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December 2008 Newsletter

November was marked with continued bad news for just about anything that related to money. The economy dropped into what will probably be the deepest recession since the 1930's. Unemployment is up and retail sales are down. The government reported a drop in the CPI, which is usually good news but this time sparked concern about the prospect of deflation. With deflation consumers have an incentive to delay spending to seek better prices, which further depresses the economy. Around the country housing prices continued to drop. Both the stock and the bond markets dropped, although we did not see the panic evident in October. At the end of November we had a 19% five day rally as measured by the S&P 500 (a measure of the stock market based on the performance of 500 widely held common stocks), which erased some of the November losses. The S&P 500 dropped 7.5% in November (down 30% over the last three months) so November brokerage statements will once again provide unpleasant reading.

The government is taking unprecedented action to slow the downward economic spiral and to get the credit markets moving again. The Federal Reserve continues to move into new territory with its initiatives. It is pulling out all the stops. While Citibank grabbed the headlines the real action was in the credit markets. The Federal Reserve broke new ground with commitments to purchase up to \$200 billion in Asset Backed Securities and an additional \$600 billion in government sponsored entities' (Freddie Mae, Fannie Mac, ect.) debt and Mortgage Backed Securities. In response mortgage rates dropped significantly.

President-Elect, Barack Obama is moving with unprecedented speed to put in place his new team and is receiving full cooperation from outgoing President Bush. A large fiscal stimulus package seems assured either to be passed this year or immediately after Obama takes office in January. Going forward we expect the government will have a much larger role in the economy. The partial nationalization of the banking system is the first step. How Washington deals with the auto industry may indicate what to expect for other troubled industries. We expect the government will be successful in ending the downward spiral, but the question is at what cost and when?

Many experts argue the recession will last into the second half of 2009 or perhaps into 2010. We can hope it will end sooner than this. After all, the recession came on us very quickly as consumer sentiment plunged. Perhaps we will be lucky and government policies will work, bolstering improvement in the economy more quickly than most predict.

We continue to believe the world has changed. We have shifted from a long economic expansion driven by excess credit to an economy where available credit is contracting. The consequences of this change are huge as households dramatically change their spending and saving habits. The result is a major recession and deflation. Consumers are likely to struggle to reduce debt and improve their balance sheets. This could continue for a number of years. After all, it took years to get us where we are. Americans are good at adapting and we believe they will adjust to the new world.

We think investment strategies should change too. For example, we believe the importance of bonds has increased. The risk-reward characteristics of bonds have improved dramatically, both because bonds have been hammered and they generally perform favorably in a recessionary/deflationary period; when interest rates drop, bond prices go up. An important question is how fast to adjust portfolios. The markets appear oversold and due for a rally and it could be a big rally, but this has been true for over a month. We will continue to stress diversification, but as we saw in October, even this does not work all of the time.

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