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Prepared by Daniel R. Shore, Chief Research Analyst, Publisher, and CEO

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Introduction:

What an incredible history making quarter this has been. Since our last newsletter on October 1st, we have witnessed unbelievable developments in the global financial markets. From the \$700 Billion Troubled Asset Relief Program (TARP) passed amid turmoil on Capitol Hill, to the 25% drop in stock markets in October and November, to the 1.25 million jobs lost over the past 3 months, to the \$50 Billion Madoff Ponzi scheme, this has been a quarter for the history books. We hate to say it again, but the only time period when we experienced this rapid rate of stock market depreciation and job loss was during the Great Depression. That was also a time period in which many investment scams and Ponzi schemes were revealed. When markets are going up, investors tend not to ask questions and scam artists can thrive as market gains allow them to hide the fallacy of their schemes. This market will certainly serve to flush out many of the scam artists in the investment world and that is why we believe there are many more Ponzi schemes yet to be revealed.

Once again this quarter global equity and credit markets experienced incredible volatility. The VIX (Market Volatility Index) hit an all-time high of 80 during October and November but has since fallen back to a level of 45. Historically VIX readings between 30 and 40 have been associated with extreme fear in the markets. In normal markets the VIX is usually less than 20. So again another historic event occurred as markets sold off this past quarter with the most fear and panic we have ever seen. The selling in October and November was across the board in all asset classes except for gold and U.S. Treasuries. It was driven by a severe freeze-up of the credit markets, which then precipitated margin calls to hedge funds and leveraged investment funds. The forced selling of assets to cover margin calls and de-leverage caused panic and a flood of selling in the world's stock and credit markets. For the past 10 years hedge funds, private equity funds, and closed-end funds have used cheap credit to leverage their investment strategies. Many of these strategies relied on access to easy credit to be successful. Also during October, the U.S. government and other governments around the world imposed a

moratorium on shorting certain stocks. This crippled many hedge fund strategies (like convertible arbitrage and long-short equity) that rely on shorting stocks to make a profit. To add insult to injury, Bernie Madoff's \$50 billion hedge fund and institutional money management Ponzi scheme was revealed by the Securities and Exchange Commission. This will undoubtedly result in investors being spooked and pulling more money out of institutional money management and hedge fund accounts in 2009. Madoff had been the Chairman of the NASDAQ stock exchange and served on numerous Securities and Exchange Commission committees. He has been well known on Wall Street for over 40 years, yet the Securities and Exchange Commission repeatedly failed to investigate his firm even after numerous complaints from investors and regulators over the years. This has substantially shaken the investment community's confidence in the regulatory agency (SEC) that is supposed to provide oversight and protection. Our research leads us to believe that there will be another wave of hedge fund selling in the first half of 2009 as more hedge fund and mutual fund redemptions come in and funds go into liquidation.

In Q4 the credit crisis started to spread into all areas of the economy from its genesis in the real estate and banking sectors. No sector has been spared as auto loans, student loans, credit cards, corporate bonds, business loans, and municipal bonds have all experienced market dislocations, diminished availability, and historically high interest rates. Meanwhile the flight to safety has resulted in Treasury yields falling to levels not seen since the Great Depression. Short term Treasuries have effective yields of zero, 10 year Treasuries are yielding 2.1% and 30 year Treasuries yield 2.6%. Meanwhile even in this deflationary environment, gold gained in value. Essentially investors are saying that they are afraid to invest in anything but short term Treasuries and gold because they are more concerned about return of capital than return on capital. Global investors are giving the U.S. Treasury their money for safe keeping in Treasuries until they become confident in other investments again.

At the end of November the Labor Department announced non-farm job losses of 533,000 for November, October's loss was revised up to 320,000, and September's loss was revised up to 403,000. From September through November the U.S. economy lost 1,256,000 jobs and year to date the U.S. has lost over 2.1 million jobs. Economists estimate an additional 2 million to 4 million U.S. jobs will be lost in 2009 as this recession deepens. Also, in November the government's National Bureau of Economic Research officially announced that the U.S. economy has been in recession since December 2007. Our subscribers will remember that Alphareturns was one of the first to make a recession call in our January 2008 newsletter a year ago. Alphareturns and Goldman Sachs were the first to accurately predict recession in the U.S. during 2008.

- January 2008 Alphareturns newsletter excerpt: ***“Because of the likelihood of recession and lower corporate earnings in the US economy, we will make adjustments in our model portfolios to take a more defensive posture going into 2008. In summary we will substantially reduce our exposure to US stocks down to a small allocation in US consumer staples and utility stocks. We will also reduce our exposure to International stocks.”***

- The January 2008 Alphareturns newsletter warned that ***“The Global Credit crisis will get worse in 2008”***.

In hindsight we were very much correct in our January 2008 forecast, although we underestimated the severity of this recession. We were also the first to forecast the credit crisis, which we did as far back as April of 2007.

- April 2007 Alphareturns newsletter excerpt: ***“One argument being floated on Wall Street is that risk can be hedged away with the use of complex investment instruments like derivatives and credit default swaps. We strongly disagree with this assumption and believe that credit spreads will widen back to historical norms as much of the debt that is being issued goes into default.”***

Unfortunately for our economy, our predictions are coming true in a more pronounced way than even we imagined. Perhaps our biggest failure was allowing ourselves to be influenced by the steady stream of blind optimism coming from Washington and Wall Street instead of following our own forecast more closely. Why is this crisis shaping up to be worse than expected? The answer lies in the fraudulent information fed to us by Wall Street Institutions and our government over the past year. Our government has failed to regulate the financial system as evidenced by the existence of massive fraud and wealth destruction. Two weeks after the passage of the \$700 billion Troubled Asset Relief Program, Treasury Secretary Paulson totally abandoned the agreed upon mission of the TARP which was to buy up troubled credit assets from financial institutions. Instead, Treasury decided to use the money to inject capital in troubled banks through stock purchases. Paulson later testified to Congress that the reason he changed his strategy was the realization after the fact that \$700 billion was not nearly enough to buy up the troubled assets in the U.S. financial system. After the bailout plan was passed and Treasury officials were given access to the detailed balance sheets of banks, they found that the troubled “level 3” assets totaled more than \$2 trillion at best. This is truly a troubling revelation. It is also the reason Congress is likely to withhold release of the final \$350 billion balance left in the T.A.R.P. legislation.

On the political front, we witnessed a historic election where Barack Obama defeated John McCain. President-elect Obama has promised a huge fiscal stimulus plan of between \$500 billion and \$1 Trillion to create 2.5 million jobs when he takes office January 20th. Washington also witnessed the Big 3 U.S. automakers’ CEO’s flying to Capitol Hill in separate private jets to ask for a \$25 billion emergency bailout to keep them from going bankrupt. When asked about their turn-around plans and how they would use the money, they acted like they had not even thought of what they would do to turn-around their failing companies. After much criticism and political theatre, Congress sent them back to Detroit to create credible turn-around plans. They drove back to Washington 2 weeks later with turn-around plans in hand and were again turned down as Congress initially passed a \$14 billion bridge loan just to have it voted down in the Senate. The White House and Treasury have since approved a \$14 billion bridge loan to the automakers. They hope this will keep the automakers alive until the Obama

administration takes office and includes money for the Big 3 in its much anticipated stimulus program. Our analysis of the Big 3 shows that GM and Ford have been technically bankrupt for over a year now as their liabilities exceed their assets. GM is in much worse shape than Ford with \$156 billion in debt and \$99 billion in assets. GM is barely able to afford to make their debt payments each month at this point. Ford's liabilities only exceed assets by \$5 billion. Chrysler has been a privately held company since Daimler Benz sold it to Cerberus Capital last year. Cerberus Capital is a private equity firm and does not disclose Chrysler's financial data to the public. Cerberus is currently in a lawsuit against Daimler Benz claiming that the financial condition of Chrysler was grossly mis-represented when Cerberus purchased Chrysler.

Prior to the spread of the crisis into the broad economy and internationally, our forecast called for emerging markets to decouple from the U.S. and Europe and avoid recession. China and Latin America have decoupled somewhat from an economic perspective, but their stock and credit markets have not decoupled. The panic and flight to quality caused by the credit-crisis have resulted in investors liquidating positions in emerging markets and repatriating this money into U.S. Treasuries. Chinese and Latin American GDP growth is still positive but is declining more than expected as the global slowdown enters a deeper more severe phase. Our portfolios have had a healthy exposure to gold and short-term treasuries and therefore are performing quite well relative to the broad markets. Going forward we will remain very cautious until we see a substantial improvement in credit markets and economic growth.

Executive Summary:

- Year to date our Conservative, Moderate, and Aggressive Model Portfolios returned -6.92%, -16.64%, and -25.71% respectively compared to the S&P500's loss of -38.49%, the Dow Industrials at -34.54%, and the MSCI-EAFE at -42.85%. Since inception January 1, 2007, our portfolios have also performed well relative to their respective benchmarks. The Conservative Model Portfolio returned 0.28% since inception vs. its benchmark of 3.39%, the Moderate Model Portfolio returned -10.23% vs. its benchmark of -19.18%, and the Aggressive Model Portfolio returned -20.08% vs. its benchmark of -36.44%. Cautious diversification in all of our portfolios created superior performance with considerably less risk and volatility than the broad markets. Even though we are beating the broad markets by a wide margin, our portfolios are all experiencing negative total returns for the year. Although we hope to avoid short run losses, we understand that successful investing requires a disciplined approach over the long run. We hope our clients will recognize this and judge our performance over a minimum timeframe of 3 or more years.
- Our economic forecast for 2008 and into 2009 now calls for a deeper slowdown in the US economy with Real GDP (real inflation adjusted gross domestic product) growth falling to 1.2% this year and -1.7% in 2009. U.S. Residential and commercial real estate markets continue to decline, as lending rates remain high. Job losses are escalating and consumers are pulling back at an alarming rate. Q4

2009 U.S. Real GDP is expected to contract by over 4%. With Real GDP growth expected to decline by 1.7% for the full year 2009, we expect U.S. corporate earnings to decline significantly. The situation is also bleak in the Euro-zone as Real GDP growth is also forecast to fall to 1.0% this year and an anemic -0.8% in 2009. Asian economies are expected to grow at a 3.0% rate in 2008 and slow to 1.6% in 2009. Even though Asian growth will be relatively strong, we believe Japan will experience recession and a contraction of -0.7% in 2009. Therefore, we are still predicting a further decrease in corporate profitability through 2009 and perhaps into the first part of 2010. This is likely to drive stock markets down further as analysts are forced to cut their earnings forecasts. The renewed fear in the market recently is due to worries over the global slowdown being deeper and longer because the crisis in credit lending has spread into all sectors within the U.S. and Euro-zone. With the U.S. Federal Reserve recently reducing the Fed Funds rate to a range between 0% and 0.25%, we expect that the Fed will have to use other forms of policy going forward. Already the Fed has voiced its intention to purchase up to \$500 billion of mortgage securities on the open market and up to \$200 billion of auto loans and consumer loans in an attempt to create a market for these securities again. We believe that the issues facing the U.S. economy are very severe and this is why the Federal Reserve has taken such dramatic action.

- As we discussed in our last newsletter, this crisis is now leading to a deflationary scenario as banks, businesses, and consumers are forced to de-leverage their balance sheets and sell assets at fire-sale prices. Furthermore, the slowdown in economic activity has rapidly reduced demand for industrial and energy commodities. In spite of OPEC's recent 2.5 billion barrel per day cut in production, oil prices continue to plummet. Oil is now at \$42 per barrel after being at over \$140 per barrel just 6 months ago. This tells us that global economic activity is falling faster than OPEC can adjust production.
- Morgan Stanley and Goldman Sachs decided to become commercial banks instead of investment banks to gain access to the T.A.R.P. bailout funds. Both announced larger than expected losses for the 4th quarter.
- Even with the recent sell-off in stocks, we still believe that U.S. and European broad markets will remain under pressure and may fall further as uncertainty persists. We take this position based upon the deteriorating corporate profit situation and the fact that credit market turmoil is in uncharted territory. When GDP growth slows below 2%, corporations have a very difficult time making a profit. It gets even more difficult when credit is not available on reasonable terms. Money market, commercial paper, municipal bond, corporate bond, and mortgage rate spreads above treasuries have come down since our last newsletter but are still well above normal historic levels.

The Alphareturns Model Portfolios for Q1 2009:

Because of the recession and weak corporate earnings, we will continue with our cautious and defensive posture going into 2009. Many so-called financial experts are telling you not to miss out on the recovery off the bottom, but we believe it is better to miss the first 15% of the recovery than to keep losing 15% in every successive bear market rally. In the last bear market of 2001/2002 there were 6 bear market rallies of 15% or more before the bottom was finally put in. It is important to note that the bottom in stocks did not finally occur until early 2003... a full year after the recession had officially ended. So don't fall for the hype that the bottom always occurs 6 months before the recession ends. That is simply not true based on the historical facts. Once again this is Wall Street desperately trying to get investors to "stay in the game" and keep paying commissions and fees while the market continues to go lower. In the past 10 years from November 1998 to November 2008 we have experienced the worst 10 years of stock market returns in the history of the U.S. stock market. As we discussed in previous newsletters, the U.S. stock market has experienced three major bubble periods in the past 100 years: the 1920's, 1950's/60's, and 1980's/90's. The stock market run-up in the 80's and 90's was the biggest bubble in size and duration. It was not until 1954 that the market recovered back to its 1929 peak level and it was not until 1982 that the market recovered back to its 1968 level. Internationally we have the example of Japan's Nikkei stock market bubble, which peaked in 1989 at a level of 38,916. After many fits and starts, the Nikkei is trading at just 8,860 today...still 75% off its 1989 high. Therefore, if history is any guide it could take 5 to 10 years more years for U.S. markets to return to their year 2000 peak. The Nasdaq, which now trades around 1500, may take 30 years to make it back to its year 2000 peak of 5,048. So the lesson to be learned from this is that the hangover from large asset market bubbles can last a decade or more. The larger the bubble, then the longer the hang-over. The table below details the model portfolio allocations we are recommending for the 1st quarter of 2009:

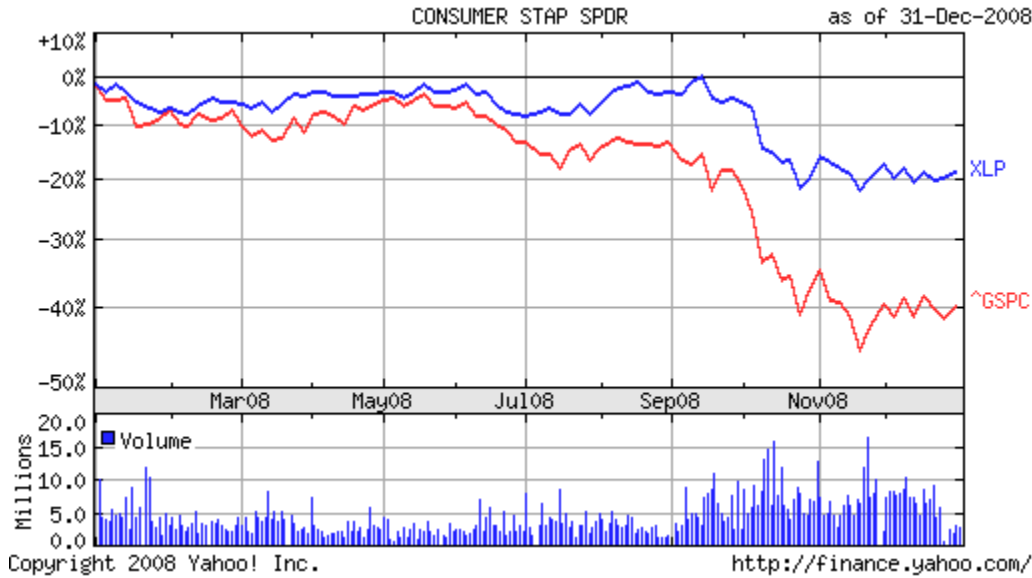
Alphareturns Model Portfolio Allocations For Q1 Calendar 2009:

Symbol	Asset Class	Conservative Risk 1-3 year horizon	Moderate Risk 4-7 year horizon	Aggressive Risk 7+ year horizon
XLP	US Consumer Staples Stocks ETF	8%	18%	28%
LQD	Investment Grade Corporate Bond ETF	50%	40%	30%
HYG	High Yield Bond ETF	7%	15%	23%
BWX	Int'l Treasury Bond ETF	8%	6%	4%
GLD	Gold Bullion ETF	5%	4%	3%
MUB	National Municipal Bond Index ETF	22%	17%	12%

We will briefly touch on the rationale behind the asset allocation choices:

US Stocks: With our cautious posture regarding the threat of recession in the US, we will continue with the US Consumer Staples ETF fund symbol XLP. Our theory is that

consumers will still buy the staples they need (food, medicine, hygiene products) even as the economy slows down. Historically during past recessions, the consumer staple sector has held up well. So far this year the consumer staples sector has lost much less than the broad market (see chart below comparing the XLP to the S&P 500).



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Consumer Staples ETF (XLP) outperforms the S&P500 (GSPC) during 2008.

Source: Yahoo Finance

Developed International Stocks: We remain cautious regarding developed international stock markets due to the global recession scenario. While valuations in Europe are getting very attractive, we believe valuations may get even better as GDP growth remains in recession territory through early 2009. We expect this weakness to parallel U.S. weakness into 2009.

Emerging Market Stocks: Chinese and Latin American markets have fallen much further than U.S. and European stocks this year. While we initially believed these markets were at attractive valuation levels, we are now concerned that the severity of the global slowdown will drive these emerging markets down further.

Fixed Income: As forecast in our previous newsletters, the credit crunch and re-pricing of risk have caused a steeper yield curve. The U.S. Federal Reserve has now lowered rates to 0%. Therefore we are recommending a shift out of the Ishares short-term 1 to 3 year duration U.S. Treasuries symbol SHY exchange-traded fund and into corporate bonds. Treasuries are still a safe haven but do not have any additional upside since the Fed cannot lower rates past 0%. At these rates we believe U.S. Treasuries are in their own bubble and have run their course. Year to date our allocation to the SHY fund has achieved a total return of 6.19%. Corporate credit markets have indeed begun to thaw and therefore we believe the risk reward ratio in investment grade corporate credit to be very attractive. Our investment vehicle of choice is the Ishares Investment Grade Corporate Bond exchange traded fund symbol LQD. We also recommend a small allocation to high yield (and more risky) corporate bonds through the Ishares High Yield

Bond exchange traded fund symbol HYG. High yield spreads have ballooned into the low teens and this sector has declined over 25% in principal since the credit markets became frozen in October. We expect a return to the mean (more normal levels of principal and yield) as the credit markets continue to thaw. The High Yield sector is likely to see defaults pick up as bankruptcies increase early in 2009. However, we believe this anticipated higher level of default may be priced in to these bonds already. The corporate debt markets should achieve stock like returns during 2009 without as much risk of loss. In addition to U.S. fixed income we are continuing with our allocation to international government bonds through the Ishares International Bond Index exchange traded fund symbol BWX. Foreign governments have not reduced rates as quickly as the U.S. Therefore, we expect further interest rate decreases to occur internationally which should continue to cause the BWX fund to outperform. Year to date it has experienced a total return of 4.01%.

Metals and Mining Commodities: Due to the deflationary global contraction underway, we are steering clear of metals and mining investments except for our allocation to gold bullion through the exchange traded fund symbol GLD. We believe gold to be the ultimate safe haven during times of crisis. Furthermore, now that Treasuries (the other safe haven) practically have no yield, we think investors will move back into gold over Treasuries as this downturn continues. When the recovery does get traction on the other side of this crisis, a massive increase in inflation is likely to occur since governments have been throwing so much newly printed currency at this crisis. Gold should serve our portfolios well both during and on the other side of this global recession. Year to date our allocation to gold has returned 4.92%.

Energy and Natural Resources Commodities: Due to the same deflationary concerns mentioned above with metals commodities, we will avoid investments in energy and natural resources commodities until the recovery gains traction.

Real Estate: Commercial and residential real estate is finally getting more attractive in terms of valuation, but we still remain cautious and patiently wait for the bottom to be put in. Our research on the U.S. real estate market shows that when a bubble finally bursts it can take years for the market to find a bottom. The commercial real estate bubble has only recently begun to contract and will likely burst in early 2009 as the recession takes its toll on vacancy and lease rates. We hope to re-invest in real estate at some point in the future, but believe it is still too soon.

Q4 2008 Performance Discussion:

Year to date our Conservative, Moderate, and Aggressive Model Portfolios returned -6.92%, -16.64%, and -25.71% respectively compared to the S&P500's return of -38.49%, the Dow Industrials at -34.54%, and the MSCI-EAFE at -42.85%. Since inception January 1, 2007, our portfolios have also performed well relative to their respective benchmarks. The Conservative Model Portfolio returned 0.28% since inception vs. its benchmark of 3.39%, the Moderate Model Portfolio returned -10.23%

vs. its benchmark of –19.18%, and the Aggressive Model Portfolio returned –20.08% vs. its benchmark of –36.44%.

Alpha returns Model Portfolios →	Conservative Risk 1 to 3 year horizon	Moderate Risk 4 to 7 year horizon	Aggressive Risk 7 + year horizon
YTD 2008	-6.92%	-16.64%	-25.71%
Since inception 01/01/07	0.28%	-10.23%	-20.08%
Dow Jones Benchmarks* →	Dow Jones Relative Risk Conservative Global Portfolio	Dow Jones Relative Risk Moderate Global Portfolio	Dow Jones Relative Risk Aggressive Global Portfolio
YTD 2008	-2.90 %	-25.18 %	-41.50 %
Since inception 01/01/07	3.39 %	-19.18%	-36.44 %

**Note: The Dow Jones Relative Risk Indexes measure the performance of conservative, moderate and aggressive portfolios based on incremental levels of potential risk. The indexes are designed to systematically measure various levels of risk relative to the risk of a global all-stock index. Investors can identify an appropriate benchmark as the index that has the most similar historic risk characteristics. Stock exposure will typically range from 20% in the conservative portfolio up to 100% in the aggressive portfolio. For more information see: www.djindexes.com/mdsidx/portfolio/index.cfm?event=showPortfolioGlobalRelativeRisk
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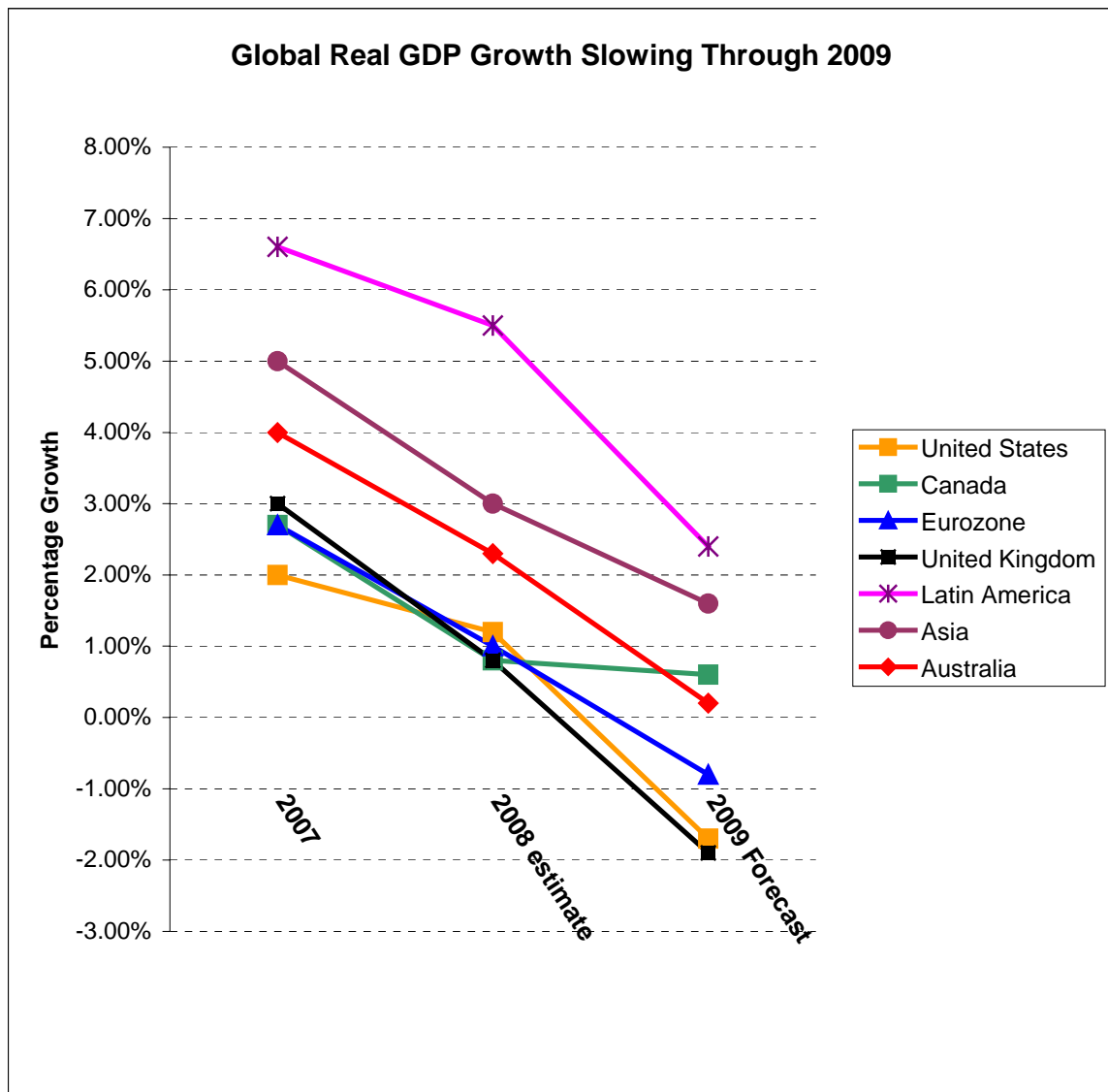
Detailed Global Economic Analysis and Outlook:

During Q4 2008, the world’s financial markets took a horrendous turn for the worse. October and November were two of the worst months in market history. During the final quarter of the year global markets experienced the following declines:

- S&P 500 U.S. Stock Index - 22.5 %
- MSCI-EAFE International Index - 20.1 %
- China Stock Index - 17.2 %
- Latin American Stock Index - 34.1 %
- GSCI Commodities Index - 47.6 %
- Oil - 54.7 %
- Dow Jones U.S. Real Estate Index - 39.5 %

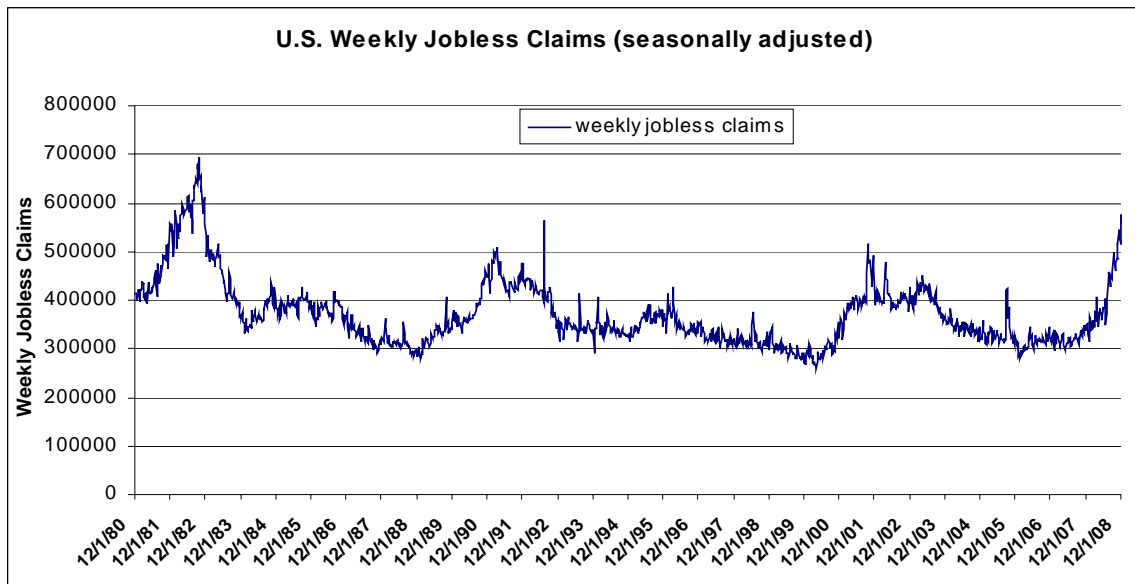
Problems continued to grow in the battered real estate and financial sectors of the US market and then spread into consumer markets. During the first week of October, the U.S. Congress and Senate proceeded with a re-vote on the Treasury’s \$700 Billion Troubled Asset Relied Program and did pass the program the second time around. The program was passed with the explicit purpose of providing mortgage foreclosure relief and buying the so-called “toxic” troubled mortgage assets from banks and financial institutions. However, after Treasury Secretary Hank Paulson and his team were able to

actually see the detailed balance sheets of the largest financial institutions, they realized that \$700 Billion was not enough to make a significant impact. Treasury realized that the level of toxic assets exceeded \$2 Trillion in the U.S. and close to \$3 Trillion internationally. After this shocking revelation, they decided that the best they could do was use the \$700 Billion to inject capital in financial institutions to buy time. At this point the first \$350 Billion has been used to buy stock in U.S. banks and insurance companies and Treasury is asking for Congress to release the remaining \$350 Billion. Treasury is hoping to buy enough time for either the real estate market/economy to recover or Congress to pass a larger troubled asset purchase plan. Either way financial institutions globally are still in a very dangerous position teetering on the brink of insolvency as the global economy continues to slow further. As we discussed earlier in our introduction, the global economy is slowing dramatically as consumers and businesses respond to declining GDP, real estate, and equity markets. The table below shows our forecast of Real GDP contraction in the world's major economies.



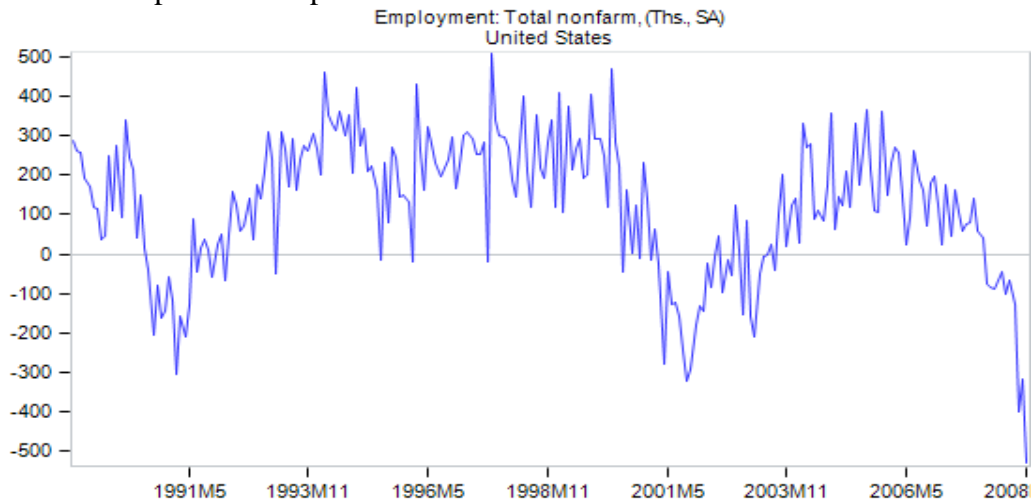
Source: Institutional Investment Research LLC

In the U.S. economy, we are experiencing a severe downturn in business and consumer spending which is driving the slowdown in overall business activity. Job losses are accelerating as economic contraction forces production and spending cuts. Weekly jobless claims are reaching levels that are consistent with prior recessions. Through the end of November year to date, the U.S. economy lost over 2.1 million jobs with a staggering loss of 533,000 jobs in November. The chart below shows the increase in jobless claims and how it compares to prior recessions in 2001, 1990, and 1981.



Source: U.S. Labor Department

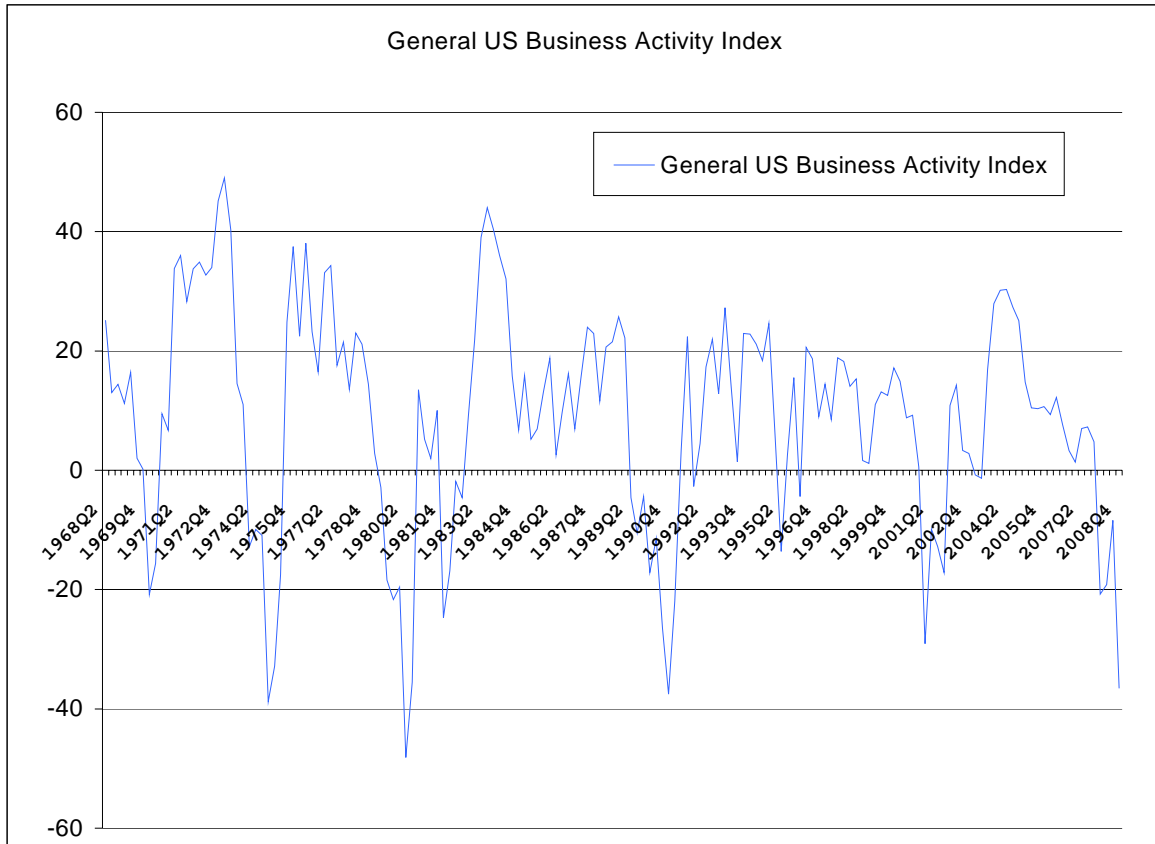
In terms of the rate of decline in job losses, the most recent quarter's loss of 1.25 million non-farm jobs is the third largest decline since World War II and is much more severe than losses in the past two recessions of 2001 and 1990. The chart below shows the dramatic plunge in non-farm employment during the past quarter and how this past year's decline compares to the past two recessions.



U.S. Non-farm employment gains/losses in thousands, seasonally adjusted

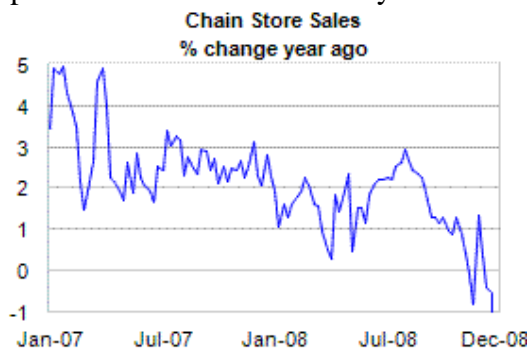
Source: U.S. Labor Department, Moody's

As job losses mount, consumers are pulling back and this is creating a vicious cycle. The chart below shows how the decline in the Philly Fed's General Business Activity index mirrors the decline in employment.

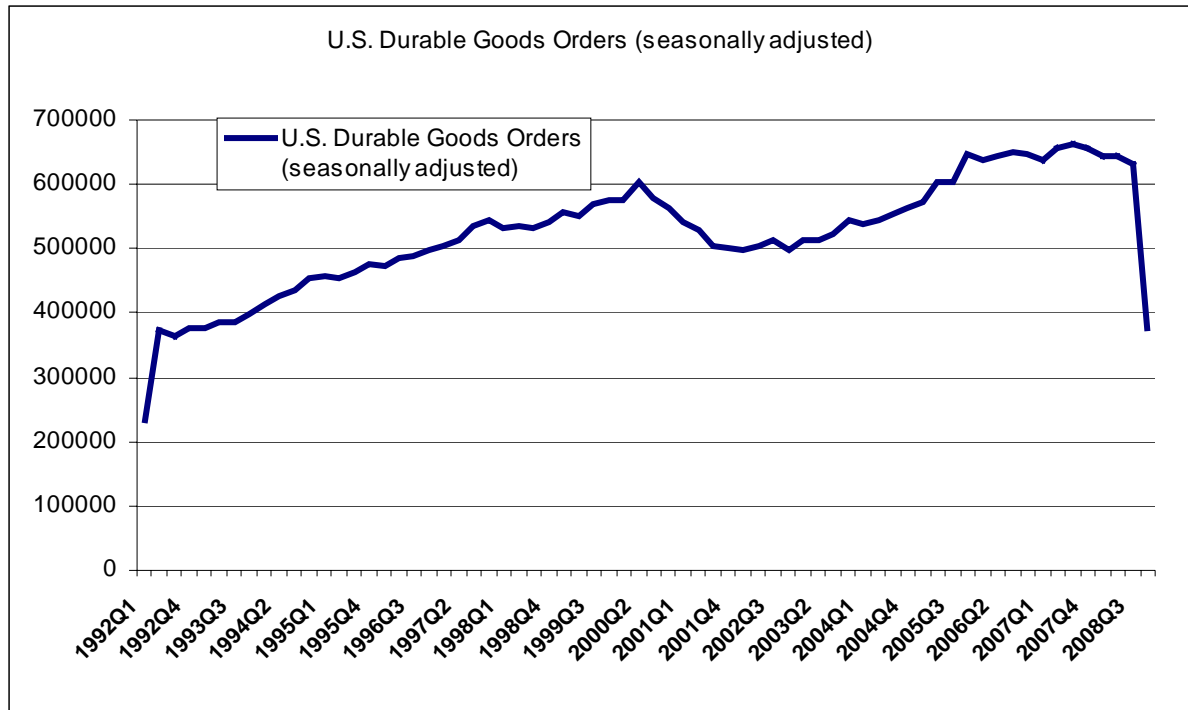


Source: Federal Reserve Bank of Philadelphia

Below we see two charts showing declines in durable goods orders and chain store sales. These charts further support the fact that the U.S. economy has entered a new, more severe phase of the recession during the 4th quarter. These charts show how the economic crisis that began in real estate, construction, and mortgage banking has now spread into the broad economy.



Source: Moody's

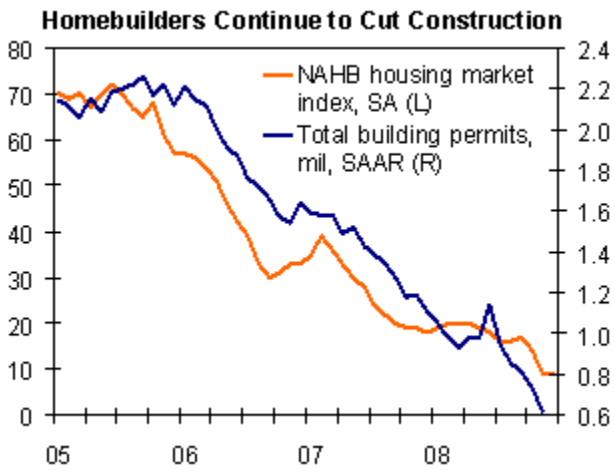


Source: Moody's

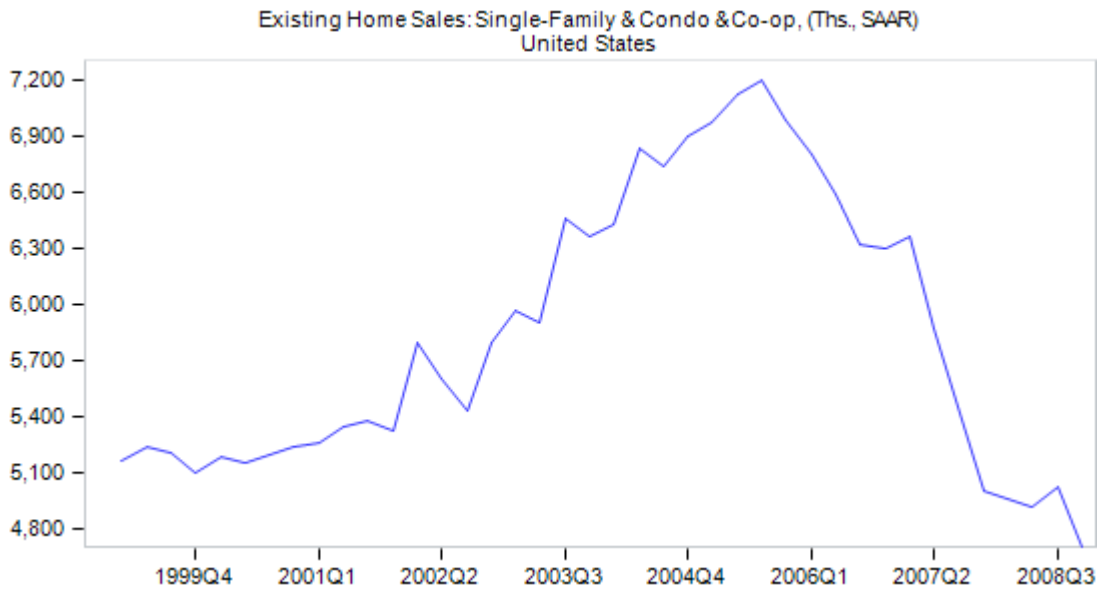
When will this recession end and where will the bottom be? The answer to this question is unclear because so much depends upon recovery in the real estate and banking sectors. Impaired mortgages and consumer credit are at the root of this credit crisis and the ensuing recession. Balance sheets for banks, corporations, and consumers will have to be repaired before economic growth can resume. When growth does resume it is likely to be at a measured pace. Real estate prices historically take a long period of time to recover due to the ill-liquid nature of real estate. Stocks may also take years to recover based on historical precedent. Later we will look at historical bear stock markets and how recovery has happened after past downturns, but first we will take a brief look at the real estate market.

U.S. Real Estate Sector Continues To Weaken:

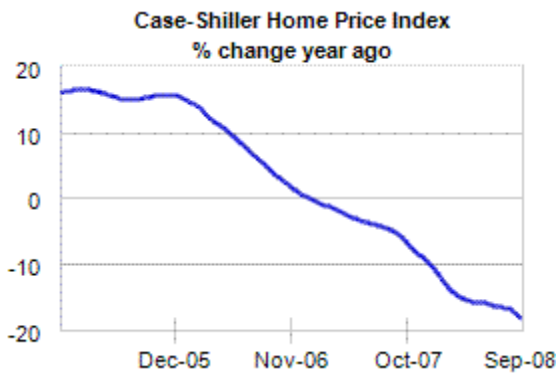
In previous newsletters we explored the weakness in the U.S. residential housing market at length, so we will not go into the same level of detail as before. In the past quarter we witnessed a re-acceleration in the decline of home sales, construction, and prices. Again, we re-iterate that the new, more severe phase of the recession we entered since September is making the real estate situation worse instead of better. As homeowners lose jobs and become increasingly concerned about employment, real estate is suffering another severe blow. The declines in construction, building permits, existing home sales, and prices all show increasing weakness during the 4th quarter with no sign of a bottom. Many prominent economists believe U.S. housing prices need to decline an additional 15% to 20% before a bottom is put in.



Source: Moody's

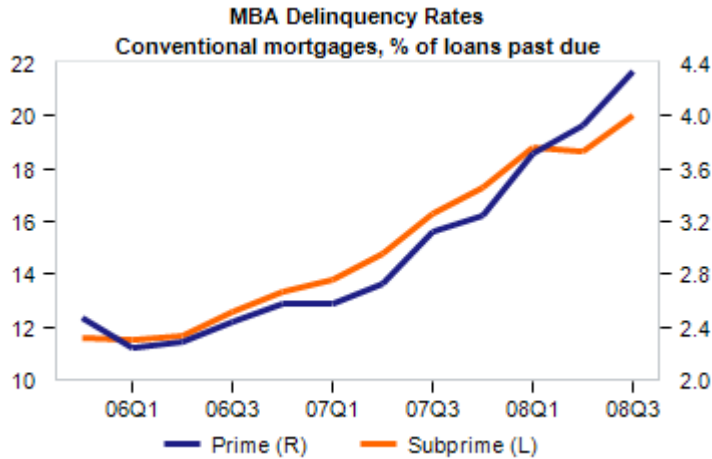


Seasonally Adjusted Annualized Rate of Change in US Existing Home Sales in Thousands,
Source: National Association of Realtors, Moody's



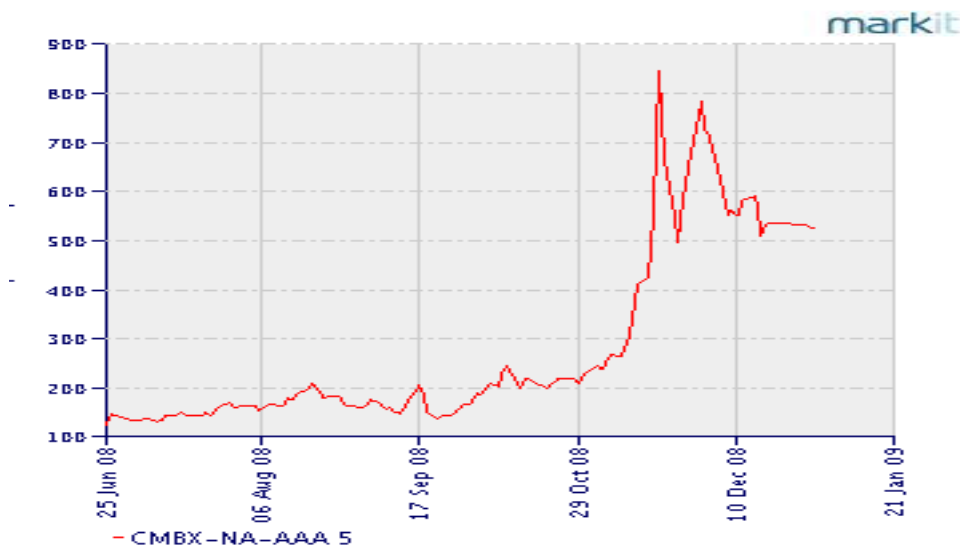
Source: Standard and Poor's

Large declines in the value of residential housing are causing a surge in foreclosures for all types of mortgages. In many cases, even homeowners who are not in the sub-prime category owe more on their mortgage than their home is worth and are walking away and leaving their home in the hands of the lender.



Source: Moody's

With regard to commercial real estate, we are seeing a severe contraction as well due to very tight lending conditions. With job losses mounting in the global economy we are concerned about commercial office vacancy rates. Even though yields on REITs (Real Estate Investment Trusts) look attractive at the moment, commercial real estate is likely to remain under pressure through 2009 and those dividends may be reduced if the economic downturn gets deeper. We see in the chart below how spreads on AAA commercial real estate mortgage backed credit default swaps have increased significantly since September. This is an indication of severe stress in the commercial real estate mortgage market as credit default insurance backing AAA rated commercial mortgages has increased 400% since September.



Source: Markit

With the situation in real estate getting worse instead of better, what is the government doing to help and how are these programs going? Below is a table showing the major government programs enacted to help the credit crisis and notes on how successful each program has been so far:

Proposal/Plan	Description	Notes
Hope for Homeowners	Lenders agree to take a loss on the loan, and the government pays off the existing mortgage and refinances into FHA loan.	Part of the July housing stimulus bill. Effective from Oct. 1 - Sept. 30, 2011. The government estimated that 400,000 would be helped; 357 people have signed up so far.
FHA Secure	Bush administration program was designed to allow homeowners with good credit who had fallen behind on payments once their loans reset to higher rates to refinance into FHA loans.	While officials estimated that it could help some 80,000 delinquent borrowers avoid foreclosure, HUD terminated the program effective Dec. 31, 2008. As of Dec. 18, some 4,100 delinquent borrowers had used the program since Sept. 2007.
Homeowners Protection Act of 2008	Bill proposes giving bankruptcy judges the power to reduce the principal amounts of home loans -- known as a cram down.	Introduced earlier this month by Rep. John Conyers Jr. Supporters include the National Association of Home Builders. However, the Mortgage Bankers Association is opposed to this program.
Private Sector Modification Plans	JPMorgan Chase, CitiMortgage and Bank of America have each announced loan modification initiatives. Other banks have also been doing modifications.	The 14 largest national banks and thrifts modified nearly 73,000 loans in the first quarter and an additional 114,000 in the second quarter.

Sources: Zelman & Associates; WSJ reporting

The table shows that the government programs put in place have actually helped very few struggling homeowners. Private sector modification plans have modified far more mortgages than the government programs. We do expect more government programs to be put in place when the Obama administration takes office. How effective these new programs will be is not clear. Ultimately, banks and mortgage investors will be faced with one of two choices: 1) write off part of the principal value of troubled mortgages so that the homeowner can refinance without being “underwater”, or 2) take troubled mortgages into foreclosure and try to recoup as much value as possible in a foreclosure sale. Either way the banks and mortgage investors will have to take losses. Having the government purchase these troubled mortgages is a third option, but this option would result in taxpayers taking the loss. The Obama administration may choose this path. If so, it will add to the massive fiscal budget deficit that this crisis has already created. To recap our position on the real estate sector, we have the following:

- House prices continue to descend and are spreading to a larger number of regions. The weak economy, which is resulting in job losses, and tight credit are still weighing on demand. Inventory increases due to foreclosures are keeping supplies high and forcing prices low.

- Given the current turmoil in financial markets and weakness in the economy, demand for housing will be soft through the rest of this year. Soft demand, combined with rising foreclosures that are dumping more inventories on an already-oversupplied market, means that there is little in the way of support for house prices. House prices are a little more than half way through a correction that will last well into 2009.

Global Credit Crisis Is Improving Slowly:

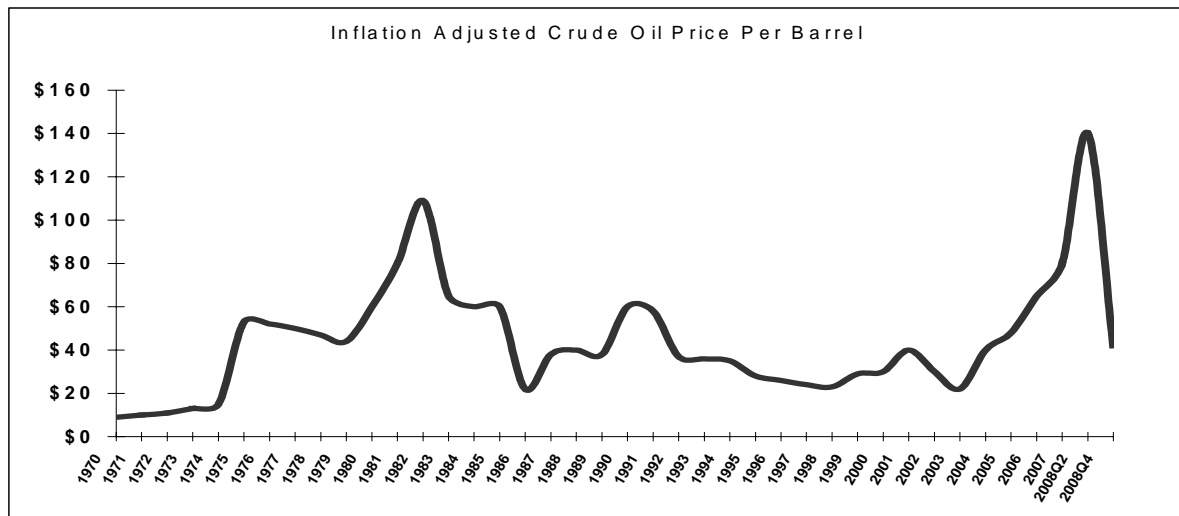
As discussed in previous newsletters, one of the best indicators of stress in the world's financial system is the TED spread. The TED spread measures the spread in basis points between short-term Treasury yield and the short-term Eurodollar LIBOR yield. During October the TED spread increased to the highest levels on record (4.64) as stock markets tumbled and panic spread through the financial sector. Since then the TED Spread has declined significantly to a level of around 1.30, however this is still a high level when compared with normal TED Spread of around 0.25. So the TED Spread currently is still more than 100 basis points above normal. This means that banks are starting to lend to one another again but are still not back to a normal lending posture with regard to their customers. To encourage banks to lend to consumers and businesses again, the Federal Reserve has taken unprecedented actions during the past quarter.

Since last quarter's newsletter, the Federal Reserve has reduced the Fed Funds Rate to the lowest level in history. The Fed Funds Rate is now set at a range of 0% to 0.25%. The Federal Reserve always has an advanced look at economic data and is able to see key pieces of data in advance of public release. We believe the Fed's dramatic actions recently suggest that the U.S. economy is facing its most severe recession since the Great Depression. Now that we are at 0%, the Federal Reserve will be forced to use non-monetary measures to continue to fight the crisis. The Fed has proposed buying long term Treasuries and directly purchasing mortgage debt in an attempt to reduce long rates and mortgage rates. Already, the Fed's plan to purchase \$500 Billion in Fannie Mae and Freddie Mac mortgage debt has helped reduce mortgage rates significantly. So far during this crisis, the Federal Reserve has increased its balance sheet from \$800 Billion to over \$3 Trillion and is running the printing press at an unprecedented pace to flood the economy and banking system with money supply. They are doing this to prevent further asset deflation. They are desperately trying to re-inflate the economy. While we do not expect inflation in the short run, it is entirely possible that the Fed's actions will produce significant inflation 18 to 24 months from now. Money supply multiplied by the velocity of money (turnover of the money supply during a given year) equals GDP. At the moment, the velocity of money has declined significantly as the pace of commerce has contracted. To counter-act this decline in velocity and the deflation of asset prices, the Federal Reserve is printing money and pumping up the money supply. When economic conditions begin to expand again and money velocity increases back to normal levels, we will be faced with high inflation unless the Fed reduces money supply accordingly. To

accomplish this feat, the Fed may have to put the country back into recession by raising rates to high levels as it was forced to do in the early 1980's. The trajectory our economy and market have taken since 1999 is starting to look a lot like the post 1969 bubble. After a long expansion after World War II, the economy and stock market fell into recession and decline after 1969. The first bear market bottomed in 1970 and recovered for a few years until another more severe bear market and recession set in during 1974. In both the 1970 and 1974 recessions, the government reduced the Fed Funds rate and tried to re-inflate the economy with fiscal stimulus. These actions combined with an oil supply shock ultimately resulted in high inflation during the last half of the 1970's. The Federal Reserve under Chairman Paul Volcker was forced to raise rates to the historically high levels of over 18% from 1980 to 1981 to mop up the excess money supply created during the 1970's and reign in the out of control inflation it created. Unfortunately, this action to counter-act inflation resulted in deep back-to-back double dip recessions in 1980 and 1982. Therefore, based upon history we are concerned about the future inflationary implications of the Fed's actions during the present crisis.

Oil and Energy:

Since our last newsletter, oil has fallen dramatically from a high of \$147 per barrel to just \$42. The decline has been the most violent correction ever for oil and has taken OPEC by surprise. OPEC has forced its members to cut production twice within the last quarter but the decrease in global demand has trumped OPEC's production cuts. We believe this dramatic price decline in the face of OPEC's attempts to stop the decline support the thesis that global economic activity and energy demand are contracting at an alarming pace. Some of the price decline is due to the absence of investor speculation and commercial hedging in the futures market. But our analysis suggests the dramatic price decline in oil is a leading indicator of a severely deteriorating global economic condition. This realization was the reason for our change of direction with regard to investment allocations to Chinese and Latin American equities. Given our forecast for deteriorating economic conditions through 2009, we expect oil to trade in the \$25 to \$50 range during 2009 unless there is a de-stabilizing geopolitical event in the Middle East or Russia.

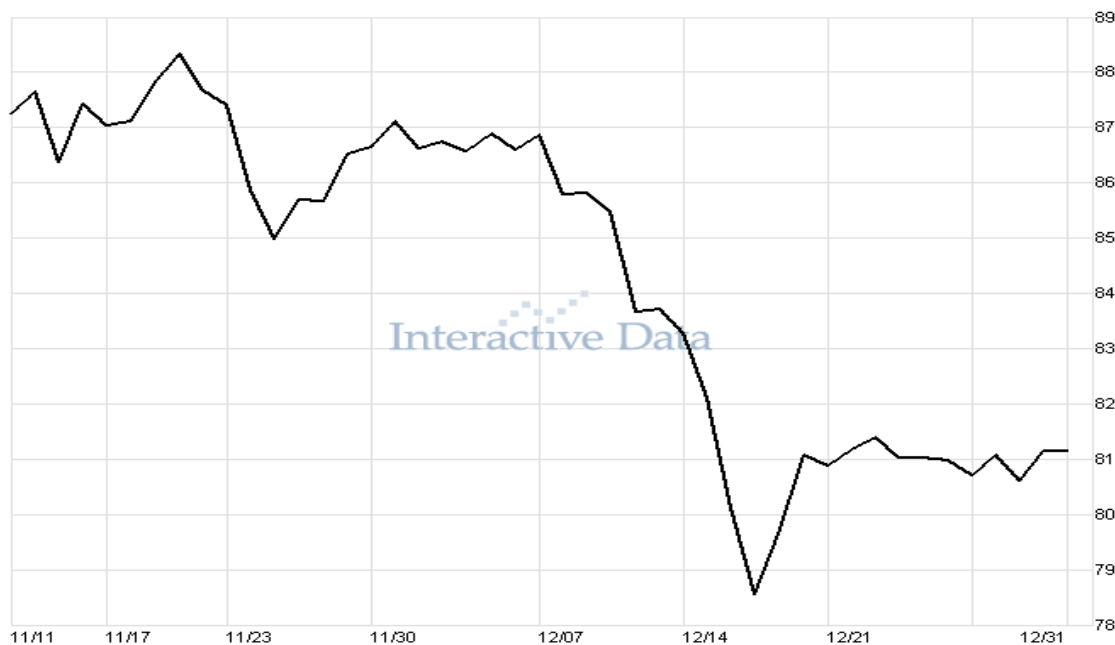


Source: Financial Times, IMF

US Dollar:

The U.S. Dollar has made a surprising recovery during 2008, with the U.S. Dollar Index (as reported in the Wall Street Journal) gaining just over 5.5% during the year. Most of this strength was due to a flight to quality as foreign investors flocked to U.S. Treasuries to escape global stock market turmoil. Now that this flight to quality has largely been completed and U.S. Treasuries have negative inflation adjusted yields, the U.S. dollar is starting to resume its long-term declining trend. If economic recovery does occur and inflation does pick up in the next 18 to 24 months, we expect the dollar to decline at an even faster pace. We will watch this closely and be prepared to move back into a larger gold position when inflation re-appears.

US DOLLAR INDEX n.a. / n.a. / ICE Futures U.S. - RT	81.15 12/31, 22:53:51	+0.70% +0.56	High: 81.76 Low: 80.57
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US Dollar Index, Source: FXSTREET.COM

Inflation Outlook:

We still believe that the slowdown in developed economies will sufficiently moderate consumer price inflation for the rest of 2008 and most of 2009. We have reduced the inflation protection components (*gold and commodities*) in our portfolios due to our belief that this credit crisis will cause a deeper recession in developed economies than we previously thought. These strong deflationary forces should moderate and reduce consumer price inflation as economic activity slows dramatically in the world's largest economies. We will keep a close eye on inflation, but for now our concerns have eased regarding the threat of consumer price inflation. Having said that, we still believe that

when this credit crisis induced economic slowdown passes; the global economy may experience a sharp up-tick in inflation. The huge increase in money supply that is being thrown at this situation will most likely cause inflation and currency devaluation down the road.

Isn't All the Bad News Priced In? Aren't Stock Markets Fairly Valued?

So by now, our readers are probably asking the question: “But isn't all this bad news already factored into stock market valuations and aren't valuations reasonable?” As we discussed earlier, we continue to be bearish on the broad markets and only bullish on the U.S. consumer staples sector. The reason for our bearish posture is our forecast for corporate profit deterioration in the U.S. and Euro-zone during 2009. Even though the S&P 500 trades at around 13 times forward 12 month earnings and this sounds like a reasonable valuation, we have to understand that this is based on a forecast of \$83.44 in operating earnings and \$42.24 in “as reported” earnings in 2009. First we have to understand that operating earnings overstate true earnings by a wide margin because operating earnings exclude re-structuring and so-called “extra-ordinary” charges. This is why there is a 49% gap between estimated 2009 operating and “as reported” earnings. So based upon 2009 expected “as reported” earnings of \$42.24 the S&P 500 is really trading at a forward PE of 21.4. So what is wrong with using operating earnings instead of “as reported” earnings? The Wall Street Journal recently ran an article addressing that question and found that since 1989, U.S. corporations have been increasingly classifying re-occurring expenses as re-structuring and “extra-ordinary” charges each year to make earnings look more attractive. Prior to 1989 there was very little difference between the S&P 500 operating and “as reported” earnings. However, since 1989, operating and “as reported” S&P 500 earnings have continued to diverge to the point where there is now a large gap. This means that S&P 500 earnings are now overstated by 30% to 50% compared to 20 years ago. See chart below:

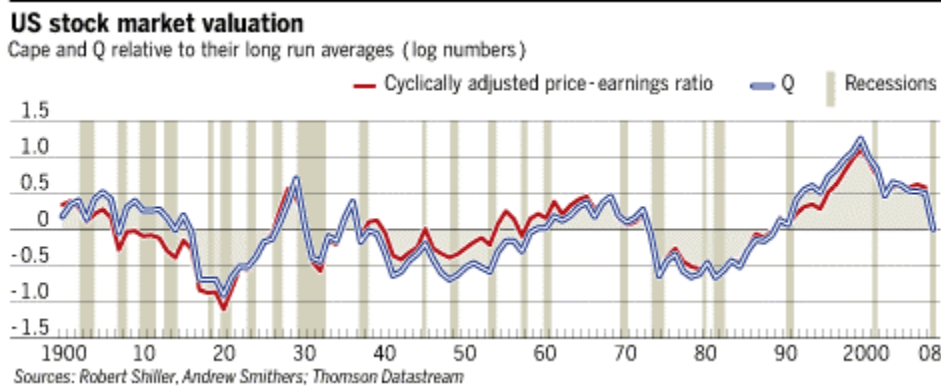


Source: Standard and Poor's and Wall Street Journal

Secondly, with global economic conditions deteriorating rapidly, we believe S&P500 “as reported earnings are likely to be lower than the Standard and Poor's forecast. Already, earnings forecasts from S&P, Thomson, Zacks, and other analysts have proven to be too optimistic for 2008 and we think the same is true for 2009. S&P500 actual “as reported”

earnings were \$66.18 in 2007 when the economy was *growing at a rate of 2%*. Now that we forecast the U.S. economy to *contract by 1.5%* in 2009 how can we possibly expect earnings to only contract 36% from 2007 levels? Already during 2008 earnings have declined 27% from 2007 levels and we expect another 25% decline in 2009. This would bring 2009 expected S&P 500 “as reported” earnings to \$36 per share and so-called “operating” earnings to around \$65. At these earnings levels and a PE of 15, the S&P 500 could trade somewhere between 540 and 900 during 2009. The S&P 500 closed at 903 at the end of 2008.

As far as PE (price earnings) ratios go, it is important to understand that during severe bear markets the PE can and often does trade below the historical average of 15. This is because investors become so risk averse that they are not willing to pay the historical average of \$15 for every \$1 in corporate earnings. The chart below shows the U.S. stock market's CAPE (cyclically adjusted PE ratio) and Q ratio (ratio of the market valuation to net assets at replacement cost). The chart shows that the U.S. stock market has had 4 major bubbles: the 1890's, the 1920's, 1950's/60's, and 1980's/90's. All of these major stock bubbles ended badly with 4 lengthy bear markets from 1906 to 1920, from 1929 to 1954, from 1968 to 1982, and from 2000 to the present. Note a few interesting facts: each post bubble bear market lasted from 14 to 24 years; in each post bubble bear market the Q valuation bottomed somewhere between -1 and -1.5 below long run average and CAPE bottomed between -0.5 and -1 relative to long run average on the chart's log scale. Based on the CAPE in today's market being at its long run average and the Q being at -0.5 relative to its long run average, if history repeats itself we are in for 5 or more years of bear market conditions while the market continues down to a level of -1 to -1.5 CAPE and -0.5 to -1 Q ratio relative to the long run average.



Having said all of this, we must note that it is entirely possible for global governments to increase money supply in an attempt to “re-inflate” asset values and temporarily stop stock markets from bottoming at their reasonable long run valuation levels. We witnessed this in the 1970 bear market as well as the 2001 bear market. In both cases, government intervention with fiscal and monetary stimulus prevented stock markets from falling to reasonable long run average valuation levels. The ultimate result was a brief bull market in stocks that eventually retested and surpassed the previous bear market low. Our belief is that government intervention can only prolong the inevitable reversion to a reasonable long run valuation level. Therefore, we are likely to experience a series of

bubbles and busts until corporate earnings finally rise to a level that can support a reasonable long-term stock market valuation level. This is what happened after the 1906, 1929, and 1968 bull market bubbles. Each one was followed by decades of short-term bull and bear markets until corporate earnings finally caught up to stock market valuations. We continue to see this process playing out in the post-1989 bubble Japanese stock market. After 20 years of fits and starts and multiple bear market rallies the Japanese stock market is 75% below its 1989 level. Japanese corporate earnings are still not back to a level where they can support those 1989 stock market prices.

UUUUUUConclusion:

2008 was a year for cautious and defensive investing. Unfortunately, we expect 2009 to be much of the same. These are very difficult times and we believe that this is not the time to take inordinate risk in the market. For Q1 2009 we will stay defensive with investments in the bond markets, gold, and a small allocation to consumer staples stocks. At Institutional Investment Research, we see many of the world's best institutional investment professionals making defensive moves to protect their clients' portfolios. Our performance (since inception and so far this year) is proving the merit of our investment philosophy. We hope our research will give you peace of mind in this otherwise turbulent and challenging investment environment.

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