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9785 Towne Centre Drive
San Diego, CA 92121-1968

One Beacon Street, 22nd Floor
Boston, MA 02108-3106

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Dear Valued Investor:

We start the New Year deep in the debris of the economic and market collapse of 2008. News coming in from the last quarter is still very gloomy, as consumers, businesses and government alike work to assess the damage, incorporate the right adjustments to carry on through this recession, and create the plan for clearing the fallout and rebuilding.

Prior to September, the employment declines had been modest, averaging 82,000 a month, but as the financial system collapsed, employment fell 403,000 in September, 423,000 in October, and 584,000 in November. Today we got the employment report for December. It showed a jump in the unemployment rate from 6.8% in November to 7.2% and a decline in payroll employment of 524,000. One possible bit of positive news here is that the latest decline was smaller than November's.

Companies appear to have been very prompt in adjusting to the onset of serious recession. Based on the employment figures, it is my guess that labor productivity rose about 3% in the fourth quarter, with total hours worked down 7.7% (annual rate) versus a consensus forecast of a -4.4% decline in GDP. That would indicate that companies are keeping productivity growth in line with wage growth and holding unit labor costs flat. I have harped on these cost control measures, because I believe they are key factors that will help moderate this still very serious recession. Typically, companies are slow to adjust in recessions and allow labor costs to pile up, making the ensuing employment decline deeper.

Given this cost control, one might expect okay profits despite the downturn, but such profits appear unlikely because of the sharp cuts in the prices of goods and services sold. Without adjusting for this deflation, the holiday sales data look very weak. For example, the retail store sales report shows a decline of 1.7% in sales compared to December 2007. But store prices, which have been falling since September, likely dropped sharply in December. So, in real inflation-adjusted terms, sales likely rose in December compared to 2007. This is good and bad news. It means that stores likely "moved the merchandise" in December and we consumers got some pretty good deals, but it also means that companies did not make much money on those sales.

I do expect further very sharp declines in the Consumer Price Index (CPI) and other price reports stemming from the decline in energy and commodity prices and the impact of the recession. That said, the Federal Reserve (Fed) has made it very clear that they intend to keep any deflation short-lived, and they have embarked on a huge expansion of the money supply to turn both prices and the real economy up again. With these and other major Fed actions aimed at unfreezing the financial system, I am already seeing some recovery in credit markets compared to the post-September collapse environment.

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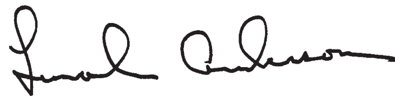
At the same time, I expect we will get prompt action by the incoming Administration on fiscal policy, with soon to be President Obama announcing an $800 billion program of infrastructure and other spending as well as tax cuts. These actions, combined with the recession impacts, will likely produce budget deficits in excess of a trillion dollars per year for several years to come. Meanwhile, I expect the "off-budget" activities of the Troubled Asset Relief Program (TARP) will resume under the leadership of incoming Treasury Secretary Geithner, and will lift more risk out of troubled financial institutions and other companies. And there is the FDIC, now out guaranteeing financial institution debt.

None of this activity leaves the financial planner in me sighing with relief or happy with these policies. All of these programs come with costs. The Fed program aimed at reflation may overshoot and lead to high 2010 inflation rates. All the troubled asset purchase and guarantee programs may yield substantial losses down the road. And, as with all government programs, I expect some misallocation of the fiscal stimulus funds to pork and other poor investment choices. Also, we will be piling up debt again at a time when we should be pulling it down to help deal with the serious actuarial shortfalls in Medicare and Social Security.

I do think we can recover from this near unbelievable mess created by a bunch of irresponsible Wall Street firms, regulators, and politicians and return to growth and healing financial markets. While these are serious losses, all the hard working labor, capital equipment, technology and spirit of innovation are still here. We just have to clean out the stables and move on. And as part of the process, we will likely have a complete rewriting of the rules and regulations governing the U.S. and global financial systems this year. It will be a full agenda to be sure in this hopefully happier New Year. Please call your financial advisor with any questions or concerns.

Best Regards,



Lincoln Anderson
Managing Director, Chief Investment Officer

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