Economic Conditions & Policy Response: Impact on Business & Capital Markets

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Discussion Topics

- How did we get here?
- Economic repercussions
- Policy response
- Impact on business & capital markets
- Implications for investment policy
- Investment outlook

How Did We Get Here?

- Excesses in housing market
- People borrowed more than they could afford to repay
- Easy money – lenders willing to lend without regard to ability to repay
- Securitization of mortgages
- Leverage added by Wall Street

Lehman Bankruptcy – Key Event

- Catalyst for massive cycle of loss recognition
- Credit contracted, even for most creditworthy borrowers
- “Too big to fail” no longer valid
- Government stance changed from BS, AIG, FRE, FNMA
- Hedge funds forced to de-leverage

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Economic Conditions Deteriorate Rapidly

- GDP
- Auto sales
- Housing/construction
- Manufacturing/capacity utilization
- Consumer confidence
- Unemployment

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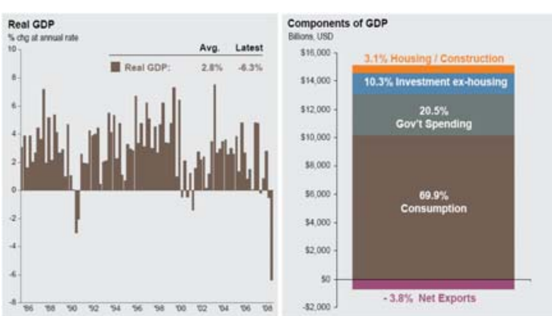
Economic Growth & Composition of GDP



Source: BEA, JPMorgan Asset Management

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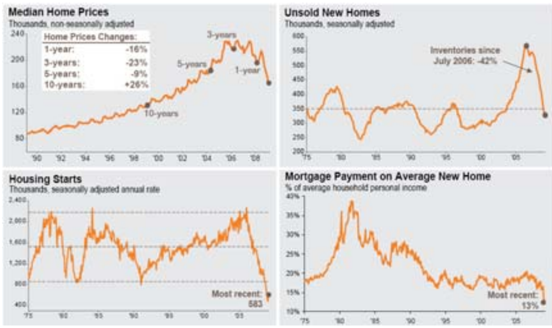
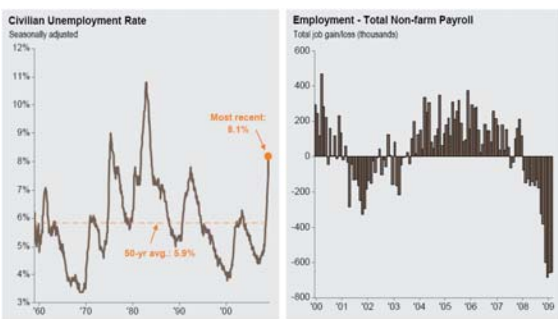
Aftermath of Housing Bubble



Source: Census Bureau, FactSet, EcoWin, Federal Reserve Board, BEA, JPMorgan Asset Management

Employment



Source: BLS, JPMorgan Asset Management

But this is not "Great Depression…"

- *Unemployment* - 8.50% now vs. 25% then
- *Decline in GDP* - 6.30% now vs. 30% then
- *Failed banks* - < 50 now vs. thousands then
- *Depositor protection* - $250,000 now vs. none then
- *Monetary/Fiscal Stimulus* - Massive amounts now vs. none for four years

This recession looks much like those in 1973-1974 & 1981-1982 in terms of economic statistics & stock market consequences

Recessions and Market Returns

Year	Length (months)	Return: During Recession	Return: 6-mo's After
1948	11	3.9%	12.2%
1953	10	18.3%	16.4%
1957	8	-7.6%	20.4%
1960	10	11.6%	9.0%
1969	11	-7.5%	20.6%
1973	16	-17.9%	1.1%
1980	6	8.1%	8.2%
1981	16	7.0%	18.8%
1990	8	3.4%	4.0%
2001	8	-4.7%	-4.5%
AVG	**10**	**1.4%**	**10.6%**

Source: NBER, Standard & Poor's, JPMorgan Asset Management

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Policy Response Has Been Aggressive

- First round of action targeted toward stabilizing financial system & restoring confidence in future of our economy
- Second round intended to revive economic growth & employment conditions

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Policy Response Has Been Aggressive

- Federal Reserve
  - Fed Funds Rate reduced to near 0%
  - Direct intervention in commercial paper, mortgage & now Treasury markets
- U.S. Treasury
  - TARP provides capital to banks & others
  - Public/private partnership to clear toxic assets

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Policy Response Has Been Aggressive

- Obama Administration
  - Stimulus package worth nearly $800 billion
  - Tax cuts for middle class
  - New spending (public works, health care, etc.)
  - Velocity of money
    - ✓ Consumer savings rate is increasing
    - ✓ Healthy but detracts from economic growth
    - ✓ Government spending replaces consumer spending

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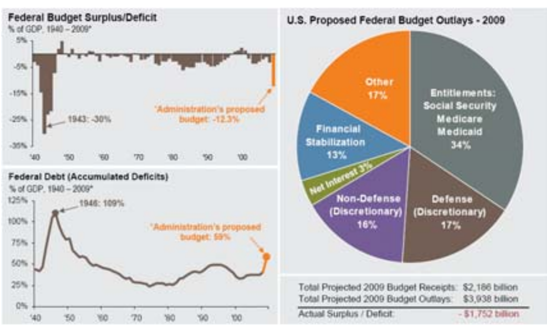
Federal Finances



Source: Congressional Budget Office, St. Louis Fed, Bureau of Economic Analysis, Office of Management & Budget, JPMorgan Management

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Potential Tax Implications

- Large & increasing Federal deficit make tax increases more likely
  - Potential increase in marginal tax rates for more affluent individuals
  - Possible changes to favorable dividend & capital gain tax rates
  - Changes to estate tax exemption/rates?

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Opportunities to Manage Taxes

- Capture unrealized losses today to provide offset to future realized capital gains
- Choose replacement investments that are tax efficient, or funds with embedded unrealized losses
- Tax-free municipal bonds offer attractive relative yields
  - 3.30% AAA 10-year Muni = 5.08% T/E (115% of taxable Treasury yield)
  - 4.00% AA Muni = 6.15% T/E
- Future economic value of these strategies may be enhanced if tax rates rise

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Impact on Business

- More difficult borrowing terms
  - Credit spreads have widened in corporate bond market
  - Tighter credit standards now for businesses of all sizes
  - Conditions affect not only ***ability*** to borrow, but ***willingness*** to borrow

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Impact on Business

- Lower demand for goods & services
  - Across most sectors/industries
  - Inventory adjusts to lower demand levels
  - Rebound likely to be slower without "easy money"
- Fewer transactions: Real Estate, M&A, etc.
- Necessitates productivity improvements, doing more with less
- Increasing instances of fraud/theft by employees

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Investment Outlook

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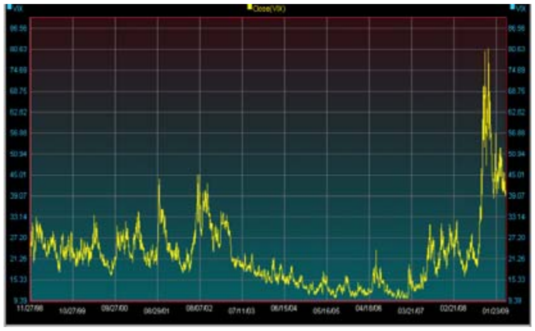
Returns through April 30, 2009

Index	2009 YTD	2008
S&P 500	-2.49%	-37.00%
S&P Mid-Cap 400	4.93%	-36.23%
Russell 2000	-1.81%	-33.79%
MSCI EAFE	-2.92%	-43.38%
MSCI Emerging Markets	16.87%	-54.48%

Source: Morningstar, Standard & Poor's

S&P 500 – 10 Year Price Chart

Volatility Remains Elevated – CBOE Volatility Index

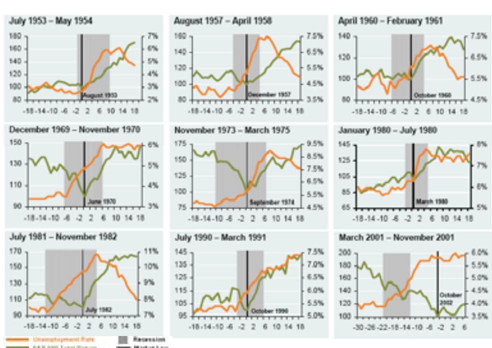


Source: Reuter's

Some Economic Indicators Are Improving…

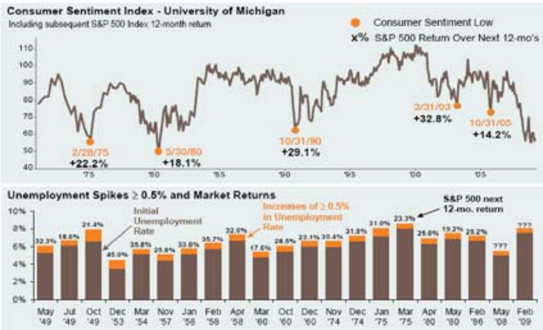
- Consumer spending up
- Housing inventory has declined, affordability up on lower prices & interest rates
- Durable goods orders increased
- Big banks had profitable 1Q 2009

Market Inflection Points, Recessions & Unemployment Rate



Source: Ibbotson, JPMorgan Asset Management, Bureau of Labor Statistics

Lagging Economic Indicators



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Have We Seen Final Lows of This Bear Market Cycle?

- To date March 9 represents lows for this cycle
- As of that day, S&P 500 was off 25% YTD and at levels not seen since 1997
- Market has risen over 30% since then
- 1Q earnings season better than expected
- A retest of the lows is unlikely, barring any new surprises from the financial sector

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Pre-conditions for Improved Investment Outlook

- Global stock valuations are at their most attractive levels in 25 years
- Cash balances are at record high levels
- Credit conditions have improved
- Consumer & investor sentiment are near all-time lows, a great “contrarian” indicator

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Return Expectations

- Dividend yields > 3% for U.S. stocks, >4% for International stocks currently
- Valuations are at 25-year lows, enhancing potential for capital appreciation as earnings normalize
- Credit spreads in bond market are near all-time wide levels, meaning more return per unit of risk
- After large asset price declines, risk/reward is more favorable to investors

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Return Expectations

- Trailing 10-year returns for U.S. stocks through 3/31/09 are negative
- History would indicate that higher than normal future returns should be expected
- We expect returns to be average to above over next cycle

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Implications for Investment Policy

- Regularly reviewing investment policy for fit to financial objectives is prudent
- Implementing investment changes based on appropriate investment policy is optimal long run strategy
- Removes emotion from decision making process
- Diversification across & within asset classes is essential in today's environment

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Implications for Investment Policy: Portfolio Rebalancing

- Rebalancing forces investors or oversight committees to sell high & buy low
- Times of extreme market movement may result in large divergence of actual portfolio allocation vs. target allocation
- Significant underweight to equities can negatively impact ability to recover value

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Implications for Investment Policy: Portfolio Rebalancing

Portfolio	4/20/08	%	4/20/09	%
Stocks	$500,000	50%	$314,350	38%
Bonds	$500,000	50%	$520,100	62%
Total	$1,000,000	100%	$834,450	100%

Returns: S&P 500 -37.13%, BarCap Aggregate Bond - 4.02%
Source: Morningstar, Inc.

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Our Investment Outlook

- More volatility/uncertainty in near term
- Lagging indicators (ex. unemployment) will continue to worsen through most of 2009
- Opportunity now to broaden diversification, position for recovery
- Second half of 2009 better than first, we expect positive full-year returns
- Buying today's prices offers good return potential 3-5 years out, despite near-term risks

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