



GRAY & COMPANY

# **CAPITAL MARKET REVIEW**

**Third Quarter 2008**

# CAPITAL MARKET REVIEW

## The Headlines from the Wall Street Journal

**Monday, Sept 8, 2008: "U.S. Seizes Mortgage Giants"**

**Monday, Sept 15, 2008: "Crisis on Wall Street as Lehman Totters, Merrill Is Sold, AIG Seeks to Raise Cash"**

**Wednesday, Sep 17, 2008: "U.S. to Take Over AIG in \$85 Billion Bailout; Central Banks Inject Cash as Credit Dries Up"**

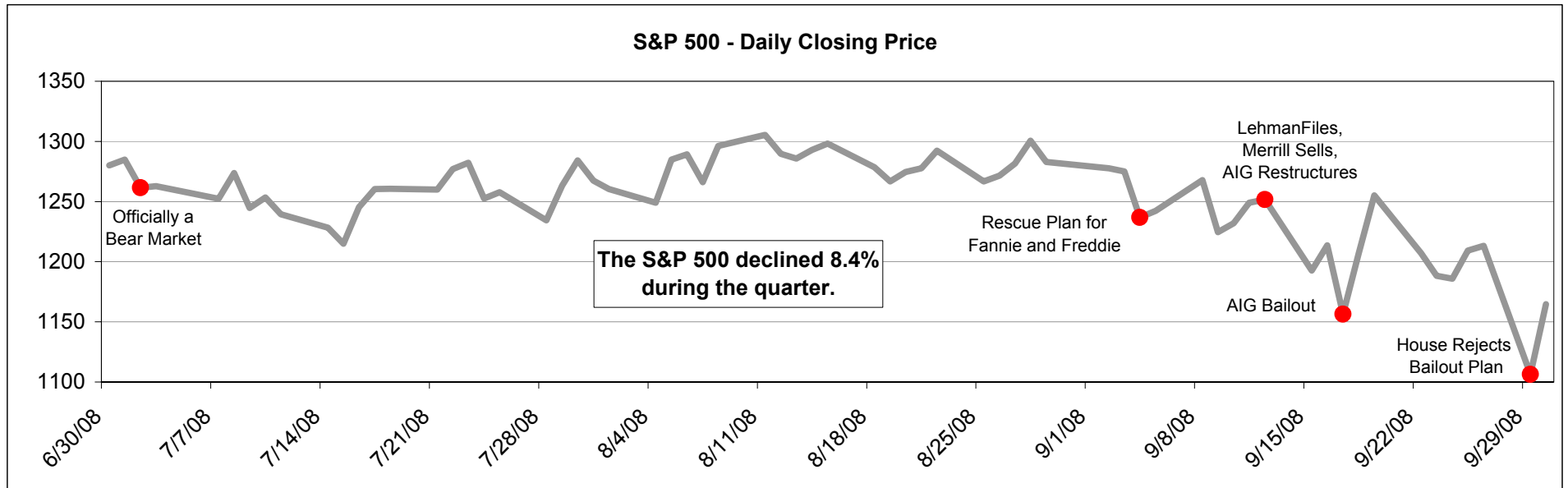
**The Rest of the Story:** The global credit crisis struck hard and often this quarter. The fear of an economic depression created an unprecedented flight to quality, disrupting the commercial paper market and causing several money market funds to "break the buck."

The search for new capital to help strengthen balance sheets is becoming more difficult; previous outside investors have experienced significant losses and new investors are wary of investing in the falling market. In September,

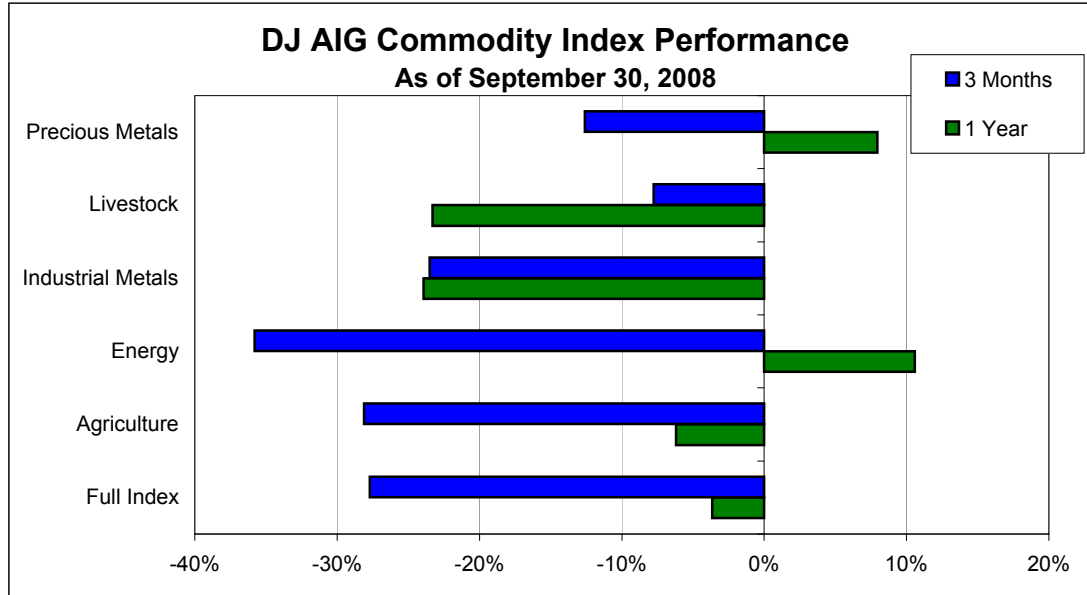
two of the oldest brokerage firms on Wall Street (Lehman Brothers and Merrill Lynch) were unable to raise additional capital; one filed for bankruptcy and the other sold itself to Bank of America.

The U.S. Government has intervened to help stabilize the markets. They seized control of the quasi-governmental mortgage agencies Fannie Mae and Freddie Mac, permitted Lehman Brothers to file for bankruptcy, structured a bailout plan for AIG, and pressed Congress for a \$700 Billion Economic Stabilization package. (Mr. Paulson and Mr. Bernanke have been very busy.) The Government has stepped in to be the lender of last resort at the American taxpayer's expense.

The financial landscape has changed. The U.S. is undergoing a historic period of deleveraging with far-reaching implications. Lets hope we have learned an important lesson that we do not soon forget.



# CAPITAL MARKET REVIEW

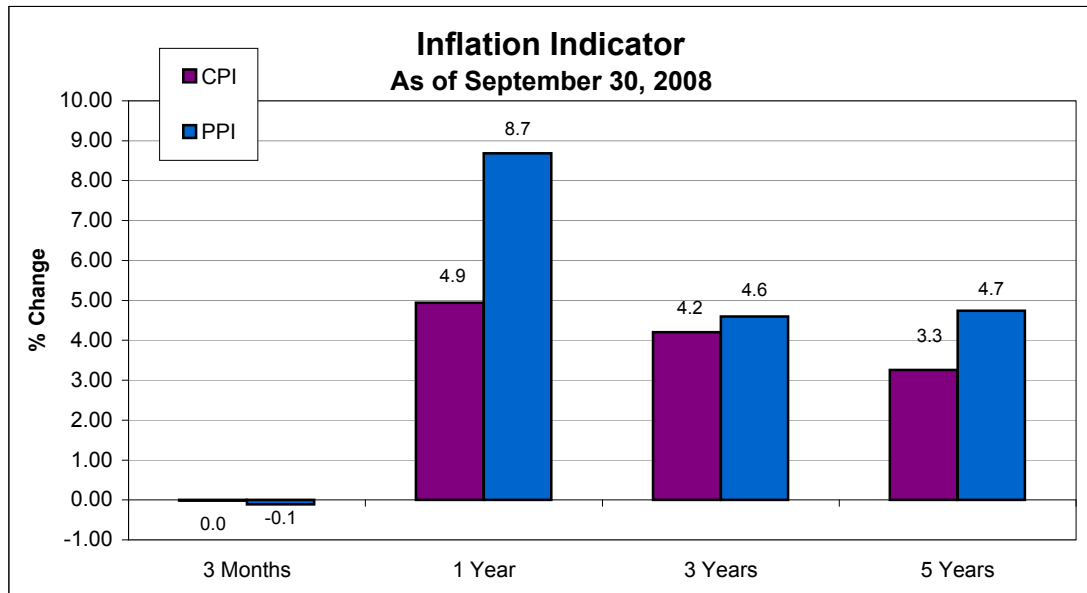


**Easy Come, Easy Go:** The long bull market for commodities came to a crashing end. Commodities, as a category, declined by 28% during the quarter, its worst quarterly performance since the inception of the commodity indexes (1970).

The downturn is attributed to the weakening demand for raw materials by developing nations as global economy slowed. The commodity market was further hindered by the credit crisis and associated lack of liquidity. It is estimated that investments tracking two of the major commodity indexes declined from \$240 billion to \$150 billion during the quarter.

Energy was the biggest loser for the quarter, falling over 35% as the price of oil fell from \$145 a barrel to \$100 a barrel. The other commodities also suffered significant losses. Even with the third quarter losses, Energy continues to be the best sector over the past year, and one of only two with positive performance.

Inflationary risk seems to have disappeared. Lower commodity prices and slowing economic growth in the U.S. and around the globe has eased inflationary pressure. The CPI was flat for the quarter and the PPI was marginally negative.



Source: Bureau of Labor Statistics

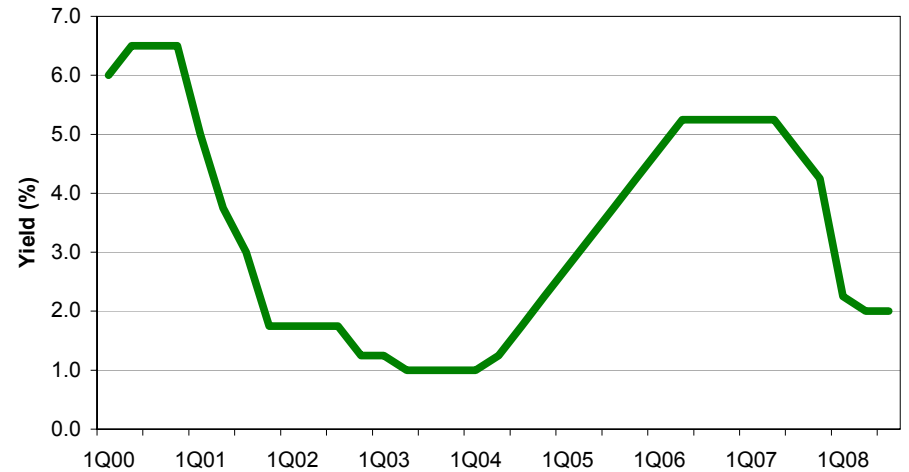
# CAPITAL MARKET REVIEW

**Treasury/Fed to the Rescue:** Batman (played by Henry Paulson) and Robin (played by Ben Bernanke) focused their attention on saving the universe this quarter. The financial crisis that started with the U.S. housing market has spread across the global capital markets. The dynamic duo is responsible rescuing the financially weak (sorry Lehman) and creating the stabilization package. Our heroes are attempting to stabilize the credit markets and avoid a deep, prolonged recession.

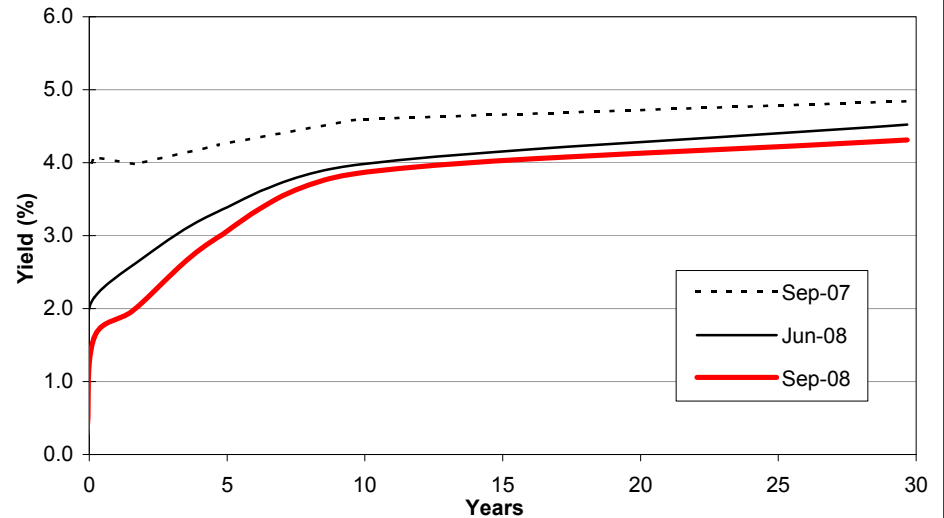
The Federal Reserve left the Fed Funds Rate unchanged during the quarter. However, the market's sentiment has changed, having shifted from the fear of higher inflation to economic depression by quarter end. Investors are expecting lower rates from the Fed in the future to help spur the economy.

Investors sold stocks, bonds, and money markets funds to purchase Treasuries in an unprecedented flight to safety. The impact drove the yield curve downward, particularly at the short-end. At quarter-end, the 3-Month T-Bill was yielding just 0.29% (on June 30th it was 1.73%).

### Historical Fed Funds Rate



### Yield Curve



# CAPITAL MARKET REVIEW

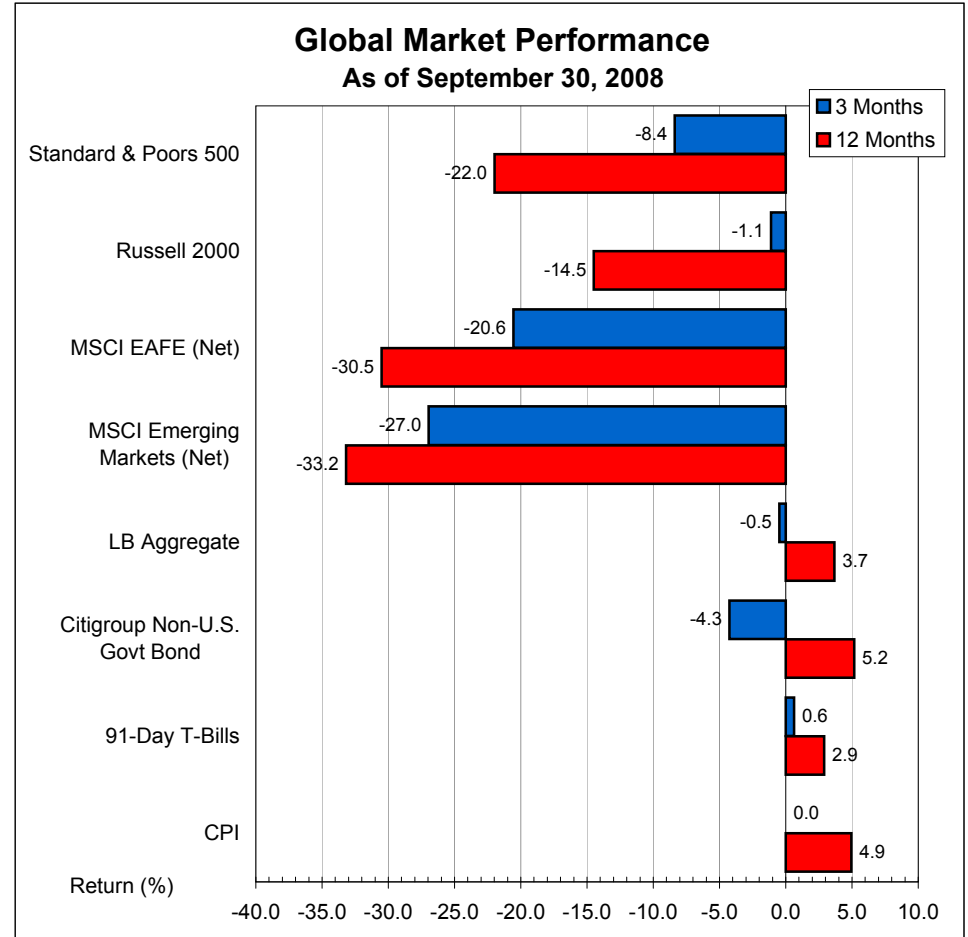
**Global Credit Crunch - Ouch!** September proved to be the turning point in the markets. With daily headlines of financial disaster in the banking industry and other industries, investors sought the safety of Government-backed bonds at the expense of virtually every other asset class.

The equity collapse was world-wide with the markets falling around the globe. On days that the U.S. stock market experienced significant losses, the Asian and European equity markets would decline on the next trading day by a similar magnitude. The correlation between the global equity markets approaches one during the most difficult periods.

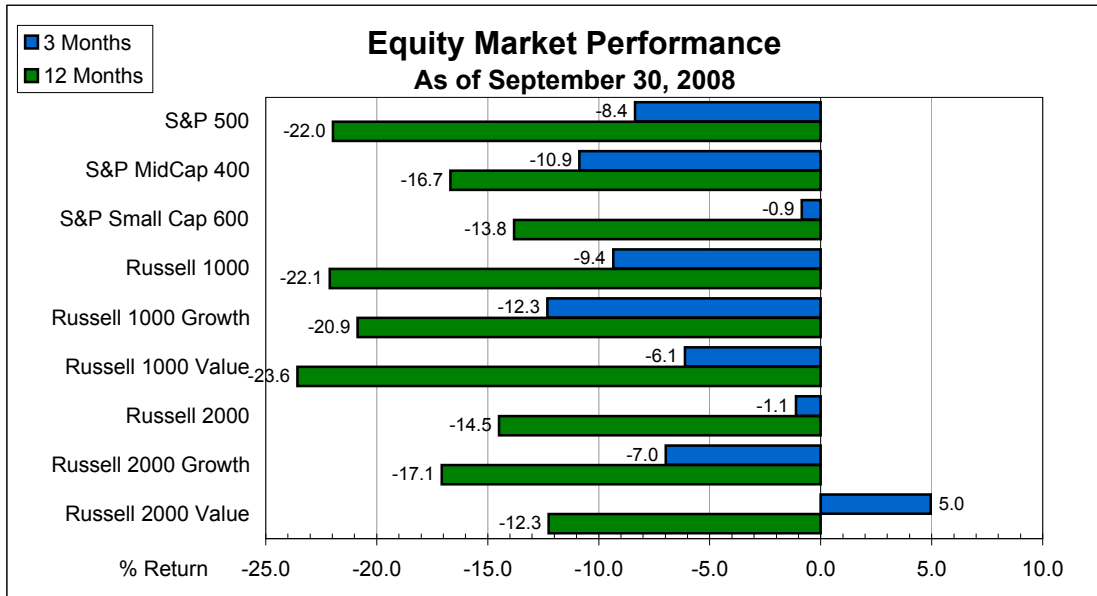
Fixed income markets offered both positive and negative returns. Government bonds rallied strongly as investors sought their safety. Corporate bonds traded lower with few buyers. The market for many securities become illiquidity, creating significant pricing declines and forcing several money market funds to "break the buck."

Central banks have reversed their position once again. Stabilizing the financial markets and spurring economic growth have replaced inflationary pressures as their primary concern. The markets are anticipating additional rate cuts before the end of the year.

The dollar stretched its winning streak to two consecutive quarters over the Euro, further hindering returns for U.S. investors. The dollar also appreciated against most other currencies during the quarter.



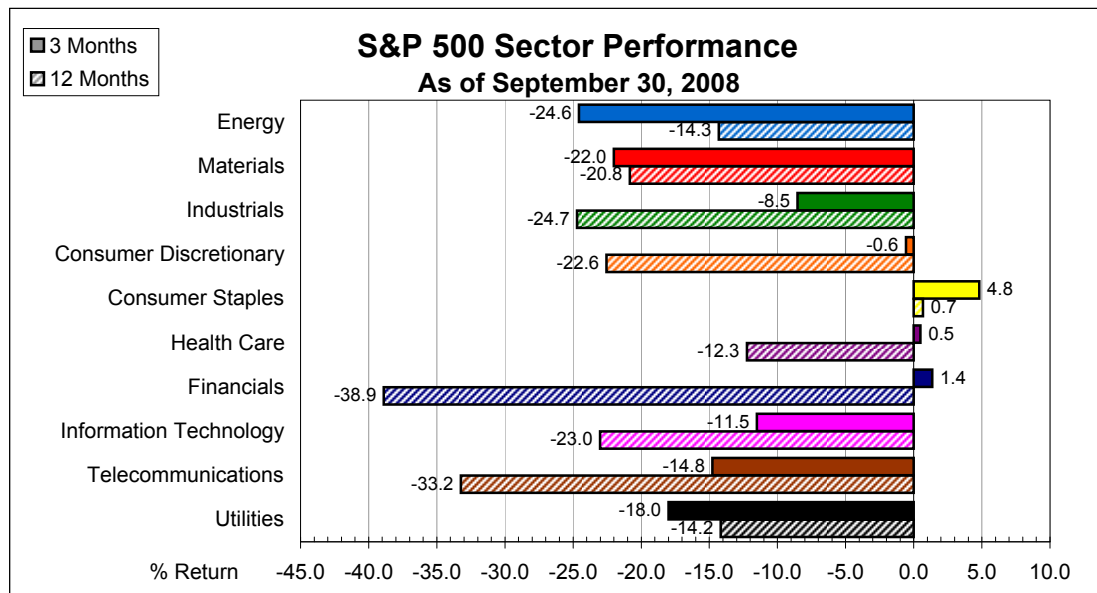
# U.S. EQUITY MARKET



**Bear Market (and Then Some):** The equity markets technically entered into bear market territory in July, falling by more than 20% from previous highs. In September, the escalating financial crisis generated another round of selling, driving stocks down significantly.

Small Cap stocks survived the best, with only minor losses for the quarter (Small Cap Value was the only positive style). Large Cap stocks dropped 8.4% this quarter, and Mid Cap stocks were the weakest, falling 10.9%. Value outperformed growth across all capitalization ranges this quarter, reversing last quarter's trend.

Surprisingly, Financials were positive this quarter and trailed only Consumer Staples, the top performing sector (for the quarter and the year). Energy and Materials suffered sharp declines as commodity prices fell, particularly oil. The growth sectors (Tech and Telecomm) also experienced double digit losses this quarter.



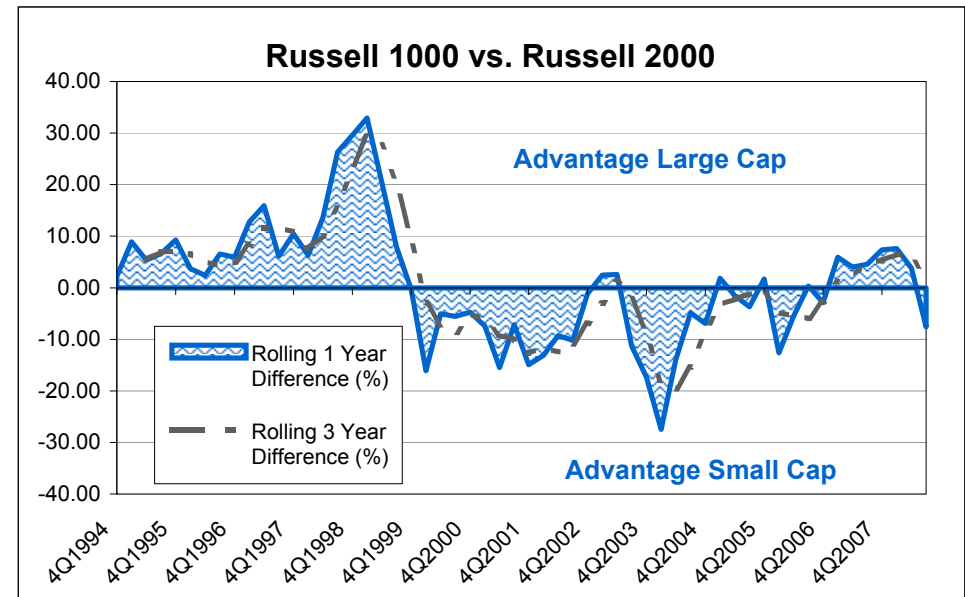
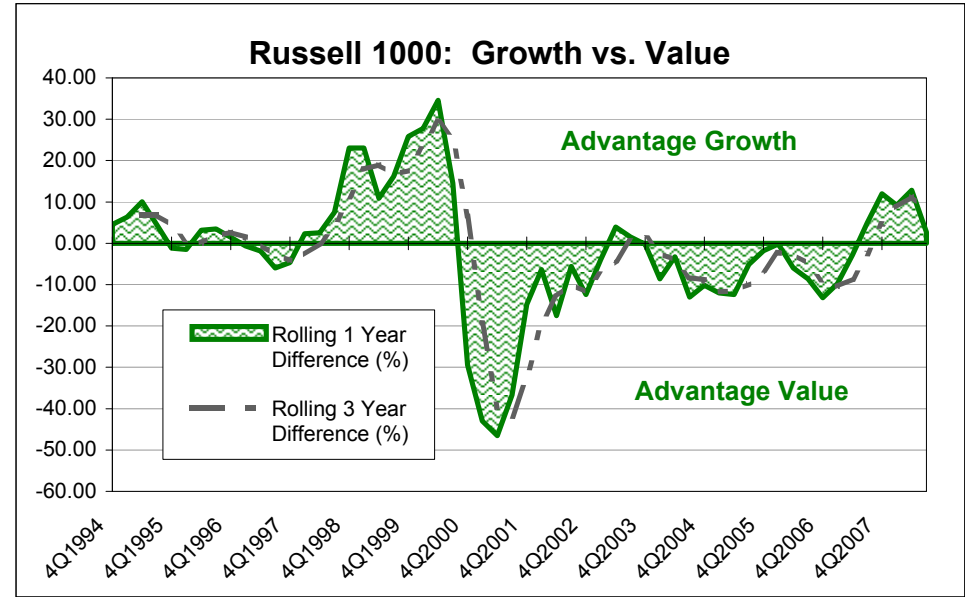
# U.S. EQUITY MARKET

**Who Cares?:** With the market collapse occurring in the final month of the quarter, both Growth and Value stocks are down more than 20% in the past year. Growth's one-year performance edge over Value declined this quarter, as Financials were the best performing sector.

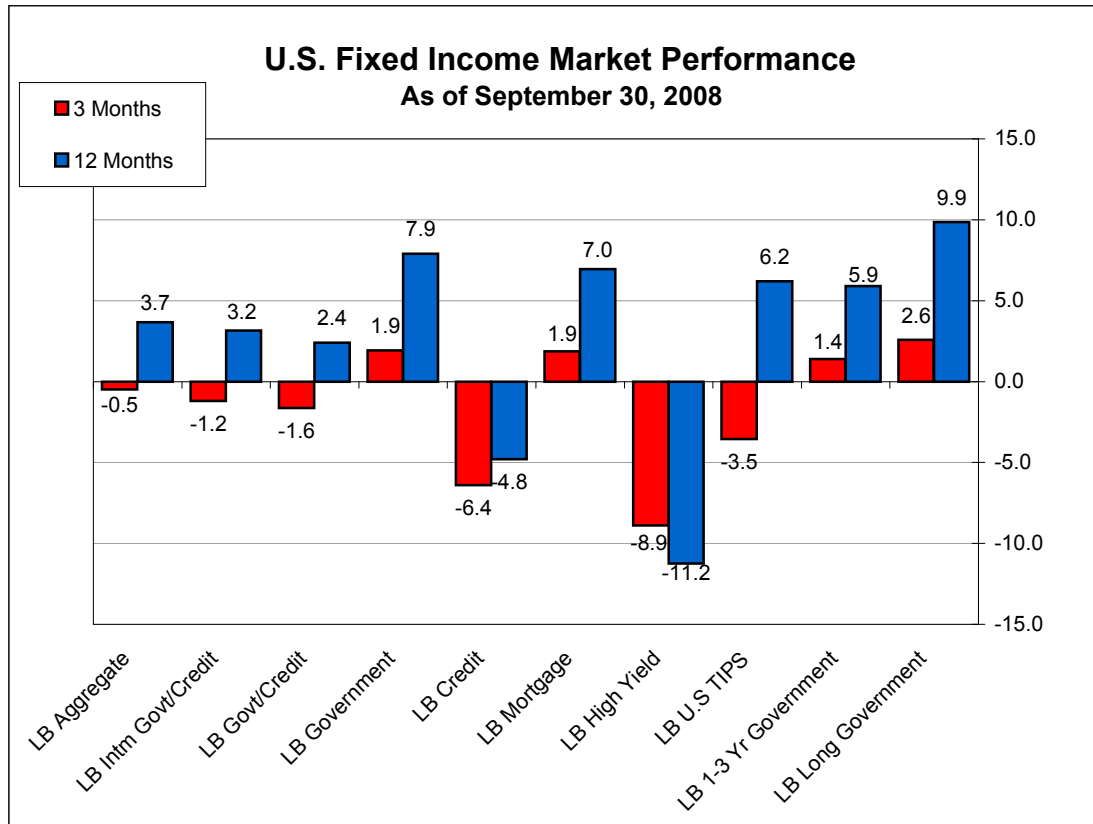
Interestingly, the style and capitalization shifts appear to be related. Value's out performance this quarter was mirrored by small cap's advantage. Small cap's rolling one-year return exceeded large cap for the first time in six quarters. In prior periods, runs in value have been accompanied by the out performance of small cap equities. Growth equities and large cap equities have also experienced periods of out performance to their style/capitalization counterparts. These style and capitalization cycles are linked to the economic cycle. The different stages of the economic cycle produce favorable conditions for different sectors of the equity market.

The economic cycle appears to be entering the slowing/recessionary stage (favoring Health Care and Consumer Staples). As the economy recovers (early-recovery stage) the Industrials and Materials sectors will tend to out perform. The late-recovery stage (favoring Technology and Telecommunications) never gathered much momentum this past cycle. Energy and Financials are being influenced by factors independent of the current economic cycle.

The volatility theme of the past year accelerated this quarter. Volatility is measured as a percentage of days during which the S&P 500 Index rises or falls by more than 1%. This increase in volatility tends to favor active trading strategies.



# U.S. FIXED INCOME MARKET



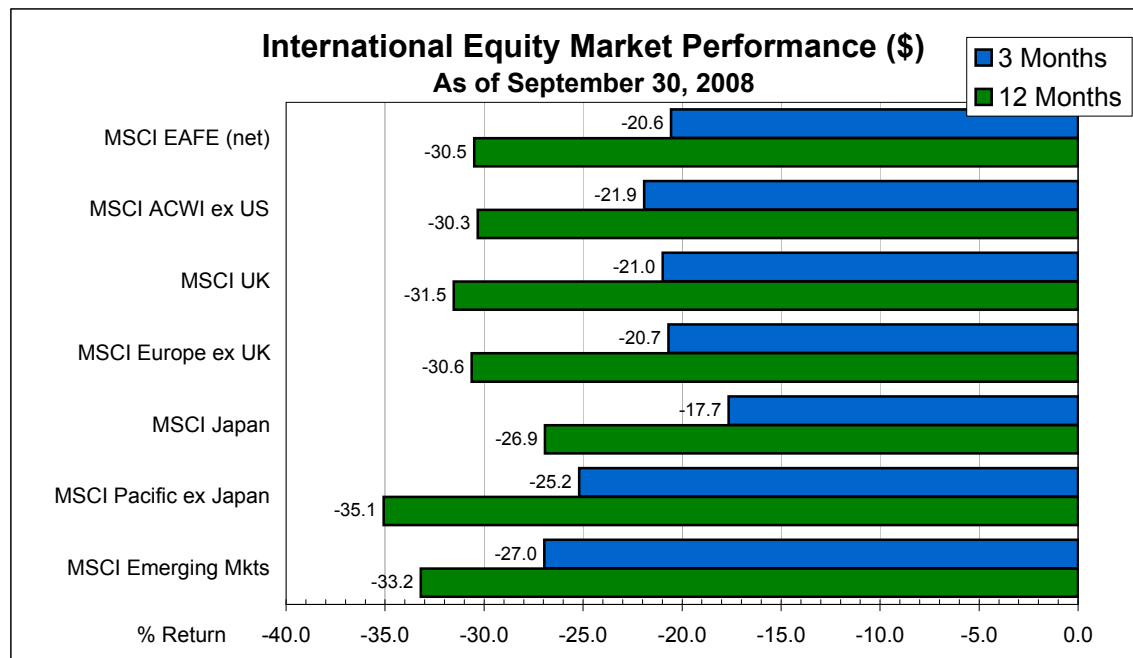
**Liquidity Crisis:** The credit markets froze up during the quarter, as the financial crisis worsened and the global economy slowed. Investors sought the safety of Government-backed securities at any price. The unprecedented flight to quality shifted the yield curve lower, reversing last quarter's upward movement.

As would be expected, traditional Government issues were the best performing segment in the fixed income market. Mortgages also performed well, due to the explicit guarantee by the U.S. Government after their seizure of mortgage agency assets. U.S. TIPS under performed as inflation expectations fell.

Investors sold off corporate securities across the quality and maturity spectrum (including the commercial paper market). Spreads widened considerably during the quarter, pricing in additional risks. Investment grade corporate bonds (LB Credit) suffered its worst quarterly loss in over 25 years. High Yield also experienced large losses.

The fixed income market continues to face several related problems: 1) the continued deterioration of the housing market and the underlying collateral for mortgage backed securities, 2) the impact of sub-prime exposure on many financial institutions and the associated damage, 3) the lack of liquidity within the market due to the fear of mis-pricing securities, 4) the lack of financing available to borrowers due to perceived counterparty risks, and 5) the slowing economy and its impact on individuals and corporations. The Treasury and Federal Reserve are working hard to restore confidence in the market. However, their actions have yet to stabilize the housing market or improve the economic environment.

# INTERNATIONAL EQUITY MARKET



## MSCI Country Indexes (Net) Three Months Ending September 30, 2008

|                       | Return<br>US\$ (%) | Return<br>Local<br>Currency (%) | Currency<br>Effect (%) |
|-----------------------|--------------------|---------------------------------|------------------------|
| France                | -18.9              | -9.1                            | -9.9                   |
| Germany               | -20.6              | -10.9                           | -9.7                   |
| Italy                 | -22.2              | -12.7                           | -9.5                   |
| Spain                 | -17.2              | -7.1                            | -10.1                  |
| Switzerland           | -13.2              | -8.3                            | -5.0                   |
| UK                    | -21.0              | -11.8                           | -9.2                   |
| <b>Europe Total</b>   | <b>-20.8</b>       | <b>-11.3</b>                    | <b>-9.5</b>            |
| Australia             | -26.6              | -10.7                           | -15.9                  |
| Hong Kong             | -22.9              | -23.3                           | 0.3                    |
| Japan                 | -17.7              | -17.5                           | -0.1                   |
| <b>Pacific Total</b>  | <b>-20.1</b>       | <b>-16.6</b>                    | <b>-3.5</b>            |
| China                 | -25.2              | -25.5                           | 0.3                    |
| India                 | -13.9              | -6.1                            | -7.9                   |
| Brazil                | -37.9              | -24.7                           | -13.2                  |
| Mexico                | -18.7              | -13.3                           | -5.4                   |
| <b>Emerging Total</b> | <b>-27.0</b>       | <b>-20.9</b>                    | <b>-6.1</b>            |

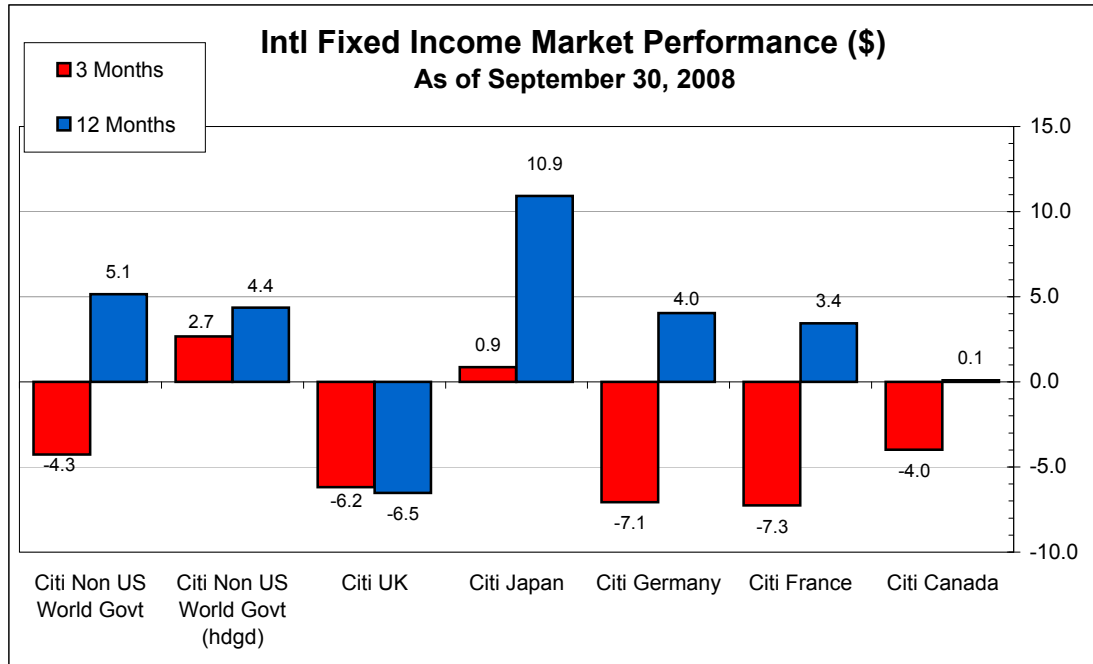
**No Where To Run To, No Place To Hide:** The common theme in all equity markets was the expanding impact of the credit crisis and the slowing global economy. The international equity markets mirrored the U.S. markets, with September being especially painful. Double digit losses were the norm, in local terms, as investors sold off stocks around the world. Compounding losses for U.S. investors was the strengthening of the dollar against most currencies during the quarter.

The United Kingdom's situation most closely resembles the U.S. with declining home values, banking issues, and a slowing economy; the equity markets lost 11.8% in local terms. Continental Europe's housing market is holding up better (the market did not fully participate in the boom). However, banks are failing due to high leverage ratios, and economies are approaching recessionary status. Most European equity markets lost 10% or more in local terms. Expectations are for significant intervention by local governments and central banks to help stabilize the banking industry and spur economic growth.

Japan is also reeling from the effects of slowing global growth - domestic demand and export growth are falling and unemployment is rising. Due to the low interest rate environment, the Bank of Japan has limited capacity to intercede in the markets.

In quarters past, emerging countries with natural resources to export have out performed the general market due to rising commodity prices. This quarter, nothing was spared; two previously strong export-oriented performers, Brazil and Russia, fell 24.7% and 44.0% respectively in local terms.

# INTERNATIONAL BOND MARKET



## Citigroup Country Bond Indexes Three Months Ending September 30, 2008

|                     | Return          |                    |                     |
|---------------------|-----------------|--------------------|---------------------|
|                     | Return US\$ (%) | Local Currency (%) | Currency Effect (%) |
| Austria             | -7.1            | 4.2                | -11.3               |
| Belgium             | -7.7            | 3.6                | -11.2               |
| Denmark             | -7.2            | 4.1                | -11.3               |
| France              | -7.3            | 4.0                | -11.3               |
| Germany             | -7.1            | 4.2                | -11.3               |
| Ireland             | -7.1            | 4.2                | -11.3               |
| Italy               | -7.8            | 3.5                | -11.2               |
| Netherlands         | -7.2            | 4.1                | -11.3               |
| Spain               | -7.9            | 3.3                | -11.2               |
| Sweden              | -9.1            | 5.3                | -14.5               |
| Switzerland         | -4.5            | 5.2                | -9.6                |
| UK                  | -6.2            | 4.8                | -10.9               |
| <b>Europe Total</b> | <b>-7.4</b>     | <b>3.8</b>         | <b>-11.3</b>        |
| Japan               | 0.9             | 1.0                | -0.2                |
| Australia           | -12.0           | 7.0                | -19.1               |
| Canada              | -4.0            | 0.6                | -4.6                |

**Govt's Rally + Dollar's Rally = More Losses:** The credit crisis stretched around the globe and investors sought the safety of government-backed securities.

Government bonds in European countries rallied strongly with returns in the 4% range in local terms. However, the strengthening dollar (appreciated approximately 11% this quarter) reversed that performance and generated losses for U.S. investors. With credit markets seizing up, inflationary pressures waning, and recession-like economic growth, the Bank of London and European Central Bank are expected to inject liquidity into the market and lower interbank lending rates.

Lower initial interest rates in Japan dampened the bond market rally; the market returned 1.0% in local terms and 0.9% in dollars. The Bank of Japan is handcuffed by the low interest rates and unable to spur the economy with monetary policy.

## SELECTED INDEX RETURNS - PERIODS ENDING SEPTEMBER 30, 2008

|                                     | Quarter | One Year | Three Years | Five Years | Ten Years |
|-------------------------------------|---------|----------|-------------|------------|-----------|
| <b>US EQUITIES</b>                  |         |          |             |            |           |
| Dow Jones Industrial Average        | (3.7) % | (19.9)   | 3.4         | 5.6        | 5.4       |
| Standard & Poors 500                | (8.4)   | (22.0)   | 0.2         | 5.2        | 3.1       |
| Russell 3000                        | (8.7)   | (21.5)   | 0.3         | 5.7        | 3.8       |
| S&P MidCap 400                      | (10.9)  | (16.7)   | 1.8         | 8.7        | 10.3      |
| Russell Mid-Cap                     | (12.9)  | (22.4)   | 0.1         | 8.6        | 8.4       |
| S&P SmallCap 600                    | (0.9)   | (13.8)   | 2.0         | 9.9        | 10.1      |
| Russell 2000                        | (1.1)   | (14.5)   | 1.8         | 8.2        | 7.8       |
| Growth Stocks - Russell 3000 Growth | (11.9)  | (20.6)   | 0.2         | 4.0        | 0.9       |
| Value Stocks - Russell 3000 Value   | (5.3)   | (22.7)   | 0.2         | 7.3        | 5.9       |

|                        | Quarter | One Year | Three Years | Five Years | Ten Years |
|------------------------|---------|----------|-------------|------------|-----------|
| <b>US FIXED INCOME</b> |         |          |             |            |           |
| LB Aggregate           | (0.5) % | 3.7      | 4.2         | 3.8        | 5.2       |
| LB Intm Govt/Credit    | (1.2)   | 3.2      | 4.0         | 3.3        | 5.0       |
| LB Govt/Credit         | (1.6)   | 2.4      | 3.6         | 3.3        | 5.0       |
| LB Government          | 1.9     | 7.9      | 5.5         | 4.3        | 5.3       |
| LB Credit              | (6.4)   | (4.8)    | 0.9         | 1.9        | 4.5       |
| LB Mortgage            | 1.9     | 7.0      | 5.5         | 4.8        | 5.7       |
| LB High Yield          | (8.9)   | (11.2)   | 1.1         | 4.4        | 4.4       |
| LB U.S TIPS            | (3.5)   | 6.2      | 4.4         | 5.2        | 7.2       |
| LB 1-3 Yr Government   | 1.4     | 5.9      | 5.1         | 3.5        | 4.6       |
| LB Long Government     | 2.6     | 9.9      | 5.6         | 5.8        | 6.2       |

| <b>INTERNATIONAL (Measured in US Dollars)</b> | Quarter  | One Year | Three Years | Five Years | Ten Years |
|-----------------------------------------------|----------|----------|-------------|------------|-----------|
| MSCI EAFE (Net)                               | (20.6) % | (30.5)   | 1.1         | 9.7        | 5.0       |
| MSCI ACWI ex U.S. (Net)                       | (21.9)   | (30.3)   | 2.6         | 11.3       | n/a       |
| MSCI Europe (Net)                             | (20.8)   | (30.9)   | 2.5         | 11.0       | 4.8       |
| MSCI Pacific (Net)                            | (20.1)   | (29.6)   | (1.8)       | 6.9        | 5.8       |
| MSCI Emerging Markets (Net)                   | (27.0)   | (33.2)   | 8.4         | 18.7       | n/a       |
| Citigroup Non-U.S. Govt Bond                  | (4.3)    | 5.2      | 5.5         | 5.6        | 5.2       |

| <b>REAL ESTATE</b>    | Quarter | One Year | Three Years | Five Years | Ten Years |
|-----------------------|---------|----------|-------------|------------|-----------|
| NAREIT Index          | 4.5 %   | (13.0)   | 3.4         | 11.2       | 11.2      |
| NCREIF Property Index | n/a     | n/a      | n/a         | n/a        | n/a       |

| <b>OTHER</b>                          | Quarter | One Year | Three Years | Five Years | Ten Years |
|---------------------------------------|---------|----------|-------------|------------|-----------|
| 91-Day T-Bills                        | 0.6 %   | 2.9      | 4.2         | 3.3        | 3.6       |
| Consumer Price Index (percent change) | (0.0)   | 4.9      | 3.3         | 3.4        | 3.0       |
| Producer Price Index (percent change) | (0.1)   | 8.7      | 4.6         | 4.7        | 3.4       |

Note: Returns for periods longer than 12 months are annualized.