Smith Affiliated Capital

FEBRUARY 2009

JANUARY CLIENT INVESTMENT REVIEW

THE WORST JANUARY / PRESIDENTIAL EFFECT

A poor first week for equities became the bellwether for the worst Inauguration Day market and the worst January ever. January also bears the onus of being the start of the post-election year – historically the toughest for stocks, especially with first-term presidents. The expectation of many investors for government to bring about positive change in the US, while it is in the deepest post-war recession within a global downturn, will be frustrated. At month-end, the release of 4Q'08 Gross Domestic Product (GDP) figures declining by 3.8% showed the largest decline since 1Q'82. The only positive contribution came from inventory investment and government purchases (all federal government). Consumer and business spending is likely to remain weak in 1Q'09. Since inventory jumped in 4Q, there will be inventory liquidation in 1Q. This implies 1Q GDP will also contract more sharply than it did in 4Q.

In this thirteenth month of formal recession, the Dow Jones Industrial Average was down 8.84%, followed by the S&P 500 decline of 8.54% and the drop in the NASDAQ Composite of 6.47%. Fixed income was mixed, reversing last year's performance. However, both taxable and tax-exempt sectors performed significantly above equities. The Barclays Capital Municipal Index led the parade, up 3.66%, while its Government/Credit Index dropped -1.54%. Gold, a traditional haven, was up 4.95% for the month.

TAXABLES

At the beginning of the new year, the world's first global recession was just getting started. While many experts previously worried that over-regulation would induce our financial markets to move to London, that honor has now been assumed, paradoxically, by Washington. Global markets will face huge political risk in 2009 as policy remedies will be limited by banking insolvency problems, which constrain monetary policy and blunt fiscal stimulus. One merely has to ponder the situations in Japan and Iceland to see that the UK is headed for a similar outcome.

Credit spreads initially narrowed during the month but as confusion over banking needs and legislation continued, they ended wider for the month. In a flight to quality and safety, Treasury Inflation-Protected Securities (TIPS) did well, and we participated in both the 10- and 20-year auctions. Large two- and five-year Treasury auctions were successfully completed and we now face the normal mid-quarter refunding in February. In all of our products, we continue to look for opportunities via duration extension to take advantage of a very positive yield curve. We also continue to strengthen and add to our corporate debt holdings, using our Agency positions for funding these efforts.

Barclays Taxable Indices	PRICE (%)	CPN (%)	TOT. RET. 1/09 (%)
Aggregate	-1.29	0.42	-0.88
Government/Credit	-1.93	0.40	-1.54
US Governments	-2.81	0.32	-2.49
US Treasuries	-3.23	0.31	-2.92
US Agencies	-1.71	0.33	-1.38
TIPS	1.50	0.18	1.69
Credit	-0.53	0.52	-0.01
Corporate	-0.09	0.54	0.45
Credit Aaa	-2.88	0.36	-2.52
Credit Baa	1.44	0.62	2.07

TAX-EXEMPT/MUNICIPALS

In January, municipals rallied strongly as cash was put to work by retail and crossover investors, and economic data weakened considerably. Total new issuance rose 5.3% compared to last year ($21.2 billion vs. $20.2 billion) as new deals providing some comfort in "price discovery" were met with strong demand. In a sign of the times, fixed-rate issues rose 18% while variable rate issues fell over 65%. Credit concerns, however, have kept quality spreads very wide while the secondary market remains very thin.

Barclays Tax-Exempt Indices	PRICE (%)	CPN (%)	TOT. RET. 1/09 (%)
Municipal Aggregate Bond	3.24	0.42	3.66
10-Year Municipal	4.30	0.40	4.70
California Exempt	3.18	0.42	3.60
New York Exempt	3.39	0.42	3.81

OUTLOOK

The S&P 500 currently has a five-week losing streak. The Obama stimulus plan has lost momentum and is now viewed as being more about social change than infrastructure. Attempts to solve the housing crisis are failing as banks increase their loan disciplines, constricting availability while the Fed tries to bring mortgage rates down. Employment costs are clearly in decline as four-day workweeks are introduced and layoffs are widespread. It is hard to see inflation when labor, the biggest cost of all, is in full retreat. For those claiming that sky-high fiscal deficits will only raise Treasury yields, ample time periods have existed in the US as well as Japan, which demonstrate that fiscal deficits are not the only ingredient in the equation that determines the direction of interest rates. In addition to the above, capital spending is the worst that it has been in many decades; the consumer is in serious retreat, with wages in decline; and credit contraction has handicapped growth, with no banking recovery in sight. Finally, there is everywhere the expectation that government will lead us out of this morass when, in fact, its course determined by an electoral cycle, most especially in the case of the House of Representatives.

Deflation, which we are presently experiencing, requires a whole new offense other than that employed for inflation. Relative performance should be abandoned and absolute performance demanded. In this new game, no loss of yardage can be tolerated as the make-up becomes more expensive. Income becomes the fullback of the offense as it buys more each passing day. Event risk rises with liquidity loss because a worldwide financial downturn can pressure global political dynamics toward radical decisions. Because of this, we have viewed gold as the best hedge for all those risks we do not know about.

We have very low equity performance expectations for the next few months and probably the rest of this year. There is a high need for ballast – namely, high quality municipal/taxable fixed income (little concern for maturity risk and continued fear of credit) – and a strong appreciation for gold as a very positive significant sector addition to any portfolio.

MARKET HIGHLIGHTS*

Foreign Money & Bond Markets	12/31/08	1/31/09	US $ Tot. Ret. (%)
3-mo. LIBOR BP Fixing	2.7700	2.16563	N/A
ML UK Gilt 10+ Index	3.74	4.37	-8.23
3-mo. LIBOR Yen Fixing	0.83250	0.67063	N/A
ML Japanese 10+ Index	1.59	1.76	-1.31
Currencies			**% Change**
British Pound (US $ per pound)	1.4593	1.4541	-0.36
Japanese Yen (yen per US $)	90.6425	89.92	-0.80
Euro (US $ per euro)	1.3972	1.28128	-8.30
Commodities			
Gold Comex Spot ($ per oz.)	882.05	927.85	5.19
CRB Future Com Pr. Index	229.54	220.37	-3.99
W. Tex. Int. Crude ($ per bbl)	44.60	41.68	-6.55
Equities			**US $ Tot. Ret. (%)**
S&P 500	903.25	825.88	-8.42
DJIA w/ Income	8,776.00	8,001.00	-8.63
NASDAQ	1,577.03	1,476.42	-6.35
NIKKEI (TOKYO)	8,859.56	7.994.05	-9.36

*Source: Bloomberg

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