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Market Comments

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After plunging from mid-September to late-November in the wake of the Lehman bankruptcy shock, global equity markets finally showed signs of stabilizing in the last few weeks of 2008. In U.S. dollars, the MSCI World index finished the year nearly 20% above its low posted in November. But that represents small comfort since the index declined more than 40% for the year overall. Market volatility subsided considerably in the last weeks of the year as well, with the VIX index of U.S. market volatility falling to nearly 40% after having reached a frightening level of 80% in November.

Market participants appear to have been encouraged by the massive policy responses to the global credit crisis that were announced in late 2008, including greater-than-expected cuts in European interest rates and a move toward quantitative easing by the U.S. Federal Reserve Bank. Those measures helped generate some signs of thawing in interbank lending and demand for the highest grade of corporate bonds and other securities. Commodity prices also showed some signs of stabilization in December, with the CRB raw industrials index posting a modest gain for the month after plunging in previous months.

That said, financial conditions remain restrictive and the appetite for riskier debt, such as junk bonds and asset-backed securities, remains far below levels from a year earlier. Global economic and company news flow also remains shockingly weak, with many economists estimating that real GDP in the developed nations contracted at an annual rate of nearly 4% in the fourth quarter. Most economists expect global contractionary forces to remain in force during the first half of 2009, with the impact of monetary easing and large-scale fiscal stimulus expected to result in only modestly positive growth rates in the second half of the year. With growth in emerging market economies now expected to be only 3% or so in 2009, global real GDP growth may struggle to reach 1.0% to 1.5%.

Weak global growth in coming quarters is likely to be associated with large increases in unemployment rates and excess industrial capacity around the world. This suggests that inflation risks are mainly to the downside in 2009, despite concerns about the rapid expansion of central bank balance sheets. We believe that the speed and scope of policymaker responses

to the credit crisis argues strongly against a multi-year Japan-style deflationary outcome, but investor sentiment seems likely to be torn between fears of deflation in the very near term and fears that policymakers' countermeasures will create strong inflation pressures down the road.