

Second Quarter 2009

Equity Markets

In the 2nd quarter of 2009, the U.S. equity markets continued the rebound that started in mid-March. Stocks jumped in April and May before settling flat in June. For the full quarter, the large cap market, as represented by the Russell 1000 index, increased 17%, while the Russell 2000 small cap index rose 21%. Equities generated a positive return for the first time since the 3rd quarter of 2007 and posted the best quarterly return in over ten years. After posting a steep decline over the last 18 months, the S&P 500 has rallied 35% from its March 9th low and has now gained 2% year-to-date.

Investors responded to indications that the economy and financial system were beginning to stabilize. The "green shoots" that Federal Reserve Chairman Ben Bernanke referred to at the end of the 1st quarter started to take hold as certain credit markets thawed. Many banks that appeared at risk of being nationalized only months earlier were able to raise substantial additional capital. Following government stress tests, the largest banks raised more than \$75 billion in capital that will serve as a cushion against future losses and provide additional lending capacity. By the end of the quarter, the federal government had given ten banks the go-ahead to repay TARP funds after these banks raised capital and demonstrated an ability to issue debt without FDIC guarantees.

As the financial crisis eased, investors regained some of their appetite for risk. International stocks, as measured by the MSCI EAFE index, rose 24%. Emerging market stocks gained 34%. Risk aversion eased in the bond market as well. Corporations, particularly investment grade ones, issued record amounts of debt to take advantage of increasing investor demand. Credit spreads over Treasury rates tightened across the board. After maxing out at over 17% in late 2008, high yield credit spreads dropped below 10% during the 2nd quarter resulting in a 20% gain for the high yield bond market. Investors funded these purchases in part by selling U.S. Treasuries that had been hoarded during the worst of the credit crisis. Within the domestic equity market, investors embraced sectors that had been shunned previously. Financial stocks in the broader market were up approximately 35% while previously outperforming defensive sectors such as utilities and consumer staples were up less than 10%.

Despite signs of improvement, the economy and financial markets face continued threats. Loan losses, particularly in commercial real estate, imperil many banks. Higher commodity prices and interest rates threaten consumer spending. Crude oil gained over 40% during the quarter, its biggest jump in almost 20 years. Despite federal programs intended to keep interest rates low, the 10 year Treasury yield, which is the basis for many mortgage and consumer loan rates, increased to 3.5% from 2.7% during the quarter. Partly as a result of these factors, consumer confidence dropped in June after rising in April and May. Inflation also remains a risk due to significant fiscal and monetary stimulus. However, with unemployment at 9.5% and manufacturers operating at only 65% of capacity, near-term inflation remains muted. Consumer prices for the twelve months ending in May fell 1.3%, the most since 1950.

Fixed Income Markets

After a few understandably sleepless nights over the past six months, it appears that Federal Reserve Chairman Ben Bernanke tuned into an infomercial by the late TV pitchman Billy Mays as the

financial markets received a good dowsing of OxiClean this past quarter. The plethora of Federal Reserve and Treasury programs designed to stabilize the markets seemed to take root and appease market participants. Credit spreads tightened significantly and the equity markets moved into positive territory for the year after being down over 30% at one point in March. After a modest start to the year, the spread sectors put in an impressive performance leading the Barclays Aggregate index to outperform similar duration Treasuries by 3.65%. With spread sectors rallying and Treasuries selling off, the Barclays Aggregate returned 1.78% for the quarter and is now up 1.90% year to date. The sectors that contributed the most to the index's outperformance during the quarter were Commercial Mortgage-Backed Securities (CMBS) and Credit, posting 14.48% and 11.87% in excess returns, respectively. Asset-Backed Securities (ABS) continued to recover from their 2008 drubbing to post 8.75% of excess return for the quarter, followed by Agencies at 1.32%, and finally Mortgage-Backed Securities (MBS) with 1.23%. A significant contributor to the CMBS sector's performance was the Federal Reserve's announcement that legacy CMBS would be included in future Term Asset-Backed Securities Loan Facility (TALF) fundings starting in July. TALF, which got off to a slow start, appeared to gain traction as the number of loan requests grew from an initial \$4.7 billion to \$11.4 billion. As investors began to move money from riskless (Standard & Poor's may disagree with this adjective!) Treasuries into risky assets, the door for raising debt and equity swung wide-open, and it seemed that door passes were limitless after months of anemic supply. Even high yield credits were allowed to join the party. With the ability to raise capital in the open market, many financial institutions that danced with the Government in the Fall of 2008 found less onerous partners this spring, leading them to return the Government's funds.

Despite these positive actions, the financial markets remain heavily dependant on the United States Government for support and a few more rounds of OxiClean may be needed to finally put this crisis behind us. Despite the exceptionally strong excess returns for the quarter, Credit, CMBS, ABS, and the Aggregate all still lag Treasuries over the past 12 months. No amount of sector spread tightening can compensate for capital lost to downgrades and defaults; only sectors with strong quality and good structure get the full benefit of spread tightening. While A-rated corporate debt may tighten, Lehman bond holders will never benefit. And, once AAA-rated subprime debt now downgraded to junk will never trade like AAA-rated debt again. The quarter saw the Government orchestrated bankruptcies of two venerable auto companies and unemployment is expected to reach 10% during 2009. In spite of the Federal Reserve purchasing nearly \$600 billion in Agency MBS, the current 30-year mortgage rate has risen more than 0.50%, denting hopes that a huge refinance wave would swiftly revive the housing market. And while inflation has been held in check so far, expectations for higher inflation have started to take root. The Federal Reserve's very actions may be counterproductive: if investors see the Federal Reserve monetizing the debt it buys, rather than driving yields lower, market participants may drive yields higher.

Combining the good and the bad of the quarter leaves a number of questions regarding the second half of the year. Can spreads continue to tighten without economic improvement? Can trillion dollar markets be controlled by the world's largest balance sheet? Will all the programs put in place provide sufficient support to the housing market to end the price declines? While these questions remain unanswered at this time, the Government has shown that it is willing to expand those programs deemed successful and reevaluate those that have not worked in their current form, indicating that it will likely remain a significant player in the financial markets for some time. At **EARNEST Partners** we continue to manage high quality portfolios built to withstand a wide variety of market conditions and we remain well positioned to deliver results for our clients with or without the Government's involvement. However, that is not the case for all market participants, so when it comes to more OxiClean for the markets, we think the late King of Pop would tell Mr. Bernanke, "Don't stop 'til you get enough."