## Economic Commentary

The gradual economic deterioration that began last year became a severe economic decline as we entered the fall of 2008 based on the liquidity freeze from the proliferation of questionable mortgage backed securities held on the balance sheets of major financial institutions both in the United States and internationally. There is no denying the severity of the current economic downturn, as Real Gross Domestic Product (GDP) is expected to be down at a 5% annual rate in the fourth quarter following a drop of 0.5% in the third quarter of 2008.

**The economy has now officially been in a recession since the beginning of 2008.**

There were a broad number of underlying causes for the freeze in the credit markets this past fall and the resulting steep economic downturn. These factors included: the over promotion of home ownership through teaser interest rates and minimal equity requirements; the misuse of securitization by the investment community through speculative degrees of leverage in the sale of mortgage backed securities, derivatives, credit default swaps and collateralized debt obligations; ineffective risk management systems and antiquated rating agencies incapable of dealing with newly designed products; politically influenced financial regulatory agencies; misguided accounting rules that compounded the markets illiquidity during its period of maximum stress; and the initial episodic efforts of the Federal Reserve and the Treasury Department that only added to the near-term uncertainty in September as different solutions were used for each new problem.

Considering the contributing causes were numerous, the severity of the problem was initially under-estimated and only became fully apparent when the financial system almost completely shut down in early fall. Economic trends currently continue to be negative with an economic recovery not expected to begin until the second half of 2009. Within the Consumer Sector, credit constraints have been tightened, short-term borrowing has become difficult, consumer net worth has declined based on lower housing and investment valuation levels, unemployment is up and consumer confidence is at a multiple decade low. Sharp consumer spending declines in the fourth quarter of 2008 and the first quarter of 2009 should begin to show an improving trend as summer approaches and the initial effects of the massive stimulus package begin to be felt. For the full year 2009, Consumer Spending is expected to be relatively flat on a year-over-year basis.

We anticipate Business Investment Spending growth to have fallen off in the fourth quarter of 2008 due to the financial market freeze having created a strong demand for short-term liquidity within the corporate sector. International demand for U.S. products also fell off sharply as foreign markets were impacted by the growing global slowdown and the spreading illiquidity created by the use of many of the same toxic mortgage backed security products internationally. It is also expected that Business Investment Spending will continue to decline during the first half of 2009 with trends becoming more positive this summer based on the effects of the stimulus package and the outlook for a more sustained recovery going into

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# The Future of Estate Taxes under President Obama

Federal estate and gift tax rules are likely to be included among the many issues receiving governmental attention this year. Some urgency is involved because under the current rules the taxes are scheduled to disappear for one year, in 2010, and return the next year with a much lower exemption amount than is currently in place.

### CURRENT RULES

The estate tax exemption is $3.5 million in 2009; the tax completely goes away in 2010 and re-emerges in 2011 at only a $1 million exemption. The lifetime gift tax exemption and generation skipping transfer tax exemption is currently $1 million. There is almost uniform consensus that something needs to be done this year before the "no tax" year of 2010 arrives.

### ANTICIPATED OBAMA PROPOSAL

To freeze the estate tax exemption at its current level of $3.5 million (45% tax rate) permanently. In addition, there is discussion of permitting married couples to combine their exemptions for a total of $7 million. An increase in the lifetime gift tax exemption above its current $ 1 million level does not appear to be part of the Obama proposal. However, practitioners are hopeful, and other proposals call for, a reunification of the estate and lifetime gifting exemptions such that both will be $3.5 million.

### POTENTIAL IMPACT IF PROPOSAL IS ADOPTED

In the event the Obama proposal is adopted without material alteration, there are several areas of potential impact:

1 It would create certainty and closure going forward which will be a relief for planners.

2 The federal estate tax will still be a major tax which high net worth individuals will need to address in their planning.

**What is President Obama's proposal on the topic and what is the potential impact if his proposal is adopted?**

3 Spousal combination of credit amounts, otherwise known as "portability", is likely to create interesting planning opportunities. For example, multiple remarriages of widows and widowers and marriages immediately before death may come under scrutiny. The alteration of asset division upon divorce to account for the exemption as an asset of the marriage is also a possibility.

4 While the portability provision on its face may lessen the need for complexity in estate plans, many people will still adopt credit shelter plans and retitling of asset strategies in order to (i) shelter assets from state taxation, (ii) protect assets from the surviving spouse's creditors and (iii) eliminate the appreciation from the surviving spouse's estate.

5 Especially given the current state of the economy, the continuance of the estate tax will focus high net worth individuals and their heirs on the need to plan for liquidity to pay any taxes due. With the tightening of credit and a possible desire not to sell assets at what might be viewed as bargain prices, life insurance may take a more prominent position in the liquidity plan.

6 In addition, in these difficult times, it is possible that some high net worth individuals focused on the need to generate income to support their lifestyle may be more likely to pursue annuities with reduced or no death benefits, thus increasing the yield to them to support their lifetime while reducing their taxable estate.

7 In the event the lifetime gifting exemption and estate tax exemption are reunified, additional planning opportunities will become available at a potentially great time for high net worth individuals. Gifting works best when the appreciation is dramatic after the gift. With today's economy there are plenty of assets depressed in value which have the potential to dramatically appreciate. The gifting strategies would still likely be similar to those used today just more doors would be open because of the increase in the exempt amount. Aside from outright gifts, for high net worth individuals one could expect more usage of trusts containing components of tax planning and creditor protection such as Grantor Retained Trusts, generation skipping trusts, personal residence trusts and charitable remainder trusts.

2010. That being said, overall Business Investment Spending should show a modest gain. Governmental Spending will continue to show positive growth during 2009 as the decelerating tax revenues and difficult borrowing conditions are more than offset by the funding stimulus and guarantees put in place by the Federal stimulus initiatives. For the full year of 2009, Real Gross Domestic Product is projected to show no meaningful growth on a year-over-year basis, however quarterly comparisons should show an improving trend.

While the current economic trends are still negative, there are significant signs of improvement that will eventually sow the seeds for the coming recovery. The massive fiscal and monetary stimulus applied over the past three months is now having an effect with bank lending rates and consumer lending and mortgage rates now down sharply from their peak rates this past fall. The capital infusion to the banking system that had initially been held for year-end liquidity purposes is now expected to be used more proactively to generate highly profitable lending growth rather than sit in historically low yielding government securities. The Federal Reserve has provided financial support to facilitate inter-bank lending, interest rates are at low levels, money supply growth has expanded dramatically and the recently enacted stimulus package should provide a significant boost to near-term spending and investment levels.

The first quarter forecast in economic activity remains negative; however, we should see material improvement throughout the remainder of 2009. The current financial downtrend has been met with a massive governmental response. The Federal Funds rate has been brought down to 0.25%, money supply is showing dramatic growth and the current economic stimulus package enacted on top of last quarter's TARP program have all added to immediate economic stimulus. In addition to these governmental initiatives, the falloff in oil prices from over $140 a barrel to under $40 a barrel in less than six months has also been highly stimulative.

## A EQUITY MARKET

As of year-end 2008 the equity market, as measured by the S&P 500 Index, recorded a decline of 38% for the year and was down by as much as 50% in November 2008 from the previous market highs experienced in late 2007. The market decline was broad based with over two thirds of the S&P 500 company shares down over 30%. The decline exceeded 30% for all major classic investment style disciplines; growth, core and value. The 30% benchmark was also exceeded by indexes representing the large capitalization stocks, mid-cap stocks and small-cap stocks. International diversification did little to lessen the market impact with the EAFE International Equity Index down by 43% for the year. It is interesting to note that since 1926, the market (as measured by the S&P 500) has only recorded four declines exceeding 30% in a calendar year. Those years were 1931, 1937, 1974 and 2008.

The initial sell-off of 20% during the first nine months of 2008 was focused largely on areas of potential economic weakness, however the final sell-off of over 20% in October and early November was widespread and impacted all areas of the market as mutual fund and hedge fund redemptions required mass liquidation of all marketable securities regardless of the strength of the underlying companies involved. Because the fourth quarter selling climax was caused by a rush to cash rather than the result of deliberate fundamental evaluation of the individual security's relative strength, numerous equities were driven to market levels well below their longer term fundamental value. Though the general market should remain volatile over the near term, we would view this period as an opportunity to add to individual securities that have the strength to successfully navigate these difficult times and return to justifiably higher valuation levels.

The S&P 500 Index has quietly rebounded by over 20% from the recent market lows. Earnings pressure will create continuing near-term market volatility for the general market over the next few months; however, the fundamental stimulus needed for the recovery has already been put in place. The market, as measured by the S&P 500, is currently being valued at 4 times underlying book value and 12 times preliminary earnings. These valuation levels remain attractive based on the

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potential earnings recovery anticipated over the next two years. The S&P 500 is providing a dividend yield of 3% and an operating earnings yield of over 8%. These returns compare to the current 10-year Treasury bond yield of just 2.1%. The general equity market typically shows a significant market value rise following general market lows within each cycle in anticipation of the eventual economic recovery well before the economic environment shows material improvement. Given the fundamental stimulus programs that are now in place, it would not be surprising to discover that this market discounting process has already begun.

## INTEREST RATE FORECAST

**We are only a few weeks into 2009, but the year appears to be off to a solid start.** Prices on most financial bonds have retraced their 2008 losses. Prices on utility and general industrial bonds have more than recouped their losses. Bid-offer spreads have narrowed significantly, particularly on agency and industrial securities. Industrial bonds have been the most popular purchase since buyers discovered there was no future upside to Treasury and Agency securities (2 year Treasury notes at 0.75%). Then the question became finding some reasonable yield, but where? It is a logical assumption that the most resilient sectors will be those with few, if any, credit rating changes over the past 5 years.

When the rest of the world is unsure about the future of the global economy, cash flows into the US markets from all corners of the globe. Treasury and agency securities are suffering overbought or flight to quality conditions. We closed 2008 with the one month Treasury bill paying a -0.08%. Yes, the buy side was willing to accept a return of less than the amount paid for a security to own US Treasury securities for safety and liquidity over year-end. Thus, US Treasury Money Market Funds were paying interest rates below 0.20%. Even municipal money market funds were buying Treasuries and Agencies. The Treasury has a heavy calendar this year attempting to issue more debt than has ever been seen historically. As the year progresses the flight to quality conditions should dissipate, pending no unforeseen economic calamities. Rates on the 10-year Treasury bond should return to levels closer to 3% without significantly affecting the corporate bond market yields. In essence, spreads will tighten as buyers search for yield. Performance will be found in financial and mortgage holdings, the sectors with the greatest current loss in relative value for the first half of 2009.

The Federal Reserve, US Treasury, the Senate and Congress have all adopted policies toward supporting the financial system, the heartbeat of the American economy. Included in this is the TARP, Fed easing and acceptance of non-traditional collateral on repurchase agreements, encouragement of several companies to apply for bank holding company status, FDIC insured bank holding company paper, etc. As 2009 began, the fruits of those labors have started to ripen with improving corporate and municipal bond prices, limited new issues in the taxable and tax exempt markets, buyers coming back to spend cash they have built up over the past 3 months, and evidence on the horizon of stabilized markets. Expectations are for a more solid economy by the end of 2009 lead by a more liquid fixed income market.




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