

INVESTMENT BACKGROUND

January 2009

Positives

- Inflation is subdued
- Interest rates remain at low levels
- Non-financial companies are cash rich – can be used for dividend increases, share repurchases, M&A, capital spending
- Liquidity – huge pools of investable funds – highest in 20 years
- Foreign interest in buying U.S. assets
- U.S. Dollar has stabilized
- Commodity and energy prices have plunged

Negatives

ECONOMIC

- Global recession
- Unemployment rising
- U.S. consumer under pressure. Retail sales slowing and more credit/solvency issues
- Housing prices still declining
- Debt bubble—government and consumer
- Low U.S. savings rate-greater thrift and savings would hurt consumer spending
- Legacy costs—pensions, social security, healthcare
- Increasing number of large corporate bankruptcies
- Investor uncertainty and mistrust of the financial system, markets, and companies

GOVERNMENT FISCAL POLICY

- Low tax on capital gains and dividends for now
- Massive economic stimulus package-credit flow has started to improve
- Infrastructure projects provide long-term benefits
- Enormous federal and state budget deficits
- Protectionist/populist economic policy moves by Congress
- Post-election probability of tax increases
- Government embracing socialists principles

MONETARY POLICY

- High liquidity provided by Government bailout programs
- Federal Reserve actions to reduce short-term interest rates including mortgages
- Lending standards are being tightened
- Current Federal Reserve ease could eventually lead to rising inflation

VALUATION

- Yield of stocks vs. 10-yr Treasury bonds
- Stock valuation measures are reasonable
- Low absolute yields
- Projected earnings are very uncertain
- Write downs continue

(over)

Positives

Negatives

TECHNICAL

- Diminished downside breadth
- Sentiment – record levels of investor bearishness
- Stock market typically leads the economy out of recession
- Mean reversion indicators-long stock market declines have eventually led to strong rebounds
- S&P 500-largest one-year decline since 1937
- Market trend indicators – neutral at best
- Weakness in the financial sector
- Few breakouts through resistance levels

GENERAL

- Stocks reasonably valued versus high grade bonds
- Hard dollar returns intact
- U.S. consumer addiction to debt-deleveraging takes time
- Banking/subprime crisis not resolved
- Proliferation of quick twitch investors—hedge funds, program trading, and derivatives
- Terrorism, military conflicts
- Crisis in municipal finance
- Pessimism feeds on itself

CATALYSTS FOR CHANGE

What could make us more bullish:

- Business friendly legislation from Washington
- Pull out from Iraq and Afghanistan
- Financial sector stability
- Corporations boost pace of hiring, capital spending, stock buybacks
- Inflation remains subdued
- Energy costs stay low
- Tax reduction
- Success of Federal Reserve/Government Policy
- Merger activity picks up

Key downside risks:

- Recession/1930 style depression
- Housing prices continue to fall
- Higher inflation and long interest rates
- Financial accident/crisis—hedge funds, derivatives, subprime lending/higher consumer default rates
- Oil prices increase significantly
- Dollar collapse—foreign liquidation of U.S. debt, foreign investors stop lending to U.S.
- International crisis—North Korea, Iran, a major terrorism event
- Unemployment rate accelerates

SUMMARY

2008 was an equal opportunity bear market. Everybody and everything except gold and U.S. Treasury securities got killed. History teaches that the greatest buying opportunities often arrive in periods of extreme stress and pessimism. At some point, stock prices and valuations become so attractive that investors should be aggressive buyers. While there is no way to know where the market will be in the short term, many conditions are in place for better performance.

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