CS McKee
U.S. Equity
Fourth Quarter, 2008

Market Outlook
A yearlong barrage of bad economic and financial market news finally came to an end. Along the way, we witnessed the end of Wall Street as we knew it, a virtual halt to normal banking operations and credit availability, domestic automakers facing bankruptcy (Chapter 22 for Chrysler), a doubling followed by a collapse in oil prices, a rapidly contracting jobs market, a Ponzi scheme of astounding proportion, and a previously unfathomable drop in home prices. An unprecedented series of events, in all.

But rather than rehash the details of a year most would like to forget, we'll focus on what we expect for 2009. The immediate future promises little economic improvement, but the groundwork has been laid for some measure of recovery from the damage.Mortgage rates are near 40-year lows and almost certainly going lower. One week into the new year the cost of a 30-year conforming loan is below 5%, already approaching the Fed's stated target of a 4.5%. Coupled with drastic cuts in new home construction, we should see a slight correction to the supply imbalance in housing later this year. Lowering the cost of consumer and corporate debt is next on the must-do list, along with the ongoing and more difficult battle to improve credit *availability*.

Lending institutions, burdened by both current and expected losses, are loath to extend credit to overburdened borrowers. Some will find it more attractive to shop the securities markets with any capital they're willing to risk. Equally important to a sustained recovery is consumers' willingness to borrow. Even those with spending power are boosting their savings rates in the face of falling asset values. A return to fiscal prudence is a wise and necessary long-term change, but it reinforces recessionary pressures in the short run. It's the wealth effect (home values, investment portfolios) working in reverse.

Interest Rates and Inflation
Our earlier, second-quarter expectation that 1.50% to 2% would mark the low in the Feds fund rate for this cycle proved incorrect. Nor did we foresee such a sharp falloff in inflation. The artificial rise in commodity prices helped sow the seeds of its own destruction by exacerbating the global slowdown. Investor leverage also worked in reverse, evidenced by the collapse in energy prices in the second half of the year to a level below our measure of fair value.

Growth and Employment

Predictions for growth and employment over a one-year time frame are difficult even in "normal" markets, and we neither enjoy normality now nor expect it during 2009. Nonetheless, we operate under the expectation that the new President's proposed stimulus plan will boost the economy into a very slow and uneven growth mode by the second half of this year, though job losses will continue their twelve-month downward slide until at least the third quarter. As emphasized in our last several updates, sustained expansion will be slow in coming and slow in pace for the foreseeable future. We have "borrowed forward" a sizeable chunk of economic prosperity and now must settle our bill.

Summary

The painful process of global balance-sheet repair continues. Massive government intervention will simply smooth the path to an eventual resumption of prosperity, doing little to expedite it's arrival. Sustained improvement in financial markets later this year will presage a return to slow and steady economic growth in 2010.

Portfolio Commentary

By now you've surely heard and read all the accounts of how volatile the markets were in the fourth quarter. The reality is that the fourth quarter of 2008 will likely be the yardstick against which future periods of volatility are measured. Without belaboring the point, consider the following statistics:

- In October, the Dow Jones Industrial Average enjoyed two of the six biggest one-day percentage gains in its history, only to give it all back and sink to new lows.
- Four of the twenty largest daily percentage declines in the Dow occurred after the collapse of Lehman Brothers in September. In early October, the Dow suffered its worst calendar-week percentage decline on record.
- After the Lehman bankruptcy, the S&P 500 Index moved more than 5% in either direction on 18 days. There have been only 17 other such days in the past 53 years.

When all was said and done, the Dow lost 18% during the quarter and nearly 32% (including dividends) for the year—its worst year since 1931. The S&P 500 Index fared even worse, losing 22% for the quarter and 37% for the full year—the third worst showing for stocks in the past 184 years.

The portfolio struggled in this volatile environment, underperforming for the quarter versus the S&P 500 Index.

For the quarter, stock selection in the Energy sector was a drag on performance. The steep decline in oil prices reduced the enthusiasm for deep-water driller Transocean and, coupled with strong hedge-fund liquidation pressure, resulted in a decline of more than 50% for this stock. The firm also moved

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