutions, was yet another policy blunder. Consistent with a historical framework, we know that trust in the entire banking system can easily be broken by one or two bank failures, which inevitably lead to the immediate cessation of credit flows. Not dissimilar to the experiences of the 1930's, a major interruption of credit flow can potentially have devastating consequences.

- It is unfortunate that our banking system has operated under the basic premise that these institutions are “too big to fail” and ultimately protected by government at times of financial crises. John Kenneth Galbraith, author of over 30 titles spanning five decades on economic policy issues that critiqued matters between the public and private sector policies, warned us about the continuing divergence between approved belief characterized as “conventional wisdom” and what he termed “reality”. In one of his last published essays in 2004, “The Economics of Innocent Fraud”, Galbraith identifies that the economic and political system in the United States cultivates its own versions of the truth with no necessary relation to reality. He concluded that in large part that which we all refer to as the ever expanding public sector is in “all practical effect in the private sector”. Despite recognizing this problem that Galbraith describes, we are still faced with the dilemma of encouraging free competition in the banking system while at the same time protecting the public interest in the face of a confidence crisis. Our cautiously optimistic stance is bolstered by the fact that mark- to-market accounting rules although severe have shortened the corrective phase of this cycle. We are further encouraged by the fact that since we now understand the problems, we are closer to arriving at appropriate solutions. We would expect the end result will ultimately be an implementation of an appropriate regulatory response that promotes sounder risk management practices as well as shifting the role of the Federal Reserve Board away from the necessary monetary responses of a post-bubble clean up towards a preemptive regulatory oversight.

Positioning Fixed Income Portfolios for Long Term Growth

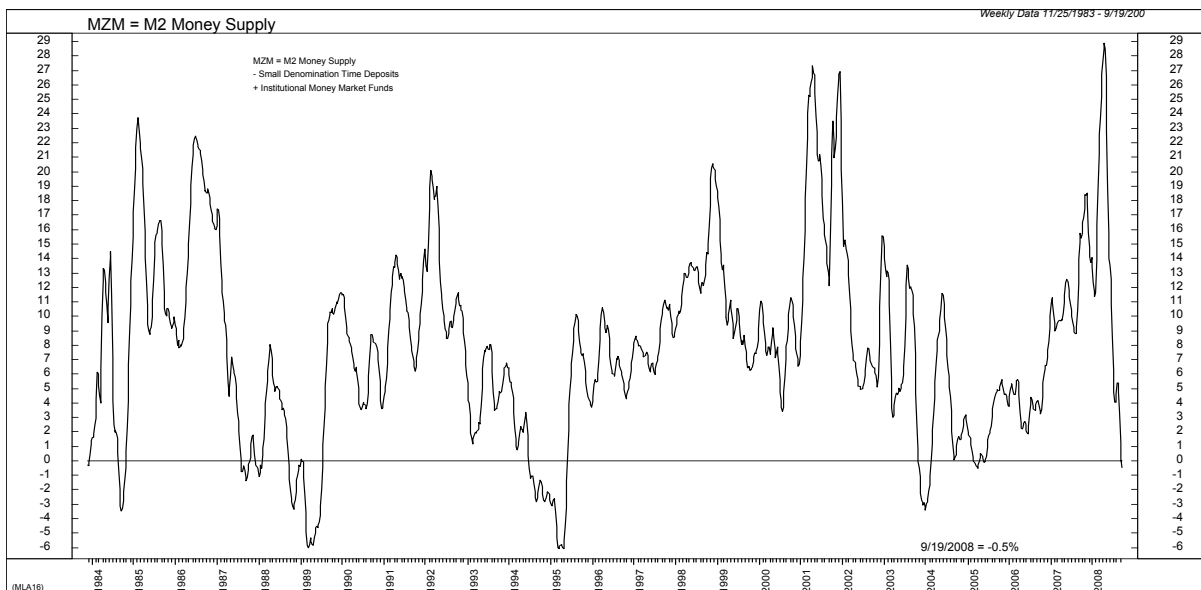
- The world economies have now joined the U.S. commencing a period of subdued economic growth and potentially intense deflationary pressures. We would anticipate the Bureau of Economic Analysis to officially declare that we are in recession (two consecutive negative quarters of Gross Domestic Production) and that we expect this condition will persist into next year. If history is any proxy for the future, we would expect that equity and bond prices should begin anticipating the recovery perhaps as early as the first or second quarter of 2009.
- We remain steadfast in our belief that stepping out of the fixed markets can have severe consequences to long term investment programs. We are reminded of countless examples such as the deflating technology bubble, the demise of Drexel Burnham Lambert’s failure after the implosion of the junk bond market, Texas and New England bank failures and the savings and loan debacle in the late 80’s. All of these examples saw significant advances in bond prices in subsequent years rewarding investors handsomely who stayed the course during the market turmoil.
- As we enter a period of global reflation, we believe that oil markets will continue under pressure. As long as global growth stays sluggish, policy reflation efforts will most likely be aimed at stabilizing banks and reviving growth overtime. Usually a dramatic fall in interest rates benefits banks and financials first, and over time the stimulative monetary impact is transferred to the broader economy. Although banks are still in crisis mode, the beaten down share prices will ultimately reward investors who can focus their sights on the longer term and emphasize the better capitalized companies in the sector. We anticipate in 2009 that the sharp fall in interest rates in the U.S. will begin lifting banking fixed income alternatives relative to the benchmarks, a trend that may take hold for the next several quarters before broadening out into the other economic sectors.
- Expecting a rally before year end, we have refocused our efforts on the profit outlook of our investment holdings with a heightened sensitivity to our non-financial profit exposure as we enter a global recessionary period. We are assuming that November marks the bottom in equity and bond prices for the broad market and that this drop culminates as one of the most severe drops in the averages than prior peak-to-trough declines experienced in past crises. The correction in the non-financial stocks has been more severe in the current cycle than in other banking crises as our moderate decoupling theory was held hostage by the fact that the U.S. consumer is still considered an

important engine of growth for the world economies. On a positive note, the U.S. non-financial sectors' weak bond performance in the third quarter has likely discounted a deeper recession than in past global housing busts.

THE U.S. ECONOMY

- The statistical data for the September – November period suggest that the decline in the economy is worsening such that fourth quarter real gross national product (GDP) in 2008 and the first quarter of 2009 could fall at annual rates of 3% - 4%. This has pushed most economists to move the potential recovery to either the latter half of 2009 or 2010. Despite the news media highlighting all the negative statistics and making comparisons with the Great Depression, the Chairman of the Federal Reserve, Ben Bernanke, invalidated these comparisons in a recent speech in Austin Texas. We however, are more optimistic than consensus. We believe the current credit freeze and the 50% decline in most stock indices from their October, 2007 highs coupled with double digit declines in housing prices have been more than priced into the financial markets and are not necessarily the precondition for a deteriorating economic landscape in the coming months.
- There are a number of considerations to keep in mind regarding future economic activity. The policy mistakes of the 1930's should not be repeated. I am reminded of Bernard Baruch's message as perhaps one of the wisest men to walk the halls of American business and finance and a counselor to many U.S. presidents after he foresaw the danger signals that preceded the stock market crash of 1929. "Mankind has always sought to substitute energy for reason, as if running faster will give one a better sense of direction. Periodically we should stop and ask ourselves if our efforts are focused upon the crux of the problem- the things that must be settled if there is to be a manageable solution- or if we are expending our energies on side issues which cannot yield a decision, no matter what their outcome"(1)
- We can make the following observations concerning the blunders of the 1930's to correct The U.S. economic crisis. These include a significant decline in the money supply, protectionist legislation, such as the Hoot-Smawley Tariff Act, (June 1930) which raised tariffs to record levels on most imported goods, and an attitude referred to as "moral hazard" towards a banking bailout. This moralistic view suggests that those that may have been potentially responsible for the crisis should some how not go unpunished.

Table I



Source: Ned Davis Research

(1). Bernard Baruch, My Own Story, (New York: Holt, Rinehart and Winston, 1957), p.263

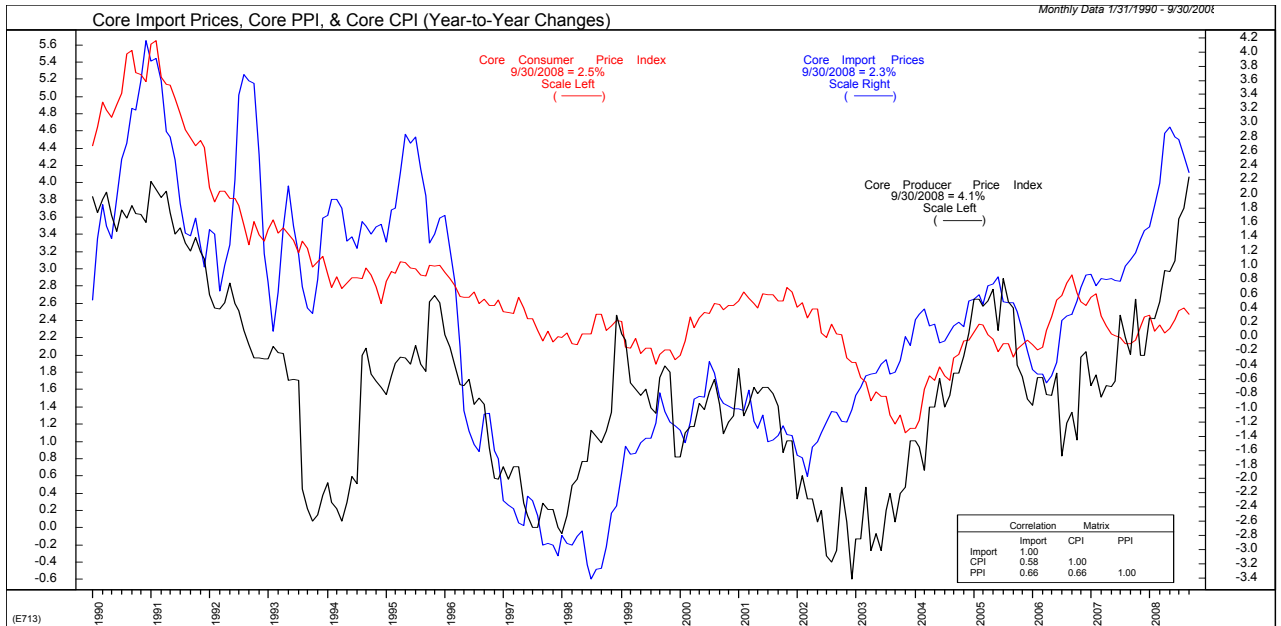
- Although the Fed response has been accommodative pushing M-1 money supply up at a 28% annual rate over the past three months, it may require more stimuli relative to the current drop. See the Table I prepared on September 19th.
- **Since the velocity of money has collapsed, there would appear to be few inflationary risks in the monetary expansion at present.** In addition, there appears to be little appetite for protectionist legislation in view of the widespread belief that globalization is an important concept for expanding trade. Emerging markets according to Morgan Stanley's Capital International Research was responsible for as much as one third of global GDP, with China accounting for 20% of the emerging market share. Since these are creditor countries with high savings rates and foreign exchange surpluses as well as fiscal surpluses, they have the financial means to stimulate economic recovery with consistent and sound policies. In addition, the new administration has already confirmed a policy initiative of significant infrastructure spending including bailouts with reform attached. However, this will ultimately lead to huge fiscal deficits on the order of \$1.5 to \$1.7 trillion for fiscal 2009. Steven Roach, the chairman of Morgan Stanley Asia and former Chief Economist, recently pointed out that "a critical distinction must be made between providing assistance for the innocent victims of recession and misplaced policies aimed at perpetuating an unsustainable consumption binge".
- **Treasury bond interest rates are at fifty-year lows allowing the federal government to borrow at historically low interest rates.** Although we have included some of the current economic statistics below, which are indeed sobering, there is some news that is positive for future growth.

ECONOMIC STATISTICS

- **Consumer sentiment, released by the University of Michigan, rose 0.3 points to 57.9 at the mid-month reading better than the consensus estimates for a decline to 56.0.** Despite the recent improvement from the low of 56.4 in June, sentiment is still below the trough of the last two recessions. The drop in energy prices is likely responsible for the increase in sentiment over the past two months. However, housing weakness, turbulent financial markets and rising unemployment continue to feed consumer pessimism about our economic future. Inflationary expectations fell to 2.9% from 3.9% on a year-over-year basis, while longer-term inflation expectations are dropping rapidly. We would expect inflation rates to be closer to 1.5% by mid year 2009.
- **Although energy prices have dropped precipitously, they have done little to stimulate vehicle purchases in the face of unemployment prospects.** The index of buying conditions for vehicles has fallen to the lowest level in about 25 years. Only just a few months ago consumers complained about high gas prices and the fuel inefficiency of the current models, now this issue has faded into the background and consumers are more worried about the uncertainty of future job market and income prospects as the primary reason to postpone plans to purchase a vehicle.
- **Nonfarm payrolls fell for the 10th straight month in October contracting to 240,000. Economists were expecting job losses 200,000.** More importantly September's losses were revised to -248,000 from -159,000 half of the downward revisions coming from the government sector. These downward revisions we haven't seen in quite some time. According to Ned Davis Research, there have been only seven other times when payrolls have declined for ten consecutive months: September 1944, July 1949, June 1958, February 1961, May 1982, April 1991, and December 2001. All except the first (during WWII) were associated with recession, and only the last three exceeded ten-year to date, job losses have totaled 1.2 million. The unemployment rose 6.5% from 6.1%, the most since March 1994. In the past six months the consensus estimate has climbed 1.55 percentage points.
- **The Leading Index dropped 0.8% to its lowest level since April of 2004, on the backdrop of large declines in stock prices, building permits and consumer expectations.** The annualized sixth month rate of change fell -4.7%. This contraction signal suggests that the U.S. may have dropped into a recession in the first half of the year before officially falling into recession in October. The year-over-year comparison for the Leading Indicators is off 3.5%, a drop similar to readings in April 2001.

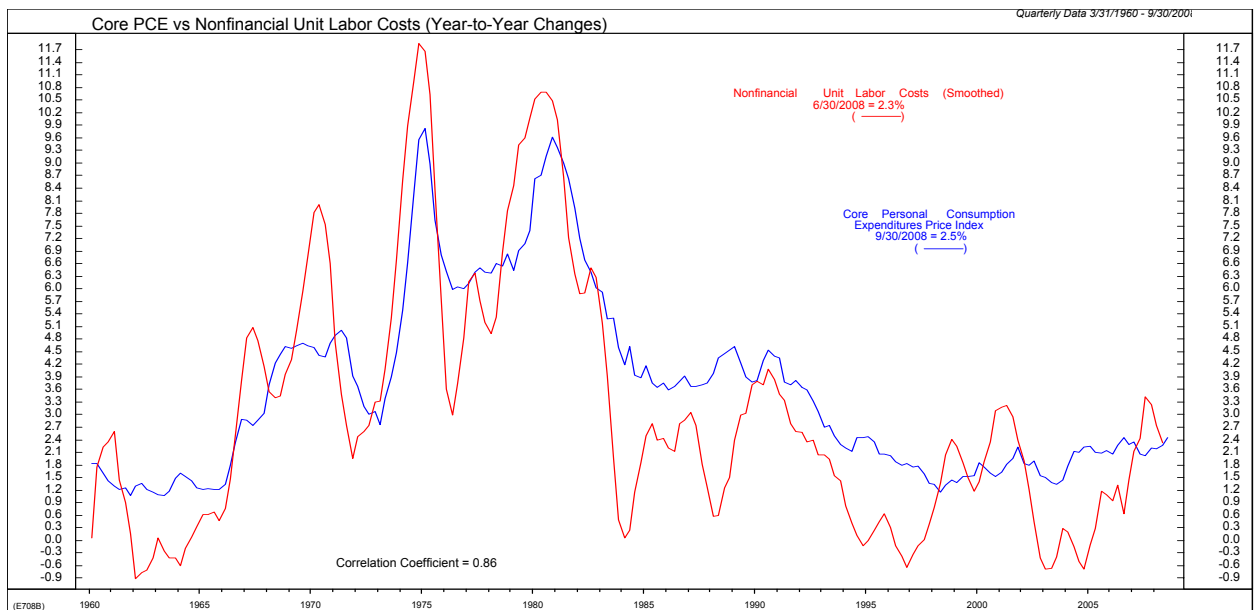
- **The Coincident Index** increased for the first time in eight months, rising 0.2% but remained close to its lowest level in two years. Weighed down by patrols further exacerbating the economy are what we call capitalized profits (the ratio of adjusted after-tax profits to corporate bond yields) which are also estimated to have fallen to levels we experienced in early 2004 and breaking its long term uptrend.
- **Import prices dropped a record 4.7% in October, greater than expectations of 4.0% decrease.** A 16.7% plunge in petroleum prices, the most since April 2003 and the third largest decline since 1988, led the way. Excluding all fuels, prices were still off 0.8%, the most since July 2001, led by a 3.1% drop in industrial supplies and materials (mainly metals), and the most severe drop in over seven years. Food prices also dropped, slipping 1.6% comparable to the February drop in 2006. From a year ago, import prices have eased to 6.7%, the least in over a year and down over two thirds from its 21.4% peak in July . While petroleum prices are most culpable from the deceleration, the growth in prices ex-fuel has also noticeably slowed. The CBO forecasted a budget deficit of \$237.2 in October reflecting \$115 billion in TARP expenditures for bank recapitalization, 21.5 billion in spending on agency MBS exceeding the original forecast of \$232 billion. This monthly report caused the 12 month total deficit to surge to a record \$635.1 billion from a \$454.8 billion in September, or 4.4% of GDP, the highest since December 1992.
- **Retail sales dropped 2.8% in October, the most since 1987 and more than the 2.4% decline expected as consumers curtailed spending on virtually everything except necessities.** On a trend basis, retail sales have fallen 1.3% from a year ago and the largest year-over-year decline since 1967. Motor vehicle and parts sales are off a record 18.45% causing its market share to fall 16.6%, the smallest share since June of 1980 according to Ned Davis Economic Research.
- **Industrial production rebounded 1.3% in October,** the most in nine years as the output rebounded after Hurricanes Gustav and Ike and a Boeing strike halted activity in the prior month. This was followed by a revision for September downwardly to -3.7%, the most downward revision in 62 years from -2.8%. Despite the hurricanes and the strike, the Fed said production fell around 2/3 of a percent in both September and October from a year ago. Output is down 4.0%, a rate of decline consistent with prior recessions. Motor vehicle sales were at a 10.5 million seasonally adjusted rate in October versus 16 million a year ago. Consumer goods are off 3.8% on a trend line basis (the worst we've seen in close to 25 years according to economists).
- **About 10 million people were unemployed in October or 6.5% of the workforce.** This is an increase of 2.8 million over the last twelve months. The unemployment rate has not started to turn up yet. We are predicting unemployment rate will rise to 7.5 -8.0% range by next summer.
- **Both the ISM Manufacturing Index and the Non-Manufacturing Index fell to 38.9 and 44.4 respectively in October with numbers under 50 representing recession.** Construction spending is down 6.6% year-over-year through September. Retail sales fell 2.8% in October and are down 4.1% from year-ago levels. Industrial production is down 4.1% from year-ago levels with capacity utilization at 76.4% versus approximately 82% a year ago. Finally, housing starts, home sales and home prices are still falling while the leading indicators are down 3% from year-ago levels in September.
- **On the positive side productivity is up 2% for the third quarter, and inflation is starting to fall rapidly with the consumer price index (CPI) falling 1% in October and the producer price index (PPI) declining by 2.8%.** Personal income is up 3.9% over year-ago levels through September and will be helped by falling inflation statistics. Also the balance of trade at -56.5 billion in September, while still enormous, is improving and the U.S. dollar has rallied significantly over the past six months. Finally, the personal savings rate in September was 1.3%, up from negative territory a few months ago.

Table II



Source: Ned Davis Research

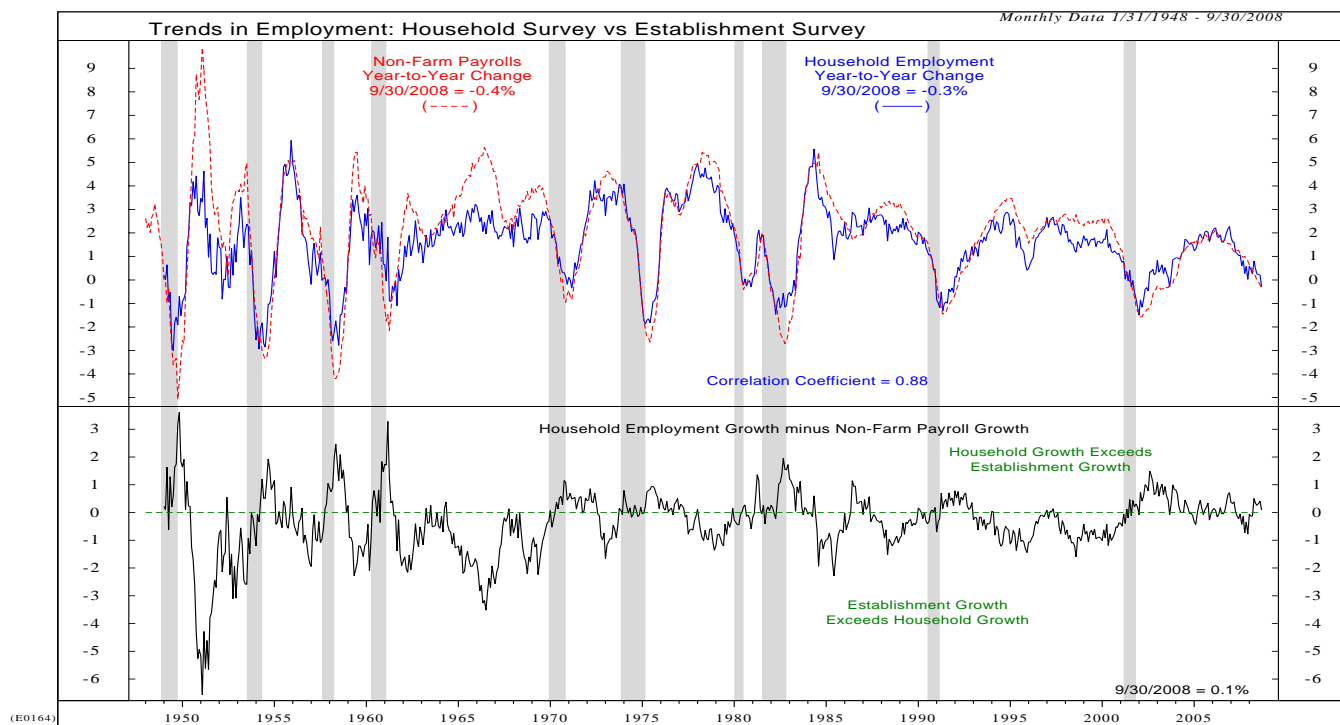
Table III



Source: Ned Davis Research

- **The main reason for being positive about the future is a change in economic policies.** The Troubled Asset Relief Program (TARP) has been redirected to build bank capital, support consumer access to non-bank credit and attempt to reduce home foreclosures. There is still \$350 billion in the \$700 billion program which will be left for the incoming administration to manage. We are acutely aware that the collapse in bank stocks since TARP was initiated suggests that there are still risks of bankruptcy in the financial sector.

Table IV



Source: Ned Davis Research

- **Our view is that real GDP will grow at an estimated 0.7% in 2008 and 1.5% in 2009, which compares to 2% in 2007.** Corporate profits are expected to fall 20% in 2008 and increase 5% in 2009. The CPI should end the year at 2.5% and remain at that level in 2009. The primary uncertainty is whether or not the economic policies of the Obama Administration can bring about an economic recovery in the second half of 2009.

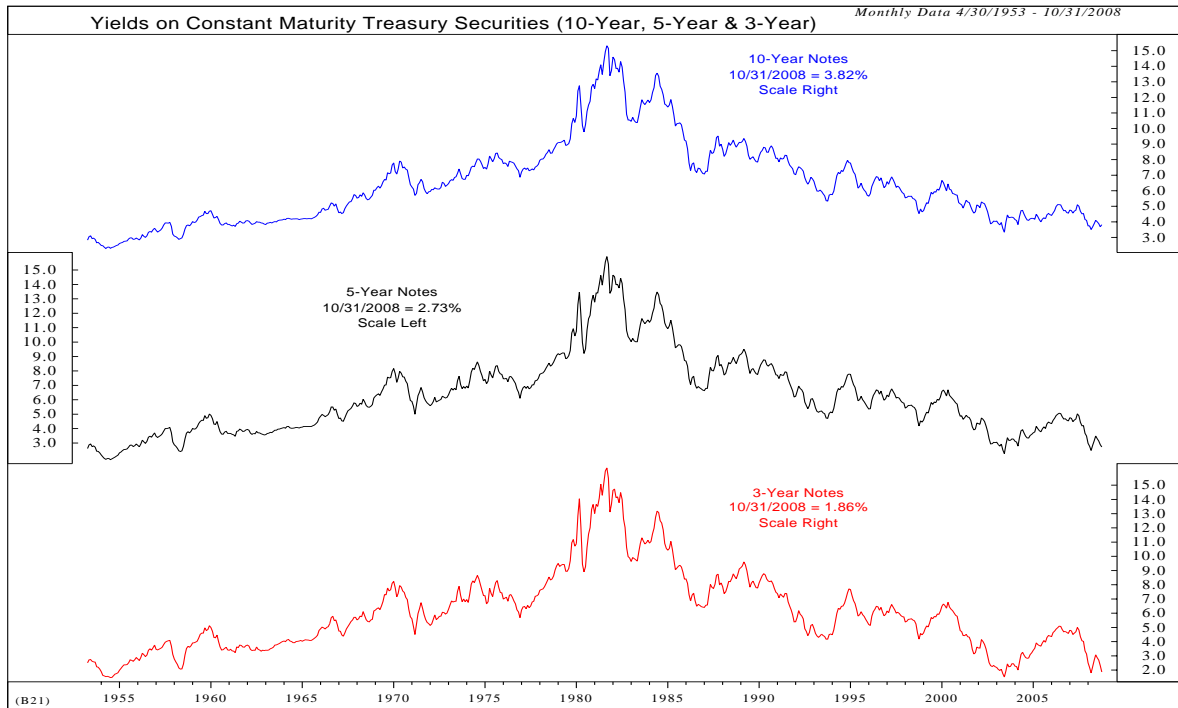
THE U.S. FIXED INCOME MARKET

- **Poor market psychology, forced liquidations, and deleveraging continue to erode consumer and business confidence.** These self-reinforcing factors point to reduced economic activity in the future. However, lower inflation expectations, improved bond market fundamentals, and another Fed rate cut could temper these negative factors. The current crop of government programs forms the best combination yet to return stability to the market, but improvement will take time. With normalization, expect a flatter Treasury curve and disinversion, a more normal sloping yield curve. Worsening fundamentals present an opportunity for quality collateralized products to prove their mettle and outperform nonsecured debt. Auto asset backed securities have exhibited good credit performance and are well set for the rough seas ahead. Corporate credit will be tested by balance sheet issues and increased defaults. A heavy investment-grade pipeline could provide further pressure, while high-yield issuance might be squeezed out by the elevated spreads in investment grade. We remain cautious and defensive but see value in some sectors and industry groups. The muni market is beginning to be tested by a larger

new issue calendar, but weaker issuers are essentially shut out. Yields are still at record levels as a percent of Treasuries and swaps.

- **HIGH GRADE CORPORATES:** We continue to be cautious on investment-grade bonds, which will be pressured by balance sheet strains, lack of demand, and the potentially heavy pipeline. Crowded short and defensive trades did not protect in the current sell off, as liquidations and redemptions are picking up speed. Long term we think some sectors appear attractive, especially for the top U.S. financials.

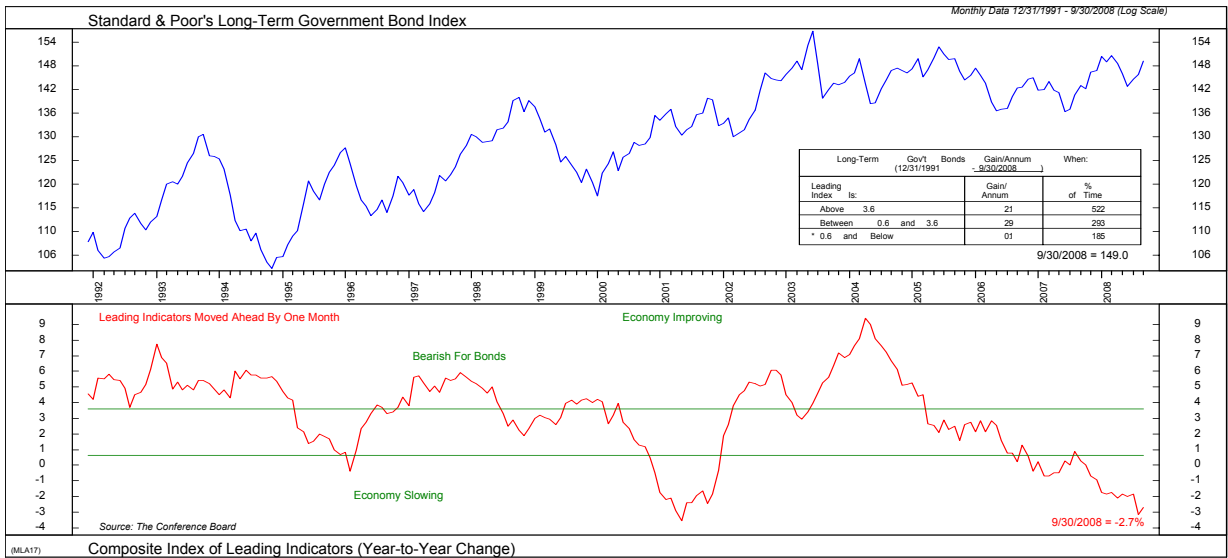
Table V



Source: Ned Davis Research

- **MUNICIPALS:** The muni market is beginning to be tested by a larger new issue calendar, particularly in upper medium-quality credits. The market is still essentially closed to weaker issuers. A strong case can be made that munis remain cheap despite the rally. Short-term yields will drop further, steepening the curve. Muni yields as a percent of Treasuries and LIBOR swaps are still at record levels tens years and in; they are near records on the long end.
- **CREDIT CONCERNS:** Federal Reserve policymakers lowered the target rate in the end of October by another half point. Rapidly fading inflation pressures and especially harsh financial conditions suggest considerable scope for additional accommodation as well as further aggressive fiscal steps. Collapsing consumer confidence appears to be reinforcing the economic downturn, with labor market weakness poised to intensify. Failure to stabilize financial conditions could introduce more severe tail risks of debt deflation. See Table VI for the Lead Indicators graphed against the Standard & Poor's Long-Term Government Bond Index.

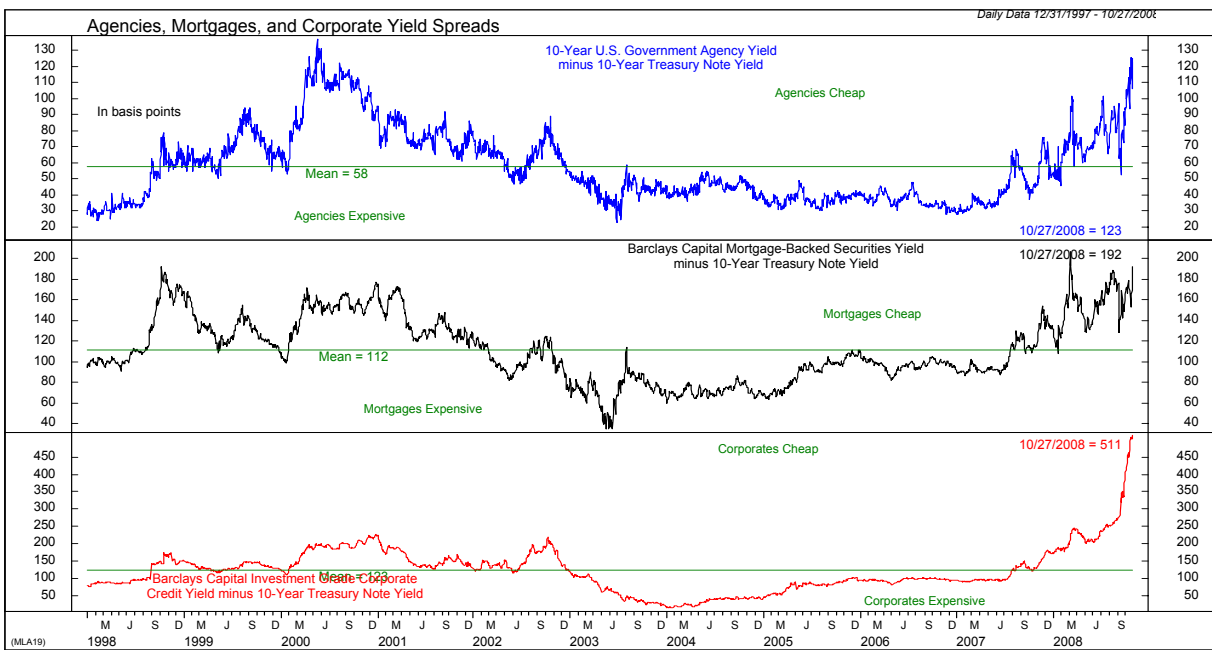
Table VI



Source: Ned Davis Research

➤ **Both domestic corporate bonds and U.S. agency mortgage pass-through securities easily outperformed 1-10 year Treasuries during the 2nd quarter.** In that quarter longer term interest rates rose on worries of higher inflation and a weaker dollar. However, the bond markets in the third quarter reversed direction as higher interest rates assumptions were far too aggressive considering the drag from declining confidence, deteriorating economic indicators and a weaker job market. At current levels, in the near term, we believe that short and long term rates will probably rise with prospects for U.S. short-term rates moving up faster and potentially flattening the yield curve. While the Federal Reserve and the ECB are unlikely to raise rates this year, that's largely contingent on ratcheting back price pressures. See Table VII for a representation of agency, mortgages and yield spreads.

Table VII



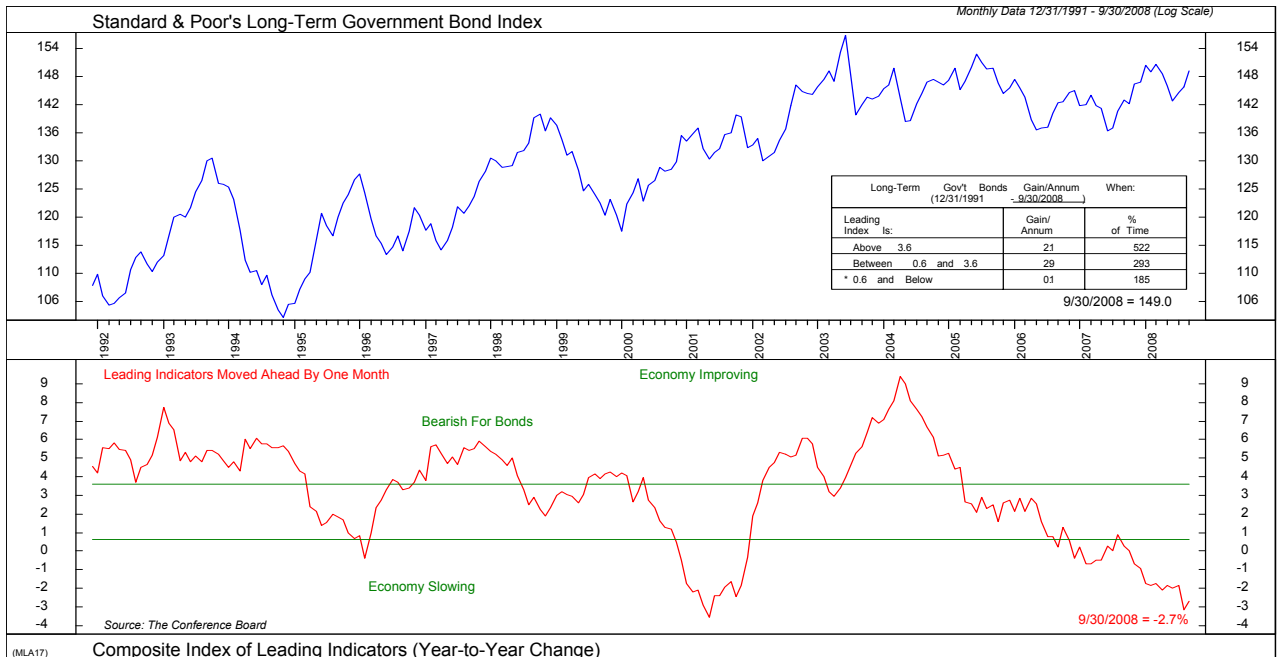
Source: Ned Davis Research

- **We continue to believe that possessing a good defense in the current climate makes good sense – stick to high-quality securities and selected opportunities in the corporate sectors.** In addition, bond investors should garner sufficient liquidity premiums for even high-quality investments that might be subject to longer-than-expected impaired market conditions (i.e., asset-backed and structured investments). We do not advocate that investors sell high-quality holdings into the unattractive valuations typical of these fragile markets as long as those investments remain consistent with long-term investment objectives.

- **The pressure on munis comes from several sources including the continual stream of bond insurer downgrades. While specific ratings vary greatly, the rating level means little for any of the insurers except the three that remain triple A: FSA, Assured Guaranty, and Berkshire Hathaway.** For any other insurer, bonds are trading based almost exclusively on the underlying credit strength of the issuer, and in some cases, identical bonds trade to a lower yield without bond insurance than they do with it. While the increases in yield are fairly modest, they have come during a period when Treasury yields were actually declining. As a consequence, muni yields as a percentage of Treasury yields have bounced back fairly sharply. Indeed, all along the yield curve muni yields as a percentage of Treasuries are almost at peak levels. On long maturities in particular, the extra yield is impressive, in our view. For 30-year maturities, the average yield as a percentage of Treasury yields for high-grade munis for the past 12 years is 90.5%. At the close of business on July 1, 2008, the ratio was just under 105%. In the five-year range, the average ratio is 77.8%, and the current level is right at 100%.

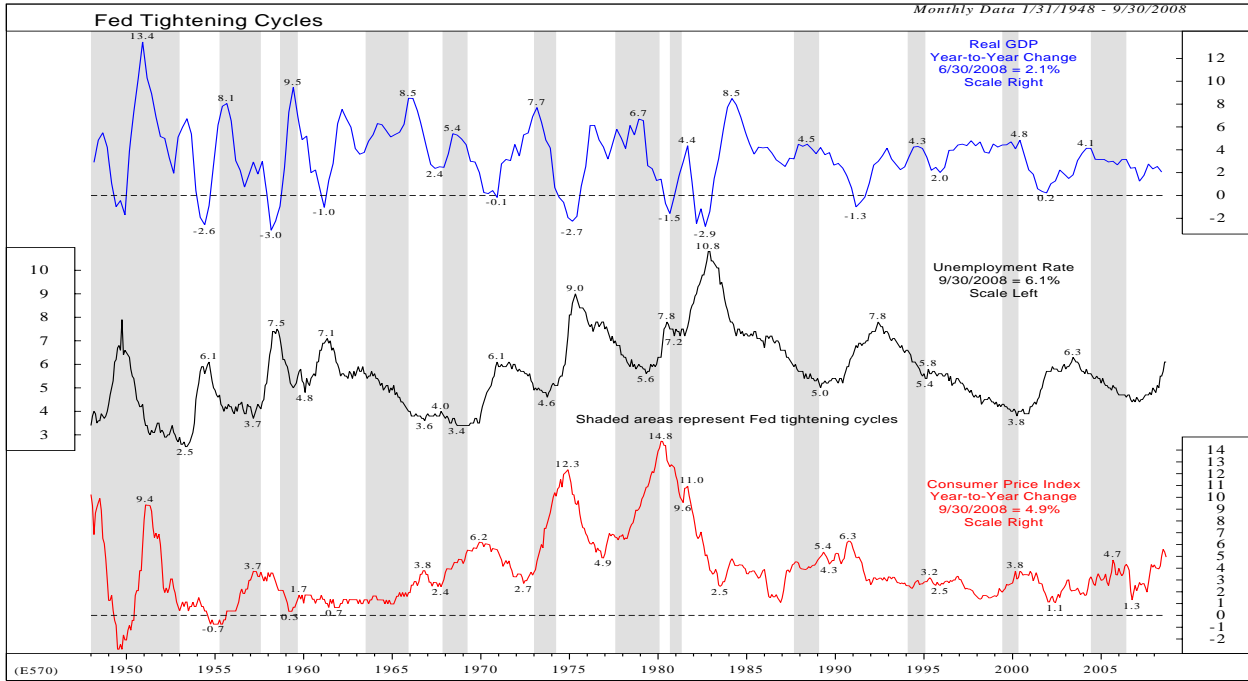
- **A number of factors contributed to the cheapening of munis in comparison to Treasuries:** (1) a renewed flight to quality as global and U.S. investors became more worried about the U.S. economic outlook; (2) downgrades of previously triple -A bond insurers and the resultant jettisoning by money market funds of variable-rate paper guaranteed by these insurers; (3) purchases of some of the high-yielding VRDNs by buyers who otherwise would have been focusing on the long-term market; and (4) a handful of liquidations of leveraged positions because their funding source was no longer money market fund eligible.

Table VIII



Source: Ned Davis Research

Table IX



Source: Ned Davis Research

FIRM UPDATE

Altman Investment Management is celebrating its seventh year managing investments for our valued clients next month, dedicated to servicing our investment partners in good and more difficult times, by achieving both consistent and superior investment performance relative to our benchmarks across both equity and fixed income classes. Our singular focus on investment performance and exceptional client service, with seasoned investment professionals, continues to solidify our long-term partnerships. We recognize that over the past eighteen months it has not been particularly easy to stay the investment course, especially during volatile periods in the markets. During periods of uncertainty, we especially appreciate our clients and business partners for their continued confidence in our process and expertise. We look forward to celebrating our ten year anniversary with the same degree of energy and passion as on our first day of incorporation.

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