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## INVESTMENT MANAGEMENT, INC.

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## YEAR END REVIEW

### 2008

Dear Friends:

The credit markets led stocks and then economies down in 2008 on a world wide scale not seen in several decades. Problems with defaults, counter party risk, plunging prices of asset backed securities caused liquidity to dry up worldwide forcing a brutal whirlwind of forced deleveraging and market declines. Stocks on a global basis, as measured by the Morgan Stanley MSCI Index, lost 42% erasing more than \$29 Trillion of value and all of the gains made since 2003. The Federal Reserve cut its key interest rate 7 times in 2008 from 4.25% at the start of the year to its December range (a totally new approach) of .25 % to zero, a historic low. The December job report showed a loss of 524,000 jobs, the 12<sup>th</sup> consecutive monthly drop and put the 2008 job lost total at 2.5 million jobs, the largest annual loss since 1945 with unemployment rising to 7.2%, a level not seen since 1990. Many asset backed and corporate bonds sank to new lows and yields soared. The Corporate Junk Bond market declined 26% its worst year in history. Investment Grade Bonds were down 7% and long term municipals were down 4%.

In 2008 every category of stock funds tracked by Morningstar was down, with loses ranging from 23% to 58%. General Bond Funds were down 7% and Government Bond funds down 2%. Morningstar also reported that the average national intermediate term municipal bond fund was down 2.4%. Only U.S. Treasuries, agencies and high grade short term municipals had positive returns for the year.

It is difficult to comprehend the magnitude of the wealth that has been destroyed by the decline in the real estate and securities markets the last 18 months. Although estimates vary, the number always ends with a "Trillion". The Federal Reserve estimates that the number at year end was \$6.9 Trillion.

In preparing for this year's "Year End Letter" I struggled for several days on how to organize and review the events of a year that has not been rivaled since the Great Depression in 1931. In the end, I decided to offer a timeline and let the reader prioritize the events. The exercise of putting this year's significant headlines on paper was quite sobering. Any of the events in 2008 alone could have been a leading annual headline in years and decades past. Never has so much fundamental change occurred in such a compressed time frame.

## **The Year that Was**

<b>January</b>	DJIA Opens at 13,265 Countrywide Financial fails and is bought by Bank of America
<b>February</b>	Auction Rates Security Market collapses
<b>March</b>	85 year old Bear Stearns collapses and is bought by JP Morgan for \$236m An amount not quite as big as the new contract for New York Yankees Alex Rodriguez Gold closes above \$1000/ oz New York Governor Spitzer resigns over a sex scandal
<b>April</b>	Q1 is worst in 5 ½ years with DJIA down 7.6% New home sales slide 8.5% in March to the lowest rate since 1991
<b>May</b>	Fed cuts Funds rate to 2%, the seventh cut in eight months Consumer Sentiment Indicator hits 28 year low
<b>June</b>	Commodity grain prices hit all time highs Gas tops \$4.00/gal Bond Insurers AMBAC and MBIA lose AAA BOND rating Senator Obama gains control of Democratic Presidential Nomination
<b>July</b>	DJIA ends second quarter down another 7.4% IndyMac Bank seized by the Fed, Largest bank failure in U.S. History
<b>September.....</b>	<b>The month that changed Wall Street for a Generation</b>
8 <sup>th</sup>	Fed seizes Fannie Mae and Freddie Mac
15 <sup>th</sup>	Merrill Lynch after 94 years is cornered into a sale to Bank of America
16 <sup>th</sup>	Lehman Brothers files chapter 11
17 <sup>th</sup>	Government seizes AIG and injects \$123 Billion
18 <sup>th</sup>	Reserve Primary Money Fund, oldest money market fund in U.S., “Breaks the Buck”
22 <sup>nd</sup>	Goldman Sachs and Morgan Stanley convert to bank holding companies The end of all five of the US largest Investment Banks
26 <sup>th</sup>	Washington Mutual seized by Fed Government, “New” largest U.S. bank failure
30 <sup>th</sup>	U.S. House of representatives defeats \$700 Billion dollar rescue package DJIA drops 777 points (7%), largest one day point decline in history. Wachovia securities agrees to Citigroup takeover
<b>October.....</b>	<b>Records that Redefine Volatility</b>
10 <sup>th</sup>	DJIA drops 678 points (7.3%), another record.
11 <sup>th</sup>	DJIA falls 20% in 7 trading days. Worst week in 112 year History
14 <sup>th</sup>	Market surges 936 points (11%) Largest one day point gain in history
22 <sup>nd</sup>	Fed announces \$540 billion support package for Money Market Funds
29 <sup>th</sup>	DJIA surges 889 points or 10.9%, second largest point gain in history Crude oil falls to \$74, down 33% in one month, a record decline and off 50% since record highs in July
31 <sup>st</sup>	Markets closes down 14% for the month

## November

- 4<sup>th</sup> U.S. October auto sales plunge 32%, lowest monthly level since 1991
- 5<sup>th</sup> Barack Obama is elected the first African-American U.S. President
- 6<sup>th</sup> Stocks take a 929 point two day decline down over 10%
- 8<sup>th</sup> U.S. Home prices fall 18% year over year in October, steepest drop in 20 years. U.S. unemployment reaches 14 year high in October at 6.5%
- 19<sup>th</sup> Detroit auto executives appeal to Congress for a bailout
- 20<sup>th</sup> October Consumer prices register largest monthly decline since WWII  
DJIA closes at 7552
- 24<sup>th</sup> Government injects \$20 billion into Citigroup and guarantees \$300 billion of it's debt.
- 26<sup>th</sup> U.S. announces plan to purchase additional \$800 billion of mortgage backed securities and consumer loans from banking institutions  
The DJIA has moved up or down triple digits 41 of the last 49 trading sessions

## December

- 5<sup>th</sup> The U.S. loses over a ½ million jobs in November, worst month in 34 years.  
Unemployment at 6.7% a fifteen year high
- 10<sup>th</sup> Treasury sells 4 week T-Bills at 0% for the first time in History  
Illinois Governor Ron Blagojevich is arrested for allegedly trying to sell Senator Obama's vacant Senate seat.
- 12<sup>th</sup> Bernard Madoff arrested in NYC in \$50 Billion Ponzi scheme.
- 17<sup>th</sup> Fed cuts Funds rate to 0%
- 20<sup>th</sup> White House agrees to \$17.4 Billion loan package to GM and Chrysler
- 31<sup>st</sup> The DJIA closes at 8776 down 4488 points or 33.8% for the year. It was the largest decline since 1931. The S&P 500 was down 38.5%, the NASDAQ 40.5% and the Dow Jones World Index down 46% and the Dow Jones Commodity Index was down 37%. According to Lipper Financial more than 60% of U.S. Equity Funds in 2008 were down more than the S&P 500.

Deleveraging and liquidation sales pounded the markets in the fall and by year end the failure of Bear Stearns and the collapse of the auction rate securities markets in the spring, seem like a distant past. By the end of 2008 the U.S. Government had committed nearly \$9 trillion dollars to rescue Wall Street and the financial industry and owned preferred stock in 206 U.S. banking institutions.

As we move into 2009 with the bursting of the mortgage bubble behind us and the consequences before us, we may be facing another bubble. The bubble of 2009 may very well be the safe haven that attracted investors all of 2008, U.S. Treasuries. Yields on U.S. Treasuries have sank to the lowest levels since the 1940's. With all of the turmoil in the credit markets the last 18 months investors have become more and more concerned with safety. Institutional investors fearing the global economic downturn and seeking to window dress year end balance sheets drove short term T-Bill rates to zero by December. With the Federal Reserve having the authorization to purchase upwards to \$600 billion of mortgage backed securities in the open market, the yield on the benchmark 10 year Treasury has gone from 3.85% in mid November to 2.40% by year end. The 30 year U.S. Treasury Bond yield has gone from 4.35% to 2.82% yield during the same time period.

The next 12 months is going to bring significant focus on the growing budget problems facing many of the state and local municipalities across the nation. Although since WWII the number of defaults of municipal bonds rated A or better has been less than 1/10 of one percent, a disciplined investment process and professional security selection in this difficult financial environment will be critical to a successful portfolio in 2009. In the months ahead the new administration's stimulus plan will bring additional Federal Reserve liquidity, job programs and a barrage of assistance to state and local governments. With U.S. Treasury yields at historic lows, municipal yields at historic relative highs and the impact of fiscal stimulus, past and future, still to be fully executed, 2009 is going to be a very pivotal year. Headline risk will continue to rock the markets and the size, structure and execution of this program will ultimately determine its success and market impact. Understanding underlying credit worthiness in this volatile market is extremely important.

The percentage yield ratio of high quality municipal bonds versus like maturity U.S. Treasuries is at historic highs. Municipal bonds are cheaper today versus Treasuries than any average annual level going back 100 years. Yields are 150-200% of like maturity Treasuries versus 115-150% during the Depression Era 1929-34.

MPI fixed income accounts both taxable and tax free had positive returns for 2008. This was attributed to MPI's consistent high quality short/intermediate maturity investment style. MPI bond accounts generally have a average maturity of approximately 4 years. Taxable accounts have rotated out of straight US treasuries, whose yields have significantly declined the last several months and are positioned primarily in agencies and modest allocations to GNMA's and TIPs. Tax free portfolios are concentrating on highly rated essential service and pre refunded issues.

According to Lipper, bond funds in 2008 had the following average performance.

<b>U.S. Government</b>		<b>Municipal</b>	
Short Term	+4.1%	Short Term	unchanged
Intermediate	-.01%	Intermediate	-1.3%
Long	+9.3%	Long	-9.45%

As with most equity mutual funds and individual portfolios in 2008, MPI's Equity accounts declined with the market averages during the year. Heading into the New Year, we remain well diversified with strategic allocations to high quality companies and funds in the Small Cap, Large Cap, International and Natural Resources sectors. We continue to add to high quality positions emphasizing growth and above average dividend yields. While no equity sector was immune from the de-leveraging and extreme market volatility last year, our accounts are well positioned to participate in a market recovery during 2009.

The recession is now a year old and if analysts are right it could match or exceed the severe 1973-75 and 1981-82 downturns in length and in depth. Those two slumps lasted an average of 16 months with peak to trough declines in real GDP of 3.1 and 2.6% respectfully. For the first time since 1957 the dividend yield on the S&P 500 (3.2% 12-31-08) exceeds the yield on the 10 year U.S. TSY (2.2% 12-31-08). Bloomberg reported at the end of November Americans had \$8.85 Trillion in cash and equivalents which is equal to 70% of the market value of the S&P and the highest levels since 1990. This significant cash on the sidelines will at some point fuel a recovery. According to Financial Planning Magazine, prior to 2008 and since 1950 there have been 12 down markets. The average peak to trough decline was 28.5% and the average recovery from the bottom was 14 months. This bear market has obviously exceeded those averages. There are several positive statistics that suggest the start of a recovery could begin later this year. In the end only the return of investor confidence will drive the timing and the magnitude of a recovery.

In 2009 fixed income markets will require careful asset allocation, security selection and duration management. The municipal market offers attractive values and will require diligent credit and structure analysis. With Fed Rates at historical lows there is only one direction for them to go. When and at what velocity is the question. As always, MPI fixed income portfolios remain high quality, short duration and focused to protect clients in an extremely volatile market place.

As MPI enters its 23d year in business, Brad, Matt and I are proud of our 2008 performance and we look forward to serving our clients, old and new, in the year ahead. Have a prosperous 2009 and as always please feel free to contact us at anytime.

Best Regards

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