

A Joseph Capital Management, LLC Special Report:
Answering Your Key Questions about the U.S. Economy,
and about the Future for Stocks

From the Research Desk
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In this *Special Report*, we'll share with you the latest economic news, as well as our thoughts about both the economy and the stock market. We issue this *Special Report* as many of our clients have expressed continued concern about the stock market declines, and we seek to furnish answers to the most commonly asked questions we've heard over the past few weeks.

As of Thursday, March 5th (market close), the S&P 500 Index, which fell in value in 14 of the past 17 trading days, had tumbled more than 56 percent from its all-time high in October 2007. On the same day the Dow Jones Industrial Average (a measure of 30 large companies) tumbled to 6594.44, its lowest close since April 15, 1997, and 53.7% below its record high in October 2007. In addition, a spate of recent poor economic news, fueled by the often passionate discourse of "talking heads" on "news" programs, has everyone talking.

Are these times scary? Of course they are. How do I feel? Probably like you and every other investor in America - frustrated, concerned, and even angry.

But things are not as bad as they might seem, and they are not likely to get *dramatically worse*. There will be more job losses (as job losses continue for several months even after the economy begins to rebound otherwise). And the overall U.S. economy will continue to contract this year, before likely entering a new phase of expansion. In all likelihood, economic recovery will begin within a year, and the stock market usually goes up in advance of economic rebounds.

We'll try to put some perspective on all of this by answering several questions which have been floating around in nearly everyone's mind.

KEY QUESTION NO. 1 – WHEN WILL THE ECONOMIC DOWNTURN END?

Consumer confidence in the future of the U.S. economy is at an all-time low. Questions are being asked such as: "Where is all the money the U.S. government is spending – where is it going? Can the U.S. afford this?"

There is no doubt that in the U.S. and worldwide, the recession has worsened. The mild economic downturn, which began in December 2007, became severe in mid-September 2008 when the bankruptcy of Lehman Brothers set off a full-blown crisis in the credit markets (with banks needing to conserve capital and hence undertaking fewer loans to businesses and each other). This credit crisis, in which a lack of liquidity extends beyond traditional banking operations and into the important worlds of asset-backed securities and commercial paper, has severely affected economies in every part of the world. The initial U.S. and foreign government

efforts to combat the financial and economic crisis were far outweighed by the severity of the “disease” that flowed through the credit markets and extended into the broader economy by November and December 2008.

The key question in every investor’s mind is, “**When will the recession end?**” As noted below, many economists predict a slow economic recovery will begin in the United States in the 4th quarter of 2009, though we believe this may not occur until early 2010. We note that economic forecasting is not a precise science, and future projections can often go astray due to new developments. As we note below, a large part of the timing of any economic recovery will be determined by the timeliness of actions taken to restore our financial system to proper functioning.

In essence, the economic recovery may “feel” bad for nearly another year. The downturn, which has now existed for 15 months, is likely to last another 8-12 months. **But “the light at the end of the tunnel” is likely approaching soon.**

As we note below, the fact that the economy might not “hit bottom” for several more months does not mean that the stock market will continue to be bad for another year. The stock market is an advance indicator of the economy, and usually begins to rebound some 6-9 months ahead of the economic rebound.

KEY QUESTION NO. 2 – WILL A “DEPRESSION” OCCUR? *Not in all likelihood.* First – what is a “depression”? It might be defined as a contraction of a country’s economy by 10% or more. It has been more than 60 years since America has had a depression, but at one time they were far more common. In fact, there are six depressions in American history that are thought to be the worst since detailed records of economic data started to be kept (around 1867): 1873-79, 1893-97 (actually two contractions separated by an incomplete expansion), 1907-08, 1920-21, 1929-33, and 1937-38.

Will we reach a “depression”? **We believe the chances for a depression are only 1 in 5 at present.** That means that **there is an 80% chance that the economy will begin to recover from its current recession** within the next 6 to 18 months. Well-respected economist Alan Blinder recently noted that the U.S. stimulus package is likely to add 5% to U.S. economic growth over the next two years, that housing prices will eventually hit bottom, and that his “best guess” is that economic growth will return, albeit mildly, in late 2009 (4th Quarter). Under current scenarios, many other economists also predict that the U.S. economy will continue to contract until late this year, or even into early 2010. Most economists expect the U.S. economy to grow at a slow rate from 2010 through 2012, given the ongoing problems with adjustable rate mortgage rates resetting in those years.

Ultimately, however, the timing of any economic recovery hinges on the government’s ability to supply financial companies with fresh capital to get credit flowing again. There won’t be an economy to stimulate without solvent banks ready to make loans to both businesses and consumers.

We’ve managed to survive two World Wars, Black Monday, prime rates over 20% and inflation near that, the Savings & Loan implosion, Presidential assassinations, 9-11, the “Tech bubble,” and more. **This too shall pass.** This financial and economic crisis, while dour, is not even

comparable to the Great Depression, when unemployment hit 25% (non-farm employment hit 37%), and the U.S. economy contracted by 30% from the summer of 1929 through early 1933. Between 1929 and 1933, 10,763 of the 24,970 commercial banks in the United States failed.

Yet the U.S. economy recovered somewhat from 1933 to mid-1937, and by June 1937 the unemployment rate had fallen to 12 percent. Then another economic downturn occurred, in reaction to a chain of poor economic policies (including the imposition of a tax on corporations' undistributed profits, the new social security tax on wages, labor cost increases due to unionization, and a tighter monetary policy instituted by the Federal Reserve Bank. The rate of unemployment rose to 19% in 1938, falling only slowly to 14.6% by 1940. A huge increase in government spending during World War II offset declines in business investment and consumer spending and unemployment due to enlistments and the draft.

Those who have lived through the Great Depression, and are still with us today, have recently told of us the conditions back then. A complete loss of all of a family's savings as banks collapsed (there was no FDIC insurance back then). Vacant homes everywhere as foreclosures were rampant. A good many Americans literally starved to death. It was, indeed, a "Great" depression. Fortunately, we are not in that kind of economic turmoil today. Look at this comparison:

	GREAT DEPRESSION	2008-2009 RECESSION (Forecast or Actual)
Real Gross Domestic Product (peak to trough)	-30%	-2.9%
Rise in the Unemployment Rate	+ 21.6%	+ 5.6% (assuming a peak rate of 10%, above many forecasts)
S&P 50/500 Index (Peak to Trough)	-80%	-56% (October 2008 - March 5, 2009)
Money Supply	-30%	+ 9.5% (Dec. 2007 through Dec. 200*)

We are in a recession, and recessions are more common than you might think. Twelve recessions occurred during the 20th Century, an extremely high rate of inflation and low economic growth happened in the early 1980's (remember "stagflation"), and other "panics" affected the stock market in recent memory (the "Asian contagion" of the late 1990's, 1987's unusual short-term (but dramatic) downturn, the 45% decline seen in U.S. stocks in 1973-74, and others). **We will face this economic crisis, we will innovate, and we will endure and rebound.**

KEY QUESTION NO. 3 - IS THE U.S. GOVERNMENT ACTING PROPERLY? We may not concur with every action the U.S. government has taken, but overall, we have been impressed by the relatively rapid and forceful response to the financial and economic crisis which has gripped our nation these last six months.

We certainly don't like all of the parts of the recently enacted stimulus package – some of the planned spending is not stimulative of the economy in the near term. The new Omnibus spending bill now working its way through Congress contains a lot of “pork.” And we believe Congress has too easily blamed many government agencies (who deserve some blame, especially on lax oversight), yet has failed to acknowledge its own role in not reforming the financial services regulatory structure (despite calls for years for hedge fund oversight and better mechanisms to detect systemic risk). Lobbyists with large wallets to stock Congressional campaign coffers still have far too much influence on Capitol Hill.

In some respects, we wish the government was even more aggressive, especially with regard to the banks. In large part, our large financial institutions were a big creator of the financial crisis, and we don't like seeing executives of banks being rewarded with million-dollar bonuses for making catastrophic decisions which led to the possible ending of their own company, much less for the effect on the overall economy. We wish the political will existed to fully take over one big bank at a time (though the FDIC, which has the authority to essentially force a bank into a very quick form of bankruptcy). Then the U.S. government might break it up into smaller pieces and sell it off. This would be costly, but we suspect it would be less costly than the current path of capital contributions and loan guarantees.

In fact, the debate on “bank nationalization” is borderline surreal. The U.S. government has already committed – between guarantees, investment, recapitalization, liquidity provision – about \$9 trillion of government financial resources to the financial system (and having already deployed \$2 trillion of this staggering \$9 trillion figure). Thus, the U.S. financial system is *de facto* nationalized, as the Fed has become the lender of first and only resort rather than the lender of last resort and the Treasury is the spender and guarantor of first and only resort. An additional necessary step of taking over the larger banks (through the FDIC liquidation process), breaking them up, and selling off the pieces (“re-privatizing” the banks, as was done with IndyMac) might be a better one in our view.

While it is easy to criticize, we also acknowledge that the problems of the banks are extraordinarily complex, and many of the solutions have never been undertaken before – certainly not to this level of scale. We are confident that some of the best and brightest minds have been put to work in the new Administration – regardless of party affiliation. And we like the fact that the top decision-makers, by and large, are experienced policy makers with academic backgrounds, and not just transplants from the very Wall Street firms which failed.

So the short answer is – **yes, we like (overall) the U.S. government's response** to this financial and economic crisis. While we may not agree with every action, we acknowledge that the broad-based response of the U.S. government is *necessary* and *appropriate*.

Moreover, similar government actions are being undertaken in Europe, the U.K., Japan, and even (with a different emphasis) in China. One of the many results of this economic crisis is the

increased coordination between governments worldwide – which should lead to even greater economic stability in the future.

KEY QUESTION NO. 4 – ARE WE BURYING THE U.S. IN DEBT? We sure are spending a lot of money, it seems. Yet, many of the Federal Reserve Bank and U.S. Treasury programs are not “spending” – but rather using cash to buy assets or invest in financial institutions. Over the long run, some of these asset purchases and investments will result in “write-offs” to the federal government (leading to real “spending” and adding to the national debt). But other asset purchases and stock investments will be “unwound” as the assets are sold off over time, and the U.S. government divests itself of (partial or full) ownership of financial institutions, and the U.S. will actually make a profit in these transactions. Hence, a lot of the “spending” is not really spending at all.

Yet, we are adding massively to the federal debt – in excess of \$2 trillion dollars over the next year, alone. The federal debt of \$11 trillion dollars at present is equivalent to almost \$36,000 for every U.S. citizen. Yes, this is a huge problem. And the actual federal debt – unfunded pension and health care benefits for government employees, and unfunded entitlement programs – is actually much greater, perhaps as much as five times greater.

Is this “solvable”? Yes. Voters might not like to hear it, but it will require both tax increases (modest, we hope, and certainly not now while the economy is in poor shape) as well as a decrease in benefits. Health care costs must be brought under control, and in future years you’ll begin to hear the words “rationing” of health care with increasing frequency. The solution is not an easy one – it will take decades to pay off the federal debt. And the solution will require a level of statesmanship and compromise in the halls of Congress not seen in decades. We don’t doubt that the solution to the federal debt problem exists – but we have some doubt over whether the political compromises necessary to reduce spending and modestly increase taxes will actually occur.

Another partial solution to reducing the federal debt – a good dose of inflation (which effectively reduces the value of long-term debt) – is likely to occur in the coming years as the U.S. government’s expenditures have increased so dramatically. It will be difficult to time the necessary decline in government spending correctly as the private-sector economy rebounds. Political decision-making will further complicate the correct pacing of reduced government spending. This is a balancing act, which will be very hard for the U.S. government to do correctly. We predict that inflation will return with a vengeance, at least for a time (we hope not, but we are not optimistic). Fortunately, policy makers do have a better understanding of how to combat inflation than government stewards did in the 1970’s.

It is right that radical government policies, including spending, tax cuts, and purchases of assets or equity stakes in financial institutions, must be undertaken right now. All of these promise to lower the probability of a depression and set the stage for economic recovery. Moreover, it must be recognized that some of the money spent will propel productivity in the future. This includes spending on key research in energy (including the much-needed transmission lines to carry wind and solar energy from the Great Plains and Southwest to urban areas), as well as spending on health care, modernization of medical records systems, and public infrastructure (roads, bridges, and the like). Not only will jobs be created by many of these projects, but they

will also likely spur on new industries, as well as lead to innovations which will foster further economic growth in future years.

KEY QUESTION NO. 5 - WHAT DOES THE FUTURE HOLD FOR THE STOCK

MARKET? What does all this mean for the stock market? Even the great Warren Buffet acknowledges that his own assessment of the economy “does not tell us whether the stock market will rise or fall.”

Yet our research reveals that the overall valuation level of the U.S. stock market is far below average levels of the past 30 years. In our opinion, U.S. stocks are now (as of Thursday, March 5th close) about 40% to 50% below normal valuation levels. To return to “normal” levels, an 80% to 100% increase in stock prices would have to occur.

Of course, such a return to “normal” won’t occur overnight. It could happen as quickly as the stock market decline (roughly, the last 15 months), or it could take several years or longer. But we do believe that – when investors see the “light at the end of the tunnel” – the large amounts of cash which has been accumulated in banks and under mattresses (and in money market funds worldwide) will flow into the stock market again.

Using Jan. 31, 2009 valuation levels, **we project average annualized returns for U.S. large company stocks of 12% over the next 15 years, and 16% for U.S. small company stocks** (assuming DFA stock funds are utilized, which have broad diversification and a great tilt toward “small” than many other funds and ETFs in the small cap area, and possess substantially lower internal transaction costs and possess relatively high securities lending revenue). Since stock prices have fallen further since January 31, 2009, when we have new data (in mid-March, for end-of-February valuation levels) we will likely see even greater long-term expected average annual returns for stocks.

Using a different methodology, we alternatively project a “dismal” future – one in which, 15 years from now, stocks have retreated further to valuation levels which are 15% to 35% lower than the valuation levels seen on 1/31/2009. And we assume U.S. economic growth, which usually averages 2.8% (on an inflation-adjusted basis), is cut roughly in half over the next 15 years. Using this methodology, which is ultra-conservative, we still forecast (using 1/31/2009 data) average annualized returns for U.S. large cap stocks of roughly 6%, and for small cap stocks of approximately 9%. Of course, stock market investing is not a “straight-line” affair – **there will be many peaks and troughs along the way. That is the nature of stock market investing, and why long-term investors are rewarded for this volatility by higher long-term returns.**

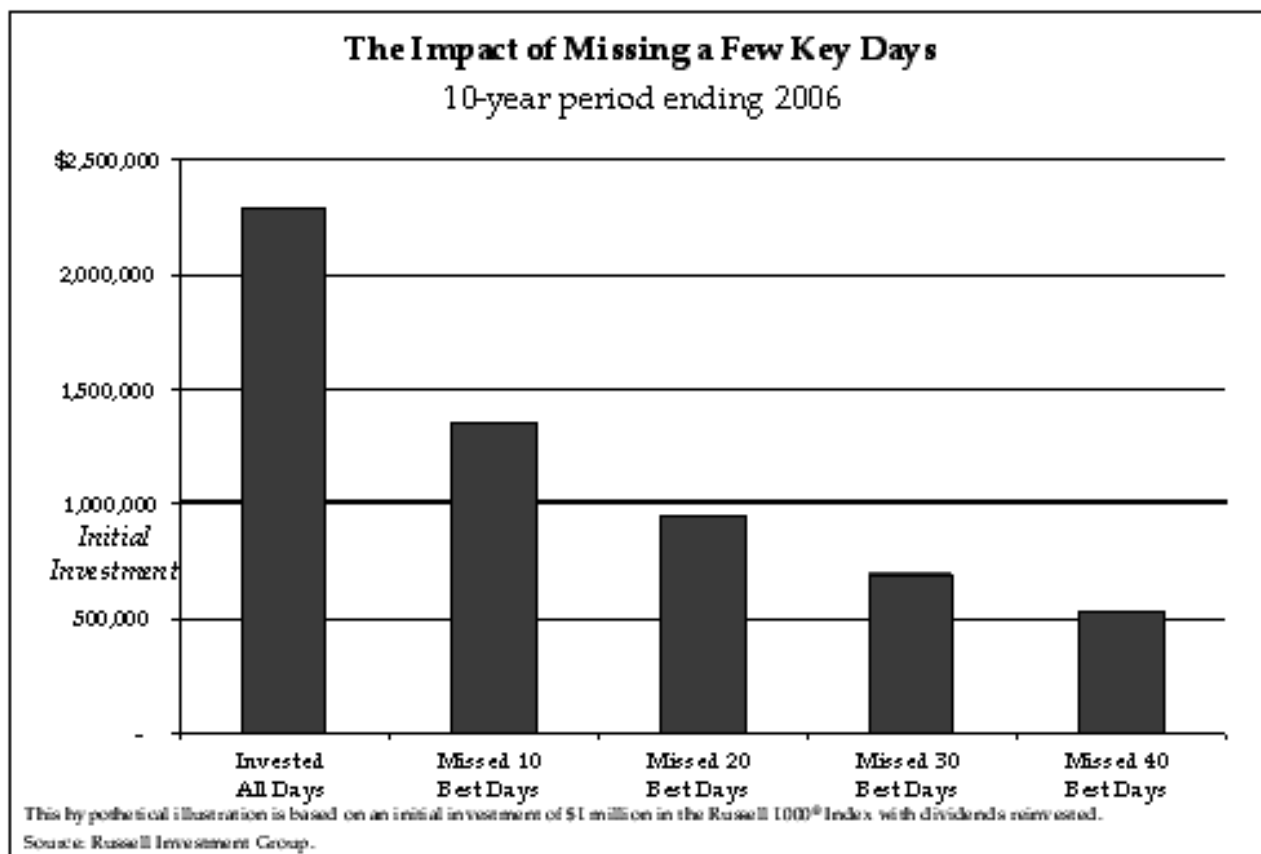
For those who say, “We don’t have 15 years to wait!” ... we do not mean to imply that a stock market recovery will take all of 15 years. It is highly likely to take just a few years. We tend to use 15-year projections because of the higher degree of certainty of longer-term stock market returns. Many downturns in the stock market were followed by very large percentage increases in stock prices over very short time periods.

One must remember that investors are not “rational” – they often follow the herd. And in February and early March, and in many of the past several months, investors have fled the stock market, even though it has gone “on sale” – of a type not seen before.

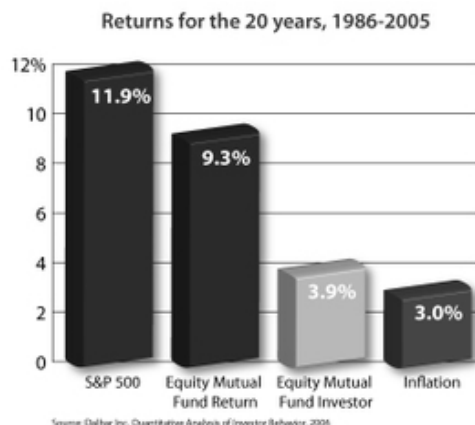
When stocks are on sale, be a buyer. When everyone likes stocks (i.e., they become overvalued), take some gains off the table. This disciplined approach has worked in the past, and it will work again now.

We recognize that it's tempting to say "I hear you, but I'm just going to get out of the market until things cool down, then I'll get back in when things look better." We'd like to do the same in our own portfolios. Unfortunately, that takes two correct guesses. Not just when to get out, but when to get back in.

One day, someone may successfully time the market, but to date, over the last 100 or so years, no one has yet done so. If you doubt me, I challenge you to name the 10 best market timers of all time. How about the 5 best? The one best? No one can name them - **because they don't exist**. The catch is, markets move back up just as quickly as they move down, so those attempting to market time will ultimately join the tens of thousands of other failed timers and end up selling low and buying high. Below is a chart I know you've seen before, but the lesson is still valid.

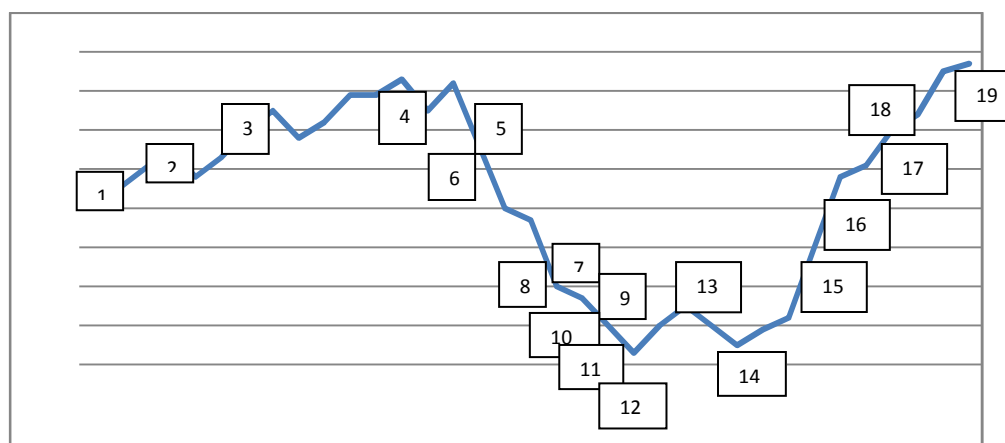


Each of our clients, and we, have agreed in the investment plan formulated, that **market timing does not work**. There are numerous examples in the past of the potential costs of being out of the market when the stock market does move up – which it will.



The chart at left illustrates that the average investor really pays the price for market timing. Taken from Dalbar's *Quantitative Analysis of Investor Behavior* research report, it demonstrates that The "Investor Behavior Penalty" of 8% is a result of investors' unsuccessful market timing. Rather than buying low and selling high (the theory), most individual investors in stock mutual funds over this time period bought high and sold low (the reality). Don't make this same mistake.

Finally, here's a chart that may help you remember how many investors, and the media, tends to react as we go through these economic cycles. This chart demonstrates why we make the investment mistakes that we do.



"Happy Trading..."

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| <ol style="list-style-type: none"> 1. Ah, the price is going up. Let's watch the market for a while. 2. The trend is holding – I'll buy at the next consolidation. 3. Damn! I missed the consolidation, but if I wait any longer, I won't profit from the trend. LET'S BUY!!! 4. Good think I didn't wait! 5. I'll use this correction to increase my position. 6. Brilliant! At this price, I'll double my position! 7. Ouch. As soon s the market goes back up, I'm selling out and cutting my losses. 8. I don't believe it's down this far. It must have hit absolute bottom! 9. OK, let's wait for the market to recover. Otherwise this will have to be a really loooooooooong-term investment. | <ol style="list-style-type: none"> 10. What is the SEC going to do about all this !?!?!? 11. Enough. I'M SELLING OUT! And staying out! 12. Good thing I sold everything! 13. It's going to tank again anyway. 14. See. I told you so. 15. You what??? 16. What the hell??? 17. More crazy investors ... they are going to get taken to the cleaners ... 18. This is it! I knew this was going to happen all along! 19. Drat it! I'll buy in again. |
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What do we believe? Pretty much the same thing that all of our more thoughtful friends, academics, and professionals around the country believe. Namely, that **we will eventually work our way out of this miserable recession, and that the only way to earn market returns over time is to be in the market.**

What stocks should you buy? *Nearly all of them.* When you invest in the Dimensional stock funds we often recommend to our clients, or a few select Vanguard index funds that might also be recommended, you invest in hundreds of companies. You own Exxon, Proctor & Gamble, General Electric, AT&T, Johnson & Johnson, Microsoft, Chevron, Wal-Mart, Pfizer, JP Morgan, IBM, Wells Fargo, and thousands of other companies. Will some of these companies go under in the coming years? Of course. But you should not lose sleep at night thinking that they will all go belly up.

Stock market investing takes discipline. It requires an investor to set aside emotions and to evaluate risk and return dispassionately. In essence, investors should think like “Mr. Spock” on the original *Star Trek* series – with logic, devoid of emotion, and with understanding that there is “reversion to the mean” over time (it happens EVERY time). **Buy low, sell high** ... simple words, but there is a great deal of truth in this simple phrase. Stated differently, the time to buy is when there is “blood in the street.” That’s now, by the way. Those who can take the pain of a bear market that seems to drop another 1% every day will ultimately triumph, by patiently amassing greater and greater equity positions at better and better prices. There can be no guarantees that we not see further declines in stocks in the near or long term; however, market history suggests that indeed the best investment opportunities are when the markets seem at their worst.

This does not mean that we cannot question *whether* to buy, in your specific situation. There may well have occurred changed circumstances in your life. Or you may now possess such a heightened awareness of risk (and higher level of risk intolerance), that further “buying low” may just be too much for you to handle. But a sound understanding of the safety found in your fixed income investments that remain, as we have specified for our clients who do need to withdraw from their investment portfolios, is a safe cache of money market and short-term bond funds that will handle at least five years’ of withdrawals, and for many clients much more. Moreover, understand that the “upside” potential for stocks is much, much greater than the downside potential, over the next five years – this understanding will go a long way. We look forward to discussing these issues with you, in our next conversations.

QUESTION NO. 6 - WHAT ABOUT BONDS? IS IT TIME TO BUY U.S. TREASURIES? We are now in a world in which “risk” is overpriced – no one wants to take on “risk” of any kind. And we are removed from the world of just two years ago when “risk” was greatly underpriced, and everyone ignored risk levels of all kinds.

Investors often confuse “certainty” with “safety.” Bond returns may be certain; historically, inflation erodes the real value of fixed income investments. It is poor consolation to get all of your money back in 10 to 20 years only to discover that the \$10,000 from your maturing bond barely gets you a Happy Meal at McDonald’s (admittedly an exaggeration, but you get my point).

Today, yields on corporate and municipal bonds remain at extraordinarily high levels, and prices on corporate debt are extremely low. This presents in our view a **good buying opportunity** (if done on a low-cost and diversified basis, through carefully selected bond funds).

At the same time, “risk-free” investments such as U.S. Treasury Notes yield very little – to near zero for short-term government debt. Rates on certificates of deposit are extraordinarily low. This is certainly not the time to invest in longer-term U.S. bonds or longer-term CDs. We note that in ten years, the “bubble” in the prices of U.S. Government debt will likely go down as one of the most dramatic bubbles in prices in U.S. history.

QUESTION NO. 7 – IS THERE SOMETHING WE CAN DO TO LIMIT THE DOWNSIDE

RISK? After the stock market is down, this is a common question we get asked. The reply is “yes” – it is possible to purchase options which protect against downside risk. But the cost of these options – especially when everyone else is looking to buy them – is extremely high. We don’t recommend that options be purchased, as they will likely substantially undermine the long-term returns of your investment portfolio.

If the stock market is substantially overvalued (note that the stock market was only modestly above normal values in October 2007), then the cost of purchasing options to cover downside risk is much lower (because investors have short memories, and are much less focused on risk during times when the stock market is going to excessive heights). When we get to the point of a large stock market overvaluation, we’ll be there to both point out that gains should be taken off the table – and that the purchase of options *at that time* might be appropriate as a hedge against further downside risk.

What makes this stock market downturn so unusual, compared to the 2000-2002 downturn and even the 1929 crash, is that the stock market did not start off in October 2007 as severely overvalued. Yes, it was moderately so – perhaps by 10% to 20% compared to normal levels over the past 30 years – but that is a condition which has often occurred.

There are no free lunches, and **if anyone really has “the answer” they wouldn’t waste their time trying to sell it to you.** They would simply follow their own advice and would soon own the free world. Then again, there is Madoff and Stanford ... investors were lured by their track records of solid returns (they had “the answer”), but those returns did not turn out to be so solid – in fact, they were empty air.

QUESTION NO. 8 – SHOULD I ADJUST WHAT I AM WITHDRAWING FROM MY

INVESTMENT PORTFOLIO? That’s a highly personalized question. Fortunately, for most of our clients, the answer is “no” – not at this time. But for a few clients an adjustment may be in order. This is something we can discuss with you during a personal one-on-one conference or telephone conference. We look forward to having this discussion with you.

We hope the foregoing has answered many of the questions you may be having. We invite you to call us or e-mail us with other question, or to schedule a private conference with your advisor.

For those who desire more detail about recent economic developments in the United States, as to events which have occurred over just the past two weeks (since our March 2009 Wealth Perspectives was issued), here's a summary:

Developments affecting the U.S. economy:

- Overall U.S. Economic Growth. Early reports indicate that the U.S. economy will likely contract in the 1st quarter of 2009 at an annualized rate at least equal to the 6.2% annualized rate seen in the 4th quarter of 2008. The contraction in the U.S. economy seen in the six-month period from October 2008 through the end of March 2009 will be the worst such period in the postwar era, beating out the fourth quarter of 1981 and second quarter of 1982. Yet, Goldman Sachs economists recently projected the U.S. economy to expand by 1% in the 2nd half of 2009, and by 2% in 2010. However, other economists believe the U.S. economy will continue to contract until very late in 2009 or early 2010.
- Banking. There is a growing realization that there isn't any magic bullet here that's going to save Citibank or Bank of America. Shares of Citibank fell below \$1 a share on March 5th – marking near the end of the line for a bank which was once (in May 2007) the United States' largest bank in terms of market capitalization (it now ranks about 148th). Using its FDIC powers, it appears inevitable to some economists and analysts that the U.S. government will have to take over these institutions, break them up, and sell away the pieces over time. Other large banks, such as J.P. Morgan Chase, Wells Fargo, and U.S. Bancorp, also possess low levels of capital. “Zombies on Life Support” is how one economist characterized many of the major U.S. financial institutions. Eric Rosengren, president of the Federal Reserve Bank of Boston, recently noted that “allowing poorly capitalized banks to continue operations with insufficient capital is likely to exacerbate problems with credit availability,” as poorly capitalized banks will not be willing to engage in loans that keep the economy growing.
- Autos. The U.S. auto industry is effectively being wiped out or nationalized, however you want to think about it. Sales of autos in February were the weakest since 1981. GM's auditor stated significant concerns about GM's prospects as a viable business entity.
- Business Investment. Businesses are cutting back drastically to survive the recession. Declining for a record sixth consecutive month, durable goods orders were led lower in January 2009 by significant declines in defense spending and computer & electronics orders. The key core gauge of non-defense capital goods, excluding aircraft, plummeted by 5.4% on top of a downwardly revised 5.8% drop in December 2008.
- Consumer Spending – A Bright Spot Ahead? Consumer spending, which makes up more than 2/3rds of U.S. gross domestic product, fell at a 4.3% annualized rate in the 4th quarter of 2008, the largest quarterly drop since 1980, according to the U.S. Commerce Department. Yet economists at Goldman Sachs believe that the worst is over for consumer spending, and they expect it to rise slowly commencing in the 2nd quarter of 2009. To the contrary, say other economists, noting that continued job losses will likely lead to continued losses in consumer confidence and weak consumer spending for months to come, and noting that the January 2009 modest rise in consumer spending was largely due to cost-of-living increases in paychecks for government workers and in the pension or social security checks of many retirees.

- U.S. Housing Market. The U.S. real estate market lost \$2.4 trillion in value in 2008, according to First American CoreLogic. The combined percentage of loans in foreclosure or at least one past due payment was 11.18%, the highest ever recorded by the Mortgage Bankers (which data goes back to 1972). The amount of loans actually in foreclosure was 3.3 %. More than 8.3 million U.S mortgage holders owed more on their loans in the 4th Quarter of 2008 than their property was worth, and an additional 2.2 million homeowners will be under water if home prices decline by just another 5 percent, according to FirstAmerican. Professor Norm Miller of the University of San Diego predicts that a third of all homeowners who see their home values fall 20% or more below what they owe will stop making payments and simply allow foreclosure to occur, a situation known as “rational default.” A key problem homebuilders have pointed to recently is that they are unable to compete with the flood of foreclosed homes hitting the market at fire sale prices – so even with housing affordability surging, efforts to stem foreclosures remain key to stabilizing the housing market.
- Unemployment. More than 650,000 Americans filed claims for jobless benefits in the last week of February 2009, marking a fifth straight week of jobless claims exceeding 600,000. Economists predict that the jobless rate is currently 8.1 %, and Goldman Sachs predicts unemployment of 10% by early 2010. About 5.1 million people are now “jobless.” Four million people have lost jobs since the U.S. recession began in December 2007. Many more are “underemployed” – working fewer than full-time hours (some voluntarily, to prevent layoffs of less senior workers) or working in jobs below their skill sets.

What is the U.S. government doing about the economy?

- U.S. Treasury Secretary Timothy Geithner and the U.S. Treasury Department:
 - On March 5th Mr. Geithner told Congress that the Administration will act to make sure the nation’s largest financial companies can get government help if needed to avoid collapse.
 - The Treasury Dept. laid out some details in late February 2009 of the Capital Assistance Program (CAP), designed to restore confidence throughout the financial system that the nation’s largest banking institutions have a sufficient capital cushion against larger than expected future losses, should they occur due to a more severe economic environment, and to support lending to creditworthy borrowers – through a program which has the following terms:
 - Capital provided under the CAP will be in the form of a preferred security that is convertible into common equity at a 10 % discount to the price prevailing prior to February 9th;
 - CAP securities will carry a 9 % dividend yield and would be convertible at the issuer’s option (subject to the approval of their regulator);
 - After 7 years, the security would automatically convert into common equity if not redeemed or converted before that date;

- The instrument is designed to give banks the incentive to replace U.S. government (USG) – provided capital with private capital or to redeem the USG capital when conditions permit;
 - With supervisory approval, banks will be able to request capital under the CAP in addition to their existing CPP preferred stock; and
 - Imposes limits on executive compensation, payment of stock dividends, stock repurchases, and cash acquisitions of other companies, while providing for monthly reports on how the capital is utilized and also providing that each institution supply a plan for how it intends to use the supplied capital.
- On March 5th Secretary Geithner informed Congress that about \$300 billion remains unspent and uncommitted in the \$700 billion Troubled Asset Relief Program (TARP) approved by Congress in October 2008; however, the Administration’s budget for the 2010 fiscal year (Oct. 1, 2009 – Sept. 30, 2010) indicates that another \$750 billion will be needed to undertake the rescue of financial institutions.
 - The Treasury Department announced on March 3rd that it will provide (commencing with the first disbursement of funds on March 25th) up to \$200 billion in financing to investors to support their purchases of asset-backed securities (debt backed by car loans, credit card loans, student loans, and SBA-guaranteed small business loans), under the Term Asset-Backed Securities Loan Facility (TALF), a component of the Consumer and Business Lending Initiative (CBLI) – some predict that this program will expand to become a \$1 trillion program within two years.
 - The Treasury Department recently said that details on a separate \$1 trillion program to remove distressed mortgage assets from banks’ balance sheets will be coming by mid-March.
 - On March 5th Secretary Geithner informed Congress that the Administration is looking at ways to expand the Term Asset-Backed Securities Loan Program, which provides loans to financial institutions in return for high-quality collateral, as a way of spurring lending by providing help to the second-loan market.
 - Secretary Geithner indicated that mortgage rates have come down, and that some commercial loan markets are starting to revive.
 - To assist the housing market, the Treasury Department launched two programs. The **Home Affordable Refinance** program will be available to 4 to 5 million homeowners who have a solid payment history on an existing mortgage owned by Fannie Mae or Freddie Mac, and this program will permit these homeowners to refinance their adjustable-rate mortgage, or higher-interest-rate fixed mortgages, to take advantage of today’s lower interest rates. The **Home Affordable Modification** program will help up to 3 to 4 million at-risk homeowners avoid foreclosure by reducing monthly mortgage payments. The Administration introduced this plan to use \$75 billion to entice lenders to modify or refinance home loans, as a means of stemming foreclosures. (We believe that Congress will need to pass the “cramdown” provision, permitting the principal amount of first mortgages on homes to be adjusted downward by bankruptcy courts, during a

Chapter 13 proceeding. This will likely make another modest impact in stemming the tide of foreclosures.)

- Federal Reserve Bank Chairman Ben Bernanke:
 - Chairman Bernanke stated to Congress, after the latest U.S. Government injection into insurance giant AIG raised the total government investment to \$170 billion: “AIG exploited a huge gap in the regulatory system. There was no oversight of the financial products division. This was a hedge fund, basically, that was attached to a large and stable insurance company, made huge numbers of irresponsible bets, took huge losses. There was no regulatory oversight because there was a gap in the system.” We agree, and we note that many of the big “investment banks” (Lehman Bros., Merrill Lynch, J.P. Morgan Chase, etc.) essentially operated the same way – borrowing short-term money at lower interest rates to invest in risky long-term debt backed by mortgages and other assets, with total disregard for the risks for both their companies and the U.S. economy.
- President Obama:
 - The President signed the \$787 billion stimulus bill, put together by Congress, which the Administration says will create or save 3.5 million jobs; yet economists believe the stimulus will not be felt at all during the first half of 2009 (this is typical for any fiscal or monetary stimulus).
 - President Obama stated that the U.S. Government will double stock purchases of Fannie Mae and Freddie Mac, in order to enable them to devote \$200 billion to expand the pool of available mortgages.

Recent economic developments in Europe:

- The 16-nation euro-region’s economy shrank at an annualized rate of 5.8% in the 4th quarter of 2008, and latest data suggest the recession is deepening. Manufacturing contracted at a record pace last month, and unemployment is climbing toward 10 %. The European Central Bank predicts that the euro-region economy will shrink about 2.7 % in 2009, and that economic growth will not return until the 2nd Quarter of 2010.
- Euro-region inflation is running at only 1.1%, and the European Central Bank expects inflation to remain “well below” 2% for 2009.
- On March 5, 2009, the European Central Bank cut interest rates to a record low of 1.5%, a reduction from the 4.25% rate seen in October 2008. Policy makers have indicated that another rate cut may come in May 2009, perhaps to 1.0%.
- Concerns exist over the banking system in Eastern Europe. Suggestions have emerged for the establishment of a program of bank re-capitalization (i.e., nationalization) similar to the efforts which have occurred elsewhere in the world.

Recent developments in the U.K.:

- Inflation in the UK declined to a 3.0% annualized rate in January 2009, and expectations exist that U.K. inflation will fall below 2% later this year.
- In the 4th quarter of 2008, the UK economy contracted at an annual rate of 6%.

- The Bank of England cut its key rate to 0.5%, a reduction from the 5% rate seen in October 2008. On March 5, 2009, the Bank of England said it will start buying U.K. government bonds to increase money supply, a policy known as quantitative easing; up to \$211 billion of purchases may be undertaken of both government and corporate bonds. The Bank of England has already begun buying commercial paper through its \$70 billion asset purchase facility.
- The UK government promised nearly \$440 billion for support of Royal Bank of Scotland Plc's investments. Lloyd's Banking Group Plc is also in talks on a government asset insurance program.

Recent economic developments in Japan:

- An unprecedented drop in exports in Japan has forced Japanese manufacturers to cut production at a record pace and fire thousands of workers.
- Small companies in Japan, which employ about 70 % of Japan's workforce, have said access to credit is the harshest it's been in at least 23 years, according to a new survey published by Skoko Chukin Bank in Feb. 2009.
- In the 4th quarter of 2008, the Japanese economy contracted at an annualized rate of 12%.
- Japan's central bank, the Bank of Japan:
 - started buying as much as \$30 billion of commercial paper in January;
 - in the first week of March it indicated it had commenced a program to purchase \$10 billion of corporate bonds held by financial institutions;
 - on March 5, 2009, said that it may need to expand its purchases of corporate debt to prevent a credit shortage from worsening the recession;
 - is also offering Japanese financial institutions unlimited loans in exchange for approved collateral;
 - in February 2009, announced it would buy as much as \$10 billion in the stock of financial institutions, to protect the capital of banking institutions; and
 - increased its purchases of government bonds to \$14 billion a month, as a tool to inject money into Japan's economy.

Recent economic developments in China:

- Banking analysts in China predict that the Chinese economy will grow by 8% in 2009, with fiscal stimulus from the Chinese government and local governments contributing 3.5% to that growth rate.
- Chinese exports are expected to decline 12% in 2009, the most abrupt contraction of exports since economic reforms in China began 30 years ago.
- Like other nations which were rich in revenues over the past several years (Saudi Arabia, UAE), China is now drawing upon its savings in order to stimulate its own economy and prevent social unrest, of the type that can result when thousands of factories shutter their doors.



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