2215 York Road, Suite 515 Oak Brook, IL 60523
www.stairwaypartners.com
630-371-2626 phone 630-371-2617 fax

STAIRWAY PARTNERS, LLC

MONTHLY

VOLUME 6, ISSUE 3 MARCH 2009

SIGNS OF LIFE

Introduction

In our December 2008 *Monthly*, we examined the relationship between the economic cycle and the stock market in the US. In that piece, we showed that financial asset prices tend to anticipate and move in advance of turning points in the underlying economic fundamentals. In contrast, press reports and economic forecasts are notoriously bad at seeing these turns ahead of time.

The current economic and financial environment is justifiably referred to as a deep recession – given the latest GDP report and weakness across a broad array of other indicators: employment, consumer spending, housing, and investment spending, for example. Given the dire current situation however, is there any evidence that things are starting to stabilize, or is the decline continuing to accelerate?

We will use this *Monthly* to examine a number of areas that appear to be starting to stabilize. There is yet to be a turn toward improvement, but parts of the economy have recently ceased deteriorating. Also, certain sectors of the financial markets have actually improved from their worst levels.

Financial Markets

One of the key indicators of equity risk, the VIX equity volatility index, remains elevated but is well below the extremely high levels hit at the peak of the crisis (Figure 1). In other words, investors appear to still be very concerned with the market environment, but seem less panicked than they were three months ago.

A similar picture is emerging in credit markets; while lending had almost completely seized up last fall, there are signs now of a thaw. Figure 2 shows the behavior of short-term inter-

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CURRENT TOPIC

Signs of Life

- *Introduction*
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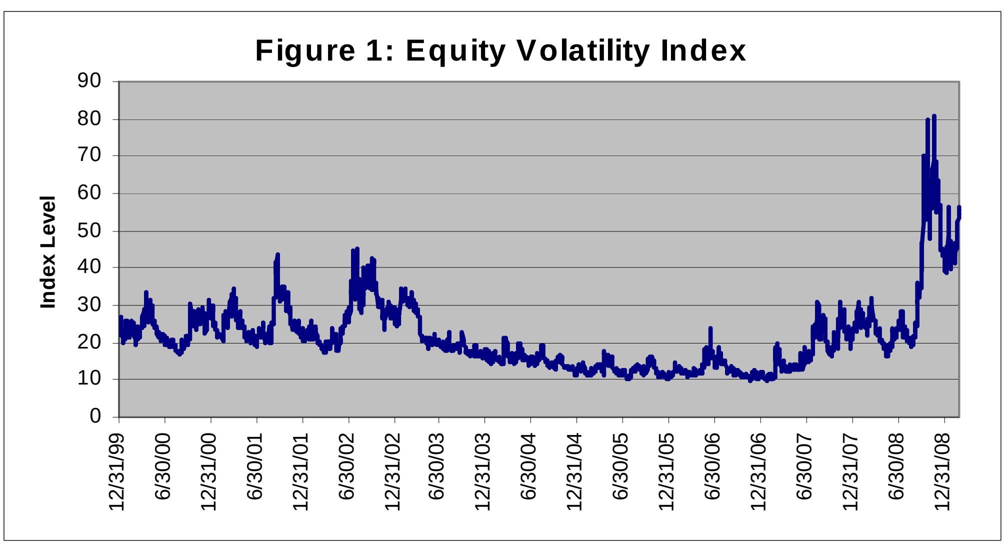
Strategy

- *There were no strategy changes during the month of February*
- *Portfolio strategies remain overweight developed equity markets and high yield bonds*
- *Equity markets are fairly close to the low levels reached in November 2008*



Source: Bloomberg

"INVESTORS APPEAR TO STILL BE VERY CONCERNED WITH THE MARKET ENVIRONMENT, BUT SEEM LESS PANICKED THAN THEY WERE THREE MONTHS AGO"

Signs of Life - Cont'd

est rates. Last fall's dramatic upward spike in Libor, the rate at which banks lend to each other, provides clear evidence that banks were willing to lend only at very high penalty rates. The resulting spread between 3-month Libor and the same maturity Treasury-bill (the TED spread) provides further proof that inter-bank lending was extremely expensive, while money flooded into the safety of T-bills. Today, the Libor rate has settled down considerably, and the spread has shrunk along with it.

Longer-term bonds also show a similar, though less dramatic, picture. Yield spreads over Treasury bonds in both the investment-grade and high yield (non-investment-grade) sectors have moved lower, although they remain considerably above their levels during the first half of last year (Figure 3). This narrowing of spreads has been accompanied by an "unfreezing" of the market for new issues. Many companies have not had much trouble raising capital by issuing new bonds recently. The *Financial Times* reported that January bond issuance by non-financial companies was a record for that month, at nearly $170 billion ("Corporate debt brings banks solace" Feb 2, 2009).

The Economy

Much of the current economic and financial market problems stemmed from problems in the housing market which affected borrowers, which then affected mortgage debt holders. Sales of new and existing homes have pretty much fallen off a cliff, resulting in dramatic rises in indicators such as the time houses stay on the market before being sold, and dramatic declines in others such as average sales prices.

Figure 4 shows levels of inventory of new and existing homes for sale. It is clear that inventory levels rose strongly in 2005-07 as residential construction boomed and homeowners in a number of regions tried to flip properties. Over the last three years however, this rise in homes for sale, coupled with the drop in sales completed, led to a doubling in the "months on market" measure of housing inventory. As Figure 4 shows, the other, encouraging, aspect is that some of this inventory backlog is beginning to be worked through. The reduction of

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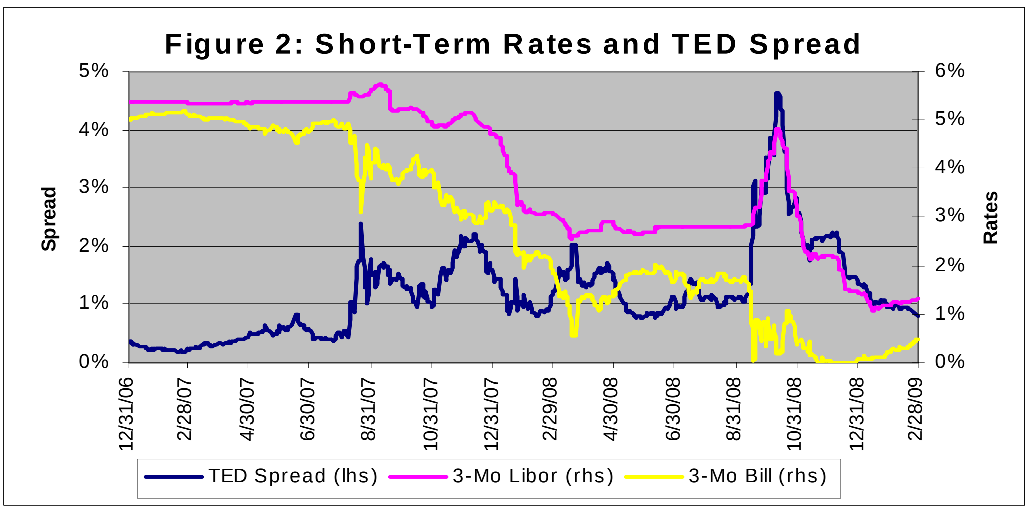
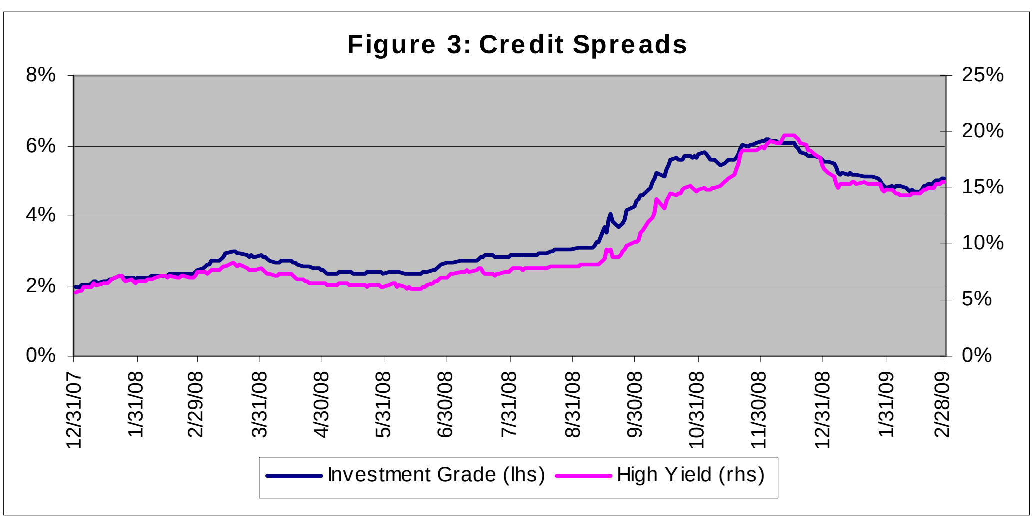
"THIS NARROWING OF CREDIT SPREADS HAS BEEN ACCOMPANIED BY AN UNFREEZING OF THE MARKET FOR NEW ISSUES"





Sources: Bloomberg, Barclays, Stairway Partners

About Stairway Partners, LLC

Stairway Partners was formed to provide our clients (starting with ourselves) with an effective and comprehensive solution for managing their wealth. Our disciplined and rigorous approach comes from our collective knowledge in serving large institutional clients over many years.

Our core investment belief is that asset allocation is the single most important determinant of success in any investment plan. The dominant amount of risk and return comes not from your choice of individual investments but from your asset class mix. Stairway Partners focuses our resources on risk management and asset allocation. This includes building your custom blueprint (investment policy and benchmark) and aligning your portfolio with our investment strategy utilizing the global capital markets.

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inventory is partially due to the greatly improved affordability of home ownership - a result of lower prices and more attractive mortgage rates for those who qualify.

Moving away from housing to look at retail sales, Figure 5 shows that sales went into a sharp tailspin toward the end of 2008. But, as with some of the other measures we have reviewed here, the latest data might indicate a possible bottoming. The January numbers came in higher than anticipated. The consensus expectation was for another decline, but sales were actually higher than they were in December, despite aggressive price discounting.

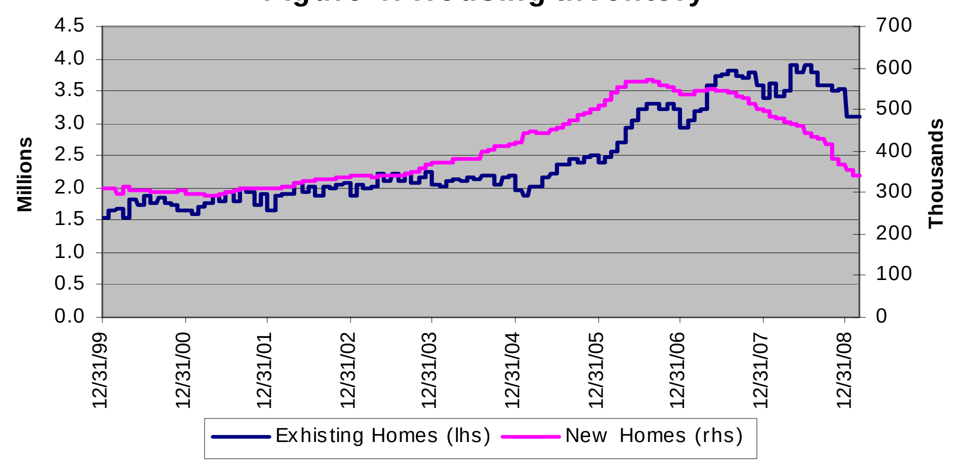

Figure 4: Housing Inventory

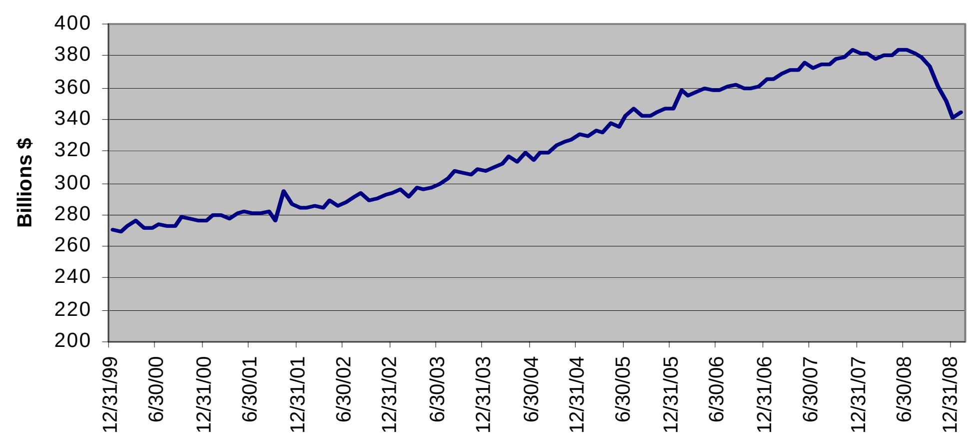

Figure 5: Retail Sales

Sources: National Association of Realtors, U.S. Census Bureau, Bloomberg

Summary

The weakening in the economy and most financial markets has been very rapid and severe. Most expectations are for this to continue essentially unabated, until well into 2010. However, things cannot go down forever, particularly at such a consistently fast pace. And when the turn occurs, it often catches people by surprise.

In fact, there are some signs, not necessarily of a turnaround or rebound, but of a bottoming in a number of economic and financial market indicators. This could mean that we will see improvement in the coming months, or it could just be a temporary lull in the crisis.

Regardless of which it is, there will eventually be a recovery. When investors anticipate that turn in the economy and start incorporating improving fundamentals into prices, the stock market and credit-sensitive bonds should produce solid returns.

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy Exposure	Comment
Equities				
US	34.3%	6.0%	over	Exposure above benchmark weight due to improved pricing
Non-US Developed			over	Asset class has become more attractive as markets have fallen
Eurozone	38.5%	6.4%		
Japan	24.1%	4.5%		
UK	31.3%	6.6%		
Emerging	30.7%	11.4%	neutral	Price declines have made asset class attractive
Fixed Income				
US Treasury Bonds			under	Treasuries expensive, but non-Treasury sectors priced better
2-Year	0.7%	2.8%		
5-Year	0.5%	3.5%		
10-Year	0.7%	4.2%		
30-Year	-0.5%	4.6%		
US Municipal Bonds			under	Long-term maturities priced better than short-term maturities
2-Year	1.3%	2.3%		
5-Year	1.7%	2.9%		
10-Year	3.2%	3.7%		
30-Year	9.5%	4.6%		
US High Yield	22.9%	4.4%	over	Sector offers good return prospects relative to its risk
Non-US Government Bonds			under	Yields remain below fair levels
Euro 10-Year	1.3%	4.1%		
Japan 10-Year	-0.4%	1.9%		
UK 10-Year	1.5%	4.6%		
Emerging Markets Debt	8.1%	4.7%	under	Although sector is priced attractively, other asset classes offer better value
Cash	2.7%	---	minimal	

Currencies	Expected FX Change	Equity Return with Currency	10-Year Bond Return with Currency	
Euro	-3.9%	34.6%	-2.6%	Euro is moderately overpriced
Japanese yen	-2.0%	22.2%	-2.4%	Yen is slightly expensive
UK pound	3.6%	34.9%	5.1%	Pound is slightly underpriced

Notes: **As of: February 28, 2009**

The expected return is our estimate of the annualized return likely to be generated over a 3-year horizon.
The expected returns are expressed in local currencies (e.g., Japanese equity return is stated in yen terms).
The hurdle rate represents the annualized return that an asset needs to generate in order to cover its risk.
Equity Return with Currency (in Currencies section) is the annual return we would expect a US dollar investor to earn from holding foreign equity markets.