MARCH 2009

FEBRUARY CLIENT INVESTMENT REVIEW

THE "D" & "N" WORDS

The taboo no longer holds: depression and nationalization are no longer whispered words; rather, they are now clearly front-and-center on the economic stage. Equities continued to deflate in the US and worldwide in February, and declined even further in the first week of March. At month-end, the S&P 500 was off 10.6% for the month, at 735. As of March 6, it had declined an additional 7.0% to 683. At these levels, the S&P 500 is down 55% from its 2007 peak of 1565 on 10/9/07 and has taken us back to the levels of September 1996. We are clearly beyond the "lost decade" and now are reaching the 13-year mark. Evidence of the destruction abounds when one considers anecdotal comparisons: it now costs more to withdraw money from a Citibank ATM than to purchase a share of its stock; a halogen bulb costs more than a share of GE; a gallon of gas is more than a share of GM; and the cost of the Sunday *New York Times* equals a share of its stock. Asset deflation has clearly arrived. While these equity values would appear to be low, the S&P 500 sports a price-earnings ratio based on the latest 12-month reported earnings of 23.7x compared to its lifetime average of 15x.

Fixed income markets and gold were a distinct contrast to equities in February. The Barclays Capital Municipal Bond Index provided a positive total return of 0.52% while the Barclays Capital Government/Credit Index was -0.83%. The gold COMEX spot price was up 1.56% in US$. Equities were led down by the Dow Jones Industrial Average at -11.19%, followed by the S&P 500 drop of -10.61% and the NASDAQ Composite drop of -6.49%.

TAXABLES

Last month, taxable fixed income consolidated to absorb $97 million of new Treasury supply. With Treasury yields described as being at bubble-rate levels, concerns abound about where the buyers will come from. This record Treasury auction amount took place at an average bid-to-cover ratio of 2.54x with significant foreign participation. The Treasury yield curve has adjusted upward from year-end, with the slope of the curve (3 mos. / 30 yrs.) increasing from 260 bps. to 346 bps., and the 2-10 year yield spread widening from 145 bps. to 204 bps. Our attraction to Treasuries remains strong because real returns of 3% (with zero inflation) are in the upper half of their historical levels. In addition, Europe and the UK have more debt and bigger financial problems than we do. Beyond that, with oil at $44/bbl, the petroleum-exporting countries are also tottering – i.e., Dubai, whose commercial real estate is faltering along with the emirate's major investments in Citibank. Given the above, whose sovereign debt would you want to own?

In a deleveraging world, there will be a dramatic reduction in the amount of private debt available. In this context, the current level of US institutional Treasury ownership is minimal among banks, insurance companies, pension funds, foundations, and endowment funds. As equities extend their period of non-productivity for investors, the personal savings rate continues to climb – now at 5.0%, up from 0.8% in August. Hence, significant new demand will arise for Treasuries, more than replacing any retrenchment of foreign buyers.

Barclays Taxable Indices	PRICE (%)	CPN (%)	TOT. RET. 2/09 (%)
Aggregate	-0.77	0.41	-0.38
Government/Credit	-1.21	0.38	-0.83
US Governments	-0.57	0.30	-0.27
US Treasuries	-0.81	0.29	-0.53
US Agencies	0.06	0.33	0.38
TIPS	-2.13	0.16	-1.96
Credit	-2.23	0.52	-1.71
Corporate	-2.51	0.54	-1.97
Credit Aaa	-1.66	0.36	-1.29
Credit Baa	-1.60	0.62	-0.98

In all product lines, we continue to be focused on system-wide credit deterioration and not with duration risk. This systemic credit concern has and will continue to dominate our fears much more so than the potential of inflation and a weak US dollar. Our currency, of course, is being supported by the synchronized global downturn, recalling the analogy that "in the land of the blind, the one-eyed man is king".

TAX-EXEMPT/MUNICIPALS

In February municipal curves, unlike Treasuries, flattened as rates for maturities longer than 11-12 years fell while shorter rates rose. The front end of the curve had out-performed in this year's rally and was giving retail investors some "sticker shock" while at the same time yield-conscious buyers moved to lock in much higher levels in the long end. Total new issuance for the month fell 4.9% compared to last year ($20.3 billion vs. $21.4) but YTD remains 5% higher. Credit spreads remain wide and secondary markets thin, with investors and dealers focused on the primary market.

Barclays Tax-Exempt Indices	PRICE (%)	CPN (%)	TOT. RET. 2/09 (%)
Municipal Aggregate Bond	0.12	0.41	0.52
10-Year Municipal	-1.14	0.38	-0.76
California Exempt	0.24	0.41	0.65
New York Exempt	0.12	0.41	0.53

In credit news, the long delayed passage of a budget by the state of California helped the California index out-perform national averages.

OUTLOOK

Deleveraging, deflation, and depression – all economic cousins – are in play, not only in the US but worldwide. This synchronization is unique to this downturn and will only serve to make the economic adjustment much longer in duration. The need to shrink personal, corporate, not-for-profit, and public balance sheets will make profit generation difficult and assets less valuable. Labor cost and unemployment are also completely correlated, making it difficult to foresee inflation. Government economic proposals, meanwhile, are attacking symptoms, not causes, and with this crisis environment, other socio-political agendas are being introduced. At this point, the Administration is only serving to extend and exacerbate current conditions.

Weathering the next two years without losing money is a key objective for all of our clients. Principal preservation, income, and equity alternatives comprise the right playbook for deflation. Absolute returns are crucial as they buy more each passing day while relative negative performance is extremely expensive. Going forward, we continue to recommend high quality fixed income, including municipals, to provide our income, and an allocation to gold. It is a unique tangible sector that hedges against all risks while providing distinct diversification characteristics and positive returns. As an equity alternative, we recommend high quality corporate debt. Away from the above, we have continued to run with minimal direct equity exposure in all of our enhanced (equity allowance) accounts.

MARKET HIGHLIGHTS*

Foreign Money & Bond Markets	1/31/09	2/28/09	US $ Tot. Ret. (%)
3-mo. LIBOR BP Fixing	2.16563	2.04938	N/A
ML UK Gilt 10+ Index	4.37	4.25	-0.47
3-mo. LIBOR Yen Fixing	0.67063	0.63750	N/A
ML Japanese 10+ Index	1.76	1.76	-8.04
Currencies			% Change
British Pound (US $ per pound)	1.4541	1.4318	-1.53
Japanese Yen (yen per US $)	89.92	97.575	8.51
Euro (US $ per euro)	1.28128	1.26686	-1.13
Commodities			
Gold Comex Spot ($ per oz.)	927.85	942.35	1.56
CRB Future Com Pr. Index	220.37	211.57	-3.99
W. Tex. Int. Crude ($ per bbl)	41.68	44.76	7.39
Equities			US $ Tot. Ret. (%)
S&P 500	825.88	735.09	-10.61
DJIA w/ Income	8,001.00	7,063.00	-11.19
NASDAQ	1,476.42	1,377.84	-6.49
NIKKEI (TOKYO)	7.994.05	7.568.42	-13.02

*Source: Bloomberg

Smith Affiliated Capital:
800 Third Avenue, New York, NY 10022
TEL: 212-644-9440 FAX: 212-644-1979
www.smithcapital.com