

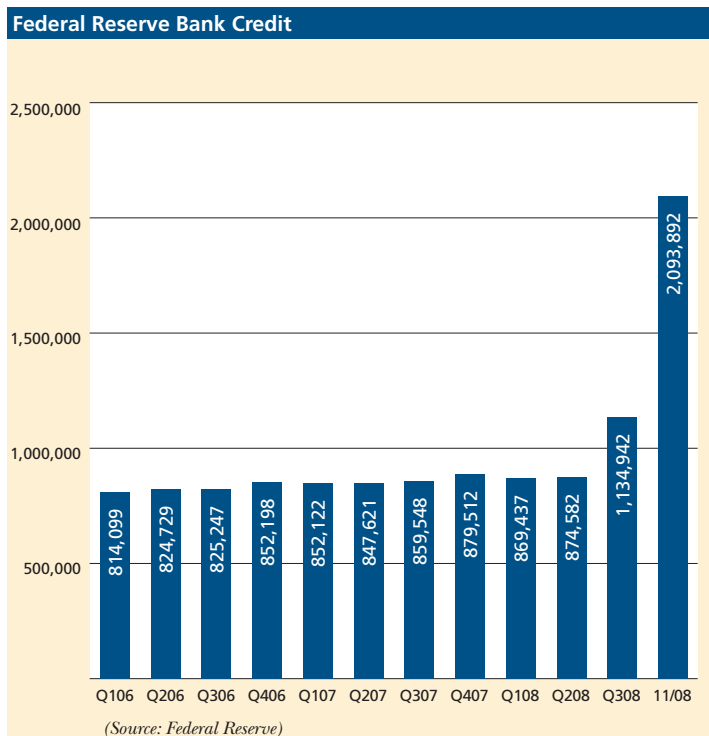
## The Printing Press is Rolling

By Mark Luschini, Chief Investment Strategist



On November 25th, the Federal Reserve announced the creation of the Term Asset-Backed Securities Loan Facility (TALF), which will lend up to \$200 billion to holders of AAA-rated asset backed securities, collateralized by newly and recently originated consumer and small business loans. By funding the purchase of these securities, the Fed is hoping to generate price discovery for these assets (which are opaque at the moment), pushing prices higher and restoring a healthy level of trading liquidity. In addition, the Fed will purchase up to \$100 billion in GSE or government-sponsored entity debt (generally speaking, the corporate bonds of Fannie Mae and Freddie Mac), and up to \$500 billion in GSE-backed mortgage securities.

With the Fed having lowered its overnight lending rate, known as the fed funds rate, to 1%, there is little room left to stimulate the economy through this more conventional tool. Therefore, the Fed must increasingly turn to unorthodox monetary policy measures to provide support and, hopefully, revive the weak economy and struggling financial markets. Between lending cash to entities that cannot expand credit facilities due to the clog in the securitization market and the direct purchase of private sector assets to bypass the banking system that has been reluctant to lend, it appears this is largely being financed by the government "printing money." And, perhaps, while it is true that the Fed is doing "whatever it takes" to drive liquidity into the system and yields lower (particularly on mortgage backed securities), it is held by many that this is not the time for the central bank to be shy about expanding its repertoire in an all-out effort to resuscitate economic activity.



The Fed's balance sheet has grown and changed tremendously over just the past few months by intruding more deeply into the credit markets in an effort to unblock the system. There is some concern that the Fed is moving in uncharted territory; and the implications related to the economic and financial markets—while hopefully successful in ending the credit crisis—are largely unknown.

Prior to this year, credit from the Fed grew at a pace very close to the growth in the real economy. The Fed would act to add or drain reserves from the system (normally by buying or selling Treasury securities) to keep the fed funds rate at its desired target level. Recently, however, the total amount of credit has increased to \$2.2 trillion (from 6% of Gross Domestic Product [GDP] in August to 15% in November) as the Fed expanded various liquidity facilities in an attempt to preserve the normal functioning of the financial sector. The first of these was the Term Auction Facility (TAF) in December 2007. Since then, notable increases to the Fed's balance sheet include the expansion of credit facilities for broker/dealers; ad hoc measures for Bear Stearns, AIG and money market funds; the commercial paper funding facility; and the Troubled Asset Relief Fund (TARP), which has injected billions of dollars into more than two dozen financial institutions and others, including, possibly, the

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Big Three auto companies. A huge increase in assets on the Fed's balance sheet is also attributed to the currency swap lines the Fed has in place with 14 foreign banks to help satisfy strong demand for dollar-based funding by banks outside of the United States.

Without directly saying as much, the Fed effectively began quantitative easing following the collapse of Lehman Brothers. The textbook definition of quantitative easing is when the central bank aggressively injects reserves into the banking system and drives down its policy rate to very low levels. In other words, the central bank "floods the system," targeting a level of reserves, or cash equivalents, in the system rather than focusing on a policy rate. With last week's announcement of the TALF, it appears this quantitative easing is continuing at an aggressive pace.

The term "printing money" is a charged phrase, because it creates worries of inflation. If the surge in reserves encourages banks to increase lending, then that concern might ultimately hold. However, at the moment, banks are mostly unwilling to boost lending. That is why the direct purchase of mortgage backed securities and GSE debt under TALF is so important. There is little hope of an economic recovery when the cost of borrowing is prohibitively high. This not only holds true for consumers but for business activities as well. Therefore, the Fed could expand this program to corporate bonds if yields in that market remain stubbornly high. In either case, the ability to direct target lower private sector borrowing rates is an important tool for supporting spending and lifting economic activity.

There is no limit to the size of the Fed's balance sheet. Through the Fed's ability to create reserves and print money, it can buy as many assets as it wants to get the job done. A sign that the Fed's efforts are succeeding will come in the form of a sustained decline in non-government bond yields, most importantly mortgage rates and corporate debt. Another will be an increase in the velocity of money, or—said another way—the pace at which money is moving through the system. The solution to stimulate growth beyond which even these unorthodox monetary measures can accomplish may ultimately come from fiscal policy; but talk of a stimulus package is still forming and is likely still a few months away.



## Stock Market Commentary

By Gregory M. Drahuschak, Vice President

Investors had little to be thankful for heading into Thanksgiving week, but the market's deeply oversold condition prompted traders to venture forcefully onto the buy side in the final trading sessions of the month.

Prior to Thanksgiving week, the S&P 500 was on track to post its worst November results in the last 59 years. The final-week rally pushed this November down the list of dubious results to end the month as the fourth worst. Previous Novembers were worst than this year only in 1973 (-11.39%), 1987 (-8.51%) and 2000 (-8.01%).

Volatility was the order of the day almost everyday last month. According to Standard & Poor's, November had eight days of five percent movements (5 up, 3 down) and only four days of less than 1% (3 up, 1 down). There have been 16 days of five percent movements this year. The average daily movement from 1928 is 0.75% (up 0.74% for the 52.9% positive days and -0.78% for the 47.1% negative days). The daily high/low spread for November was the second largest, at 5.43%, with the largest being October at 6.92% compared with the average from 1962 of 1.48%.

December for the stock market perennially is a month when investors look forward to an upwardly biased market. Historically their enthusiasm is justified.

Since 1950 the S&P 500 December's average 1.61 percent gain is the best average result of all months of the year. At 74.14 percent, December also has had the highest probability of producing a gain.

The only down Decembers from 1950 through 2007 are listed in the following table.

Year	% Change	Year	% Change	Year	% Change
2002	-6.03%	1986	-2.83%	1983	-0.87%
1968	-4.16%	1996	-2.15%	2007	-0.86%
1980	-3.39%	1969	-1.87%	1961	-0.32%
1957	-3.31%	1974	-1.78%	1966	-0.15%
1981	-3.01%	1975	-1.15%	2005	-0.10%

These down December, however, were easily offset by stellar results in other years. The best ten Decembers include the following:

Year	% Change	Year	% Change
1991	11.19%	1970	5.68%
1971	8.62%	1998	5.64%
1987	7.28%	1976	5.25%
1954	5.85%	1960	5.08%
1999	5.78%	2003	5.08%

The stock market's monthly history is interesting but perhaps only from an academic standpoint. After being battered for most of this year and specifically the last few months, investors are only interested in the here and now.

Leading into the Thanksgiving week rally, nearly all technical measures were at severe extremes that often ignite a rally. And what a rally it was.

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From its November 21 intraday low, the S&P 500 rallied 20.95 percent to a peak the Friday after Thanksgiving. The National Bureau of Economic Research's formal declaration that a recession began in December of 2007, however, blunted the upside the first day of this month.

As we enter this December our focus is on what we suspect will necessitate a multi-pronged approach to the market in order to maximize potential return, maintain a cautious near-term allocation and build the foundation for longer-term success.

The first step for long-term investors is to determine which currently-owned stocks they want to retain as the base of a long-term investment portfolio. The process of determine which equities fit into this base should be able to withstand a strenuous fundamental examination. They also should be stocks that will be held regardless of interim market movement. Current dividend yield should be considered but the ability to raise the dividend periodically also should be a key consideration.

This process could mean that some stocks should be sold if they do not meet stringent fundamental characteristics.

Successful market participation going forward is likely to require more active portfolio management. This does not mean trading stocks aggressively, but it does include being willing to pare holdings during periods of market upside and add positions on market pullbacks.

For some investors this might not appear to suggest managing a portfolio any differently than has been done in the past. For many others, however, moving to more active management instead of merely buying and holding positions may not be comfortable. For these investors, using a money manager that practices more active management might be an appropriate alternative to a do-it-yourself process.

In our view the likelihood of the market remaining in a trading range is high. The range might be relatively wide, however, which suggests the potential to benefit from consequential interim market swings instead of relying totally on a buy and hold approach that could result in mediocre returns. Scale buying and selling into pullbacks or rallies is one way to avoid precise timing while allowing portfolios to participate in the major part of a move.

This does not mean that timing should be the sole determinant of what to buy or when to buy it. Many sectors and individual stocks go through cycles that do not require precise timing in order to benefit from the price changes.

On a very short-term basis, the massive volatility experienced lately has not altered the fact that the market appears to be in the process of building a base for a trading rally that would be much more consequential than the upswing during the last week of November.

In keeping with the concept of active management, we would look for the rally to offer a chance to pare the most questionable portfolio positions and lower exposure to the most economically sensitive stocks.

## Auto Sales as a Barometer

By Guy LeBas, Vice President



Economic data released over the course of the last month ran the gamut of bad to worse, as sign after sign appeared that economic performance is in for an extended slump. One piece of data that we view as a major signpost for consumer strength—or lack thereof—is total vehicle sales. Given the systemic importance of the auto industry to the American economy, auto sales not only provide a key barometer of consumer spending, they also provide evidence of the deepening problems facing the manufacturing sector as a whole.

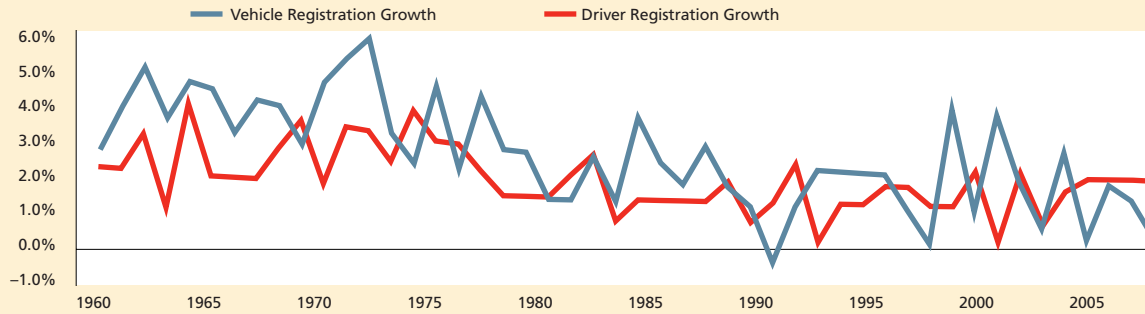
Total vehicle sales for the month of October slid to far below replacement levels to a 10.6 million annual pace, as all manufacturers posted twenty-plus percent year-over-year declines for the month. The October decline in the auto sales market was the lowest level of vehicles sold since April 1991 and, if sustained, would mark the weakest period of sales since the 1980 – 1983 era. According to comments from General Motors executives during a monthly update call, overall industry sales, when adjusted for population growth, proved the weakest they've been since World War II, when a significant portion of original equipment manufacturer (OEM) production was devoted towards supplying the military.

While automobile purchases represent a relatively limited portion of the average consumer's annual budget, the growth in vehicles on the road has been a remarkably consistent phenomenon that's been in place for nearly a century. Data going back to the first half of the twentieth century is challenging to find; but Wards Automotive noted in a press release that the only period in which the U.S. economy experienced an outright decline in the total number of vehicles on the road during an economic downturn was from 1930 to 1940. Meanwhile, even that period saw a growth in vehicle populations in 7 out of the 11 calendar years.

From 1960 to today, a 47 year period in which the number of vehicles grew by an annual average 2.57% rate, there has only been one year—1991—in which total vehicles on the road posted a net decline—and that was only of 0.53%. Estimating whether the motor vehicle population is growing or shrinking is a complex exercise; but it appears that auto sales of around 12.7 million units is roughly equivalent to the domestic replacement rate. The National Auto Dealer Association estimates this rate based on a number of factors, primarily through a combination of sampling techniques and Highway Administration data on the average age of vehicles on the road. Thus far, in 2008, auto sales from all manufacturers have paced a rate of 13.7 million; but given the current slowing pace of sales, we anticipate that 2008 vehicle sales will total approximately 13.1 – 13.5 million, perilously close to the 12.7 million replacement rate. In that light, even if the 2008 change in vehicle

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## U.S. Vehicle vs. Driver Registration Growth



(Source: U.S. Department of Transportation, Federal Highway Administration, Highway Statistics 2003.)

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population remains positive, after a year-to-date 34.5% decline in the pace of sales, we're seriously contemplating a 2009 in which vehicle populations decline for only the second year since the Great Depression.

As we noted, vehicle expenditures represent a relatively limited portion of consumer spending. Their long-term stability suggests that consumer balance sheets and the potential for consumer spending to recover are even weaker than what numerous other (also pessimistic) indicators suggest. Even so, there's a unique aspect of the auto sector, one that's developed more acutely in the past quarter-century or so, that makes sales a less-compelling indicator of consumer activity in this environment. That aspect happens to be financing.

While autos are typically counted as a big-ticket consumer durable good, they're a big-ticket item that typically requires some form of financing, be it a loan or a lease. While auto loans have generally experienced better performance than either mortgage or credit card lending amid the ongoing consumer lending and subprime concerns, worries from the captive auto finance companies that further weakness will emerge has largely shut off financing options for all but the very highest quality borrowers. Even those loans are tough to fund, with the captive finance firms unable to borrow in the capital markets. Moreover, losses on lease residuals as used SUV values fell far short of forecasts have put further pressure on the finance companies, which responded by sharply curtailing or eliminating lease business at, what we'd argue, is precisely the wrong time.

Recent moves by the Federal Reserve to shore up the commercial paper markets should ease some of the auto finance tensions; but lending hesitancy and lease restrictions are likely to remain in place for an extended period. In a manner of speaking, the auto finance companies have managed to raise the effective price on new vehicles at the same time that consumer weakness is negatively impacting demand – not exactly a sensible strategy; but, because of the requirement for financing, one without an alternative.

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