

The Economy and the Markets

As the economy struggled through the toughest conditions in decades, Washington, Wall Street and Main Street searched hopefully for signs of a turnaround.

The signs weren't to be found in unemployment statistics, which showed job losses rising at the fastest rate of any recession since World War II. And concerns about bank finances continued to flare up regularly during the quarter. But positive developments emerged in retail sales and durable goods orders, and one government report concluded that home prices rose in January for the first time in 10 months. Also on the plus side, depreciation in energy and commodity prices continued to give consumers and businesses some relief. Prices are likely to remain down for a while, a result of depressed demand.

The economic "green shoots" pointing to future growth that Federal Reserve Chairman Benjamin Bernanke cited are positive relative to the most difficult days of 2008. The general consensus now is that a depression or very deep recession is less likely.

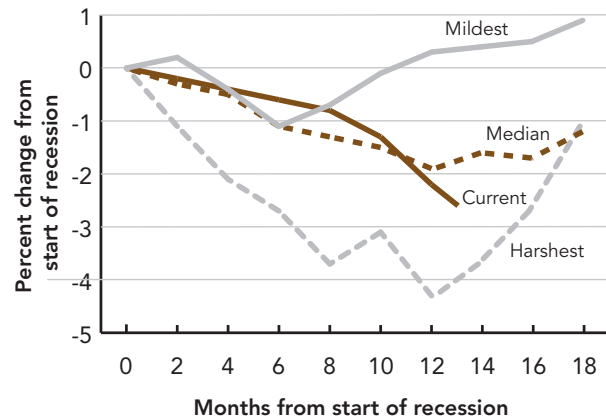
Optimists think we will struggle for a while, and start growing later in the year. Middle-of-the-road thinkers believe we'll muddle through a period that really won't feel like much of a recovery. The third school of thought is that those green shoots won't take root and the economy will continue to fall. We don't believe the third scenario is likely because of the significant initiatives launched by the Federal Reserve and executive branch.

Equities

After dropping for most of the quarter, equity markets surged in mid-March. Investors concluded that the economy was unlikely to worsen, and that equity valuations had been pushed lower than warranted. The markets responded positively to a Treasury plan to relieve banks of toxic assets, and sent the Dow Jones Industrial Average up 6.8 percent on the day the plan was announced.

The Standard & Poor's 500 Index returned -11.0 percent through March 31. The Dow ended the quarter at 7,609 after reaching a 12-year low of 6,547 in early March.

**Change in Employment:
Current Recession vs. Postwar Recessions**



Source: Federal Reserve Bank of Minneapolis

Compared with the harshest, mildest and the median of the 10 recessions since 1946, loss of employment in the current recession is approaching the harshest level in more than 50 years.

The equity markets face many challenges in the months ahead. First quarter earnings are likely to see more downward pressure and may set a less-than-positive tone for the markets during the second quarter.

Fixed Income

Spreads — the difference in interest rates between U.S. Treasury bonds and other fixed income securities — remained wide, after narrowing earlier in the quarter. Nervous fixed income investors continue to cling to quality, driving Treasury yields down to where it would seem they don't have anywhere further to drop. Investor concerns were driven by the high number of credit rating downgrades, which are exceeding upgrades by a 10-to-1 margin.

The more highly leveraged a company is, the more it is likely to suffer. Companies with heavy amounts of debt, in particular below-investment-grade firms, may find it difficult to refinance. We expect the volume of corporate defaults in the months ahead to exceed anything we've seen in the past half-century.

Continued

When the quarter ended, the Barclays Capital Treasury had returned -1.32 percent, while the Barclays Capital U.S. Corporate Index was -1.93 percent through March 31.

Real Estate

Commercial real estate fundamentals are suffering, with rents dropping from 5 to 10 percent, depending on the region. Office properties and hotels have been hit the hardest, while multi-family and senior housing properties have fared the best.

There continues to be retrenching in commercial real estate, with a great deal of uncertainty about the market for commercial real estate loan refinancing. We are likely to see an increase in commercial mortgage loan defaults as real estate equity investors find themselves unsuccessful in rolling over their debt.

On the residential real estate side, the large inventory of homes for sale remains the biggest obstacle to a housing turnaround. Foreclosure rolls are growing and delinquencies are increasing, which only adds to inventory. Until buyers burn through the backlog of homes on the market, housing won't stabilize.

Housing remains the key to getting the economy going. Home prices and consumer incomes need to reach a point where they are back in sync for the housing market to stabilize. It is very difficult to make this happen quickly.

Outlook

Although we do not look for a strong economic rebound in 2009, we may see a moderate recovery by year end. For a real turnaround to occur, the housing market needs to stabilize, concerns about bank solvency must fade, and job losses need to slow.

We expect the investment markets to remain volatile, with euphoric rises likely to be followed by sharp drops. Almost \$4 trillion is on the sidelines in money market funds, according to the Investment Company Institute. Once conditions appear less dire, the re-entry of that money into the markets could drive a sustained upward movement.

The S&P 500 Dividend-Adjusted Index is market-value weighted based on 500 common stocks, which are traded on the NYSE, AMEX and Nasdaq. The weightings make each company's influence on the performance of this index directly proportional to that company's market value.

The Dow Jones Industrial Average is a price-weighted average of 30 actively traded blue-chip stocks, primarily industrials including stocks that trade on the New York Stock Exchange.

The Barclays Capital Treasury Index represents public obligations of the U.S. Treasury with a remaining maturity of one year or more.

The Barclays Capital U.S. Corporate Index is representative of publicly issued, investment-grade, fixed rate, dollar-

denominated, non-convertible, U.S. corporate debt securities that have at least \$250 million par amount outstanding. To qualify, bonds must be SEC-registered.

You cannot invest directly in an index.

Past performance is not indicative of future results.

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