

## GOOD RIDDANCE, 2008 / WAITING FOR 2009 TO END

As the somber holiday season ends, Goldilocks, the fairy godmother of many financial forecasters, has vaporized along with most who twirled her curls. The bull market in lies, puffery, deceit, and the inability of the regulators to define moral hazard as financial fraud culminated with the \$50-billion Ponzi scheme of Bernard L. Madoff and his feeder-fund network. The chase for absolute returns through fantasy or leverage on the part of 'sophisticated' investors will now be severely challenged legally and eventually by the regulatory community. In the end, the only positive returns and inverse correlation (diversification) for each of the last nine years has been provided by the unleveraged, direct ownership of high-quality fixed income. This was especially true with US Treasuries, a sector rarely found in 'sophisticated' institutional or individual portfolios. The decline in trust and creditability has reached new lows, abetted by Treasury regulatory policy that has undergone radical course changes from week to week, supplemented by a Federal Reserve that has ranged from central banking to central planning in its broad new extensions of monetary policy. The introduction in December of 'ZIRP' (zero interest rate policy), and the Fed's quantitative intervention into all maturities and credit sectors reflects its fear of deflation and the credit contraction brought on by the inability to value the asset side of anyone's balance sheet.

Fixed income, led by taxables, was the strongest performer of all sectors for the month. The Barclays Capital Government/Credit Index was up 4.53% for the month, providing a positive 5.70% for the year. The Barclays Capital Municipal Bond Index was also positive with a 1.46% result in December, but not enough to make a positive year at -2.47%. Equities were negative for the third month in a row. The decline for the month was led by the Dow Jones Industrial Average of 0.40% and a full-year return of -33.80%. The S&P 500 was up 1.05% for the month and down 38.50% for the year. The NASDAQ Composite was up 2.70% for the month but the weakest for the full year at -40.09%.

### TAXABLES

The month of December continued to witness the yields on US Treasuries plunging historic low levels. The GSE (government service enterprises) debt load of foreign banks continued to decline as Treasuries more than picked up the difference. From the previous week into the week ending Wednesday, 12/17/08, Treasury holdings of overseas central

banks at the Fed surged by \$26.344 billion to \$1.669 trillion. In contrast, the Fed's custody of agency securities held by offshore central banks fell for an eleventh straight week. This underscores the need for Treasuries as the only liquid securities available in which to accomplish portfolio operational objectives.

<b>Barclays Taxable Indices</b>	<b>PRICE (%)</b>	<b>CPN (%)</b>	<b>TOT. RET. 12/08 (%)</b>
Aggregate	3.30	0.44	3.73
Government/Credit	4.11	0.42	4.53
US Governments	3.11	0.34	3.44
US Treasuries	3.06	0.33	3.39
US Agencies	3.23	0.35	3.59
TIPS	4.77	0.20	4.96
Credit	5.72	0.55	6.27
Corporate	6.22	0.58	6.80
Credit Aaa	3.22	0.37	3.59
Credit Baa	5.17	0.65	5.82

Credit spreads continued to widen during the month. Treasuries continued to rally to historic low yields as they again led in performance. This reflects credit contraction and the consequent deleveraging impact of the dealer community, resulting in their inability to provide any facilitation to either the secondary or primary credit markets. The slope of the yield curve has flattened with the mid-month introduction of the Fed's ZIRP policy. During the month, we continued to look for duration extension and tactical opportunities in all Treasury sectors, within our product composites.

### TAX-EXEMPT/MUNICIPALS

The municipal index had a very positive month, up 1.46%, and a fourth-quarter increase of 0.74%. Municipals were off 2.47% for the year. This made 2008 their worst year since 1999, mainly because of the structured market events, which occurred over the first three quarters. During this year, we have out-performed our benchmarks. The failure of tender option bond programs (TOBs), auction rate securities, and monoline municipal-bond issuers are events we have commented on, and suffice it to say that it has created the most historically attractive investment levels. For example, AAA general obligation bonds due in 30 years rose to a record 2.2 times Treasury yields from the historical average of almost 0.96 times. Concurrently, the municipal yield curve has achieved a current yield spread of 450 basis points

between one and 30 years, which historically has averaged 150 basis points. Almost all of these valuation highs have been created by structural market problems and not the underlying municipal credits. Despite now being confronted with a severe economic contraction, these current valuations more than discount the contraction. However, shabby behavior on the part of our political leaders (most especially "The Terminator" in California) has made investors apprehensive. It should be noted that of all the headline risk created in California to defuse the blame for the fiscal discipline required, Gov. Schwarzenegger's budget was submitted on December 31 while he was out of the office on a ski vacation. His budget contains the service cuts and tax increases needed to balance the budget for the next 18 months.

<b>Barclays Tax-Exempt Indices</b>	<b>PRICE (%)</b>	<b>CPN (%)</b>	<b>TOT. RET. 12/08 (%)</b>
Municipal Aggregate Bond	1.03	0.43	1.46
10-Year Municipal	1.83	0.40	2.23
California Exempt	0.91	0.42	1.34
New York Exempt	1.24	0.43	1.66

We continue with our orientation toward high quality large issue GOs and vital service revenue bonds as the only way to provide the income stream offense for this deflationary environment.

## OUTLOOK

Evidence of a really severe global recession with deflation abounds everywhere. Despite this, the consensus has been that inflation is around the corner, with a second-quarter bottom in economic activity. The Fed is not printing money; it is only making credit available. It has done little to establish market clearing prices and transparency for the toxic assets. In every instance, federal assistance has been contrary to the economic needs of Main Street and has served only to provide life support for our domestic financial institutions and foreign central banks. This has created domestic 'zombie' institutions whose only banking activity has been with the Federal Reserve.

The risks for 2009 are the nationalistic reactions to this broadly based global recession and deflation, i.e., competitive devaluation, protectionism, and military conflict. Self-preservation becomes key, with energy and commodity prices now at multi-year lows. The cost of capital will be much higher with the retreat of securitization, leverage, and credit contraction. US consumption will also decline with the enforced increase in domestic savings brought on by these conditions. In our view, deflation requires a different investment offense; preservation of capital is paramount and negative relative performance cannot be tolerated. An income stream is key and gold becomes a most important hedge against many forthcoming governmental policy missteps, by which we have already been badly abused. In this new environment,

the US dollar will remain strong, contrary to the general consensus. This is because of the rising worldwide fear of problems abroad (especially in Europe) being more severe than the US. Going forward, equities cannot be considered a viable sector until coupon returns on corporate bonds drops substantially. We continue to believe that interest rates are biased down for a long period of time and that there will be a realization of the need to increase exposure to Treasuries as the only sector allowing active portfolio management. All other credit sectors, while attractively priced, are buy-and-hold securities and have minimal capabilities to alter these conditions.

## MARKET HIGHLIGHTS\*

<b>Foreign Money &amp; Bond Markets</b>	<b>11/30/08</b>	<b>12/31/08</b>	<b>US \$ Tot. Ret. (%)</b>
3-mo. LIBOR BP Fixing	3.91000	2.7700	N/A
ML UK Gilt 10+ Index	4.25	3.74	0.80
3-mo. LIBOR Yen Fixing	0.93500	0.83250	N/A
ML Japanese 10+ Index	1.98	1.59	11.06
<b>Currencies</b>	<b>% Change</b>		
British Pound (US \$ per pound)	1.5377	1.4593	-5.10
Japanese Yen (yen per US \$)	95.525	90.6425	-5.11
Euro (US \$ per euro)	1.2691	1.3972	10.09
<b>Commodities</b>			
Gold Comex Spot (\$ per oz.)	818.05	882.05	7.82
CRB Future Com Pr. Index	242.20	229.54	-5.23
W. Tex. Int. Crude (\$ per bbl)	54.43	44.60	-18.06
<b>Equities</b>	<b>US \$ Tot. Ret. (%)</b>		
S&P 500	896.24	903.25	1.05
DJIA w/ Income	8,829.00	8,776.00	-0.40
NASDAQ	1,535.57	1,577.03	2.79
NIKKEI (TOKYO)	8,512.27	8,859.56	10.21

\*Source: Bloomberg

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