



**Nicholas P. Sargen**  
Chief Investment Officer

## Market Update

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Our New Year's greeting: *2008 is finally over!* That's the good news. The bad news is the spillover from the housing and credit market bubbles is still very evident in the United States and around the world. Even so, it will be hard for 2009 to match last year's horrid investment results (see Figure 1), which will go down as the period of greatest wealth destruction on record for U.S. households: Cumulative losses on equity, fixed income and real estate holdings are estimated to exceed \$10 trillion.

| Figure 1           |            | 1st Half | 2nd Half <sup>1</sup> | YTD <sup>1</sup> |
|--------------------|------------|----------|-----------------------|------------------|
| <b>Equities</b>    |            |          |                       |                  |
|                    | S&P 500    | - 11.9%  | - 28.3%               | - 36.5%          |
|                    | EAFE (\$)  | - 10.5%  | - 36.3%               | - 42.0%          |
|                    | EM (\$)    | -11.7%   | - 46.9%               | - 52.7%          |
| <b>Bonds</b>       |            |          |                       |                  |
|                    | Treasuries | 2.2%     | 11.2%                 | - 13.7%          |
|                    | Corporate  | - 0.8%   | - 4.1%                | - 4.9%           |
|                    | High Yield | - 1.2%   | -25.3%                | - 26.1%          |
| <b>Commodities</b> |            |          |                       |                  |
|                    | Oil (WTI)  | 45.8%    | - 59.6%               | - 55.6%          |
|                    | CRB (all)  | 29.0%    | - 50.4%               | 36.0%            |
|                    | Gold       | 11.0%    | - 5.0%                | 4.6%             |

<sup>1</sup>Returns for equity indices include dividend except emerging markets, which are price changes. Source: Bloomberg

The toll on the U.S. and overseas economies is the worst global recession in three decades. According to the National Bureau of Economic Research (NBER), the U.S. economy has been in recession for just over a year, already surpassing the two previous recessions. Moreover, the depths of the current recession, measured from peak to trough of real GDP and also in job losses, now rival the downturns of the mid 1970s and early 1980s, and the recession could become the most severe in post-war history.

U.S. policymakers now find themselves scrambling to limit the economic deterioration and to restore financial stability. After under-estimating the problem for more than a year, they are now embarking bold new programs. The Federal Reserve is pursuing unorthodox policies to reignite credit markets and to lower mortgage rates while setting short term interest rates near zero. In addition, the Obama Administration is preparing a record U.S. fiscal stimulus package that could reach \$1 trillion over the next two years. These actions will play a key role in shaping the course of the economy and financial markets this year and next.

## Looking Ahead

As we begin 2009, the consensus forecast sees the economy contracting further in the first half of the year, and then stabilizing in the second half as policies begin to take hold. While this scenario is plausible, we are also cognizant that it is similar to the consensus view for 2008, which proved to be wrong. Forecasters a year ago did not envision the multitude of problems in the financial sector, and this could happen again. Accordingly, we are paying close attention to what bearish forecasters are saying, and we are establishing markers to discern which view is right.

What investment strategy makes sense in this environment? We begin with the obvious. Current conditions are the most turbulent we have ever experienced, and a quick improvement in the economy or return to normal market volatility is unlikely. We also believe a re-opening of credit markets is critical for recovery of the economy and risky assets. Consequently, our strategy is to explore opportunities in fixed income markets first, beginning with investment grade corporate bonds. Over time, as credit markets thaw, riskier instruments including high yield bonds and equities are likely to improve, as well. Finally, the asset that appears most overpriced to us is U.S. treasuries, and yields on them are likely to rise as the economy stabilizes.