

ECONOMIC AND MARKET OUTLOOK FIRST QUARTER 2009

There is little left to analyze in determining the current state of the domestic economy. The latest data and substantial revisions to earlier data confirm that the United States is in a recession. The National Bureau of Economic Research places the start of the recession as far back as December, 2007. Whether the date is accurate or even meaningful, it is apparent that recessionary conditions lately have taken a turn for the worse. The daily onslaught of financial shocks has dealt a heavy blow to confidence, and no sector of our vast economy is immune to its effects. The United States economy is limping into the New Year under a dark cloud of fear and uncertainty.

The economy is facing multiple challenges. Excesses in housing and the implosion of the mortgage market are the seminal causes of the chain of events which have led to this recession and the loss of confidence in the financial markets. Stabilization of housing in its many underpinnings is necessary for economic recovery to gain traction, in our judgment. The issue is characterized by its perplexity. Nationally, house prices have declined roughly 22% since the peak in mid 2005. Many homeowners owe more on their homes than they are now worth. October and November showed further declines in prices although the rate of deterioration lately appears to be moderating. The inventory of homes available for sale remains elevated, and mortgage terms have been tightened. Foreclosures are still rising.

In spite of the dismal picture we believe the housing market is near a trough. Affordability has improved sharply. The national average mortgage rate in mid December, released by Freddie Mac, was 5.18% down from 6.64% in July. The favorable trend in conventional thirty year fixed rate mortgages has pushed down the share of adjustable rate mortgages sharply. New home construction has also been scaled back dramatically. New starts in November were 50% lower than the peak rate of new house construction reached in mid 2005. Sales appear to be improving in certain sections of the country which have been particularly hard hit, and low interest rates are allowing some homeowners to refinance at favorable rates. Demographics also favor a return to a healthy housing market once confidence returns.

Increased affordability alone, however, will not cure housing market ills as long as people remain concerned about losing their jobs. The last three months has seen a steady increase in job losses and a rise in the unemployment rate to 6.7%. Moreover, the near term trend is discouraging. The four week moving average of initial jobless claims, a widely followed statistic, points to higher job losses in the months immediately ahead. Unemployment reached 7.8% in the last recession and could exceed that level this time around. We do not look for improvement until late spring or early summer. Consumer spending will also remain depressed by the tremendous declines in overall personal wealth resulting from the turmoil in the credit markets. For most people houses represent their most significant asset. Stock market losses in 2008 add to the sense of insecurity and alarm

as people become more aware of the extent of these realities. Consumers are reacting to the destruction of wealth by cutting back. For the first time ever total consumer debt declined in the third quarter and is likely to decline further in the fourth quarter. Paying down debt has replaced aggressive use of debt in this cycle. The domestic economy is entering a new phase where deleveraging is replacing debt for growth as well as speculative purposes. We view the trend positively for our future economic health.

The good news is that the decline in energy prices is producing an economic tailwind at a critical juncture. Consumers are receiving the economic equivalent of a large tax cut while the Federal Reserve is set free from any inflation fighting constraints, at least for 2009. From a peak of \$4.17 per gallon in July gasoline prices currently hover around \$1.75 per gallon. Similar declines have been experienced by other commodities. Deutsche Bank economists estimate that each \$1 dollar change in retail gasoline prices is the equivalent of \$100 billion change in household cash flow on an annual basis. Assuming inflation remains down in 2009, as appears likely, a similar benefit will accrue to manufacturers. We foresee a reasonable chance of the manufacturing sector reaching stability by mid year as input costs decline and other costs are kept under strict control. Profit margins will improve thereafter.

We view 2009 as a transition year. Following quickly on the seizure of Fannie Mae and Freddie Mac, the collapse of Lehman was a watershed event which caused a complete halt to business activity in the fourth quarter. In this respect the reaction was similar to that of September 11, 2001, when businesses were paralyzed by shock and fear. This phase is passing and the country is now actively engaging its problems. Aggressive fiscal and monetary stimulus has been put in place. While frustration in the slowness of the recovery is evident in some quarters, the fact remains that the Treasury and Federal Reserve addressed the problems early and deeply. Financial institutions now are awash with cash. Credit markets are slowly beginning to open again. The slow improvement in the commercial paper market is an early sign of this. Volatility as measured by the VIX Index has improved somewhat in December from the elevated level of October and November. We are also on the threshold of a new Administration which will bring major new spending initiatives of its own to government policy. Changes in taxes and trade policy are likely to be slow to materialize in our opinion. The realities of governing in "real time" will trump personal preferences and campaign rhetoric. The fact is that a severe cyclical slump is already discounted. Given that the overhang of housing inventory and price weakness will linger a while longer, we expect recovery to be slow. Economic recovery, however, is not a single event in time but a series of small improvements spreading across sectors. Such a process is very likely to be visible by mid 2009.

**Investment Policy Committee
Alfred A. Lagan, CFA, Chairman
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December 29, 2008**

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