

A Letter From

Dr. Charles Lieberman, Chief Investment Officer

A quarterly report from Advisors Capital Management, LLC a registered investment advisory firm.

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Economic reports reflect very weak economic performance, although the economy should bottom this spring. Even so, recovery is not yet assured. Credit availability has been improving in recent weeks, but conditions have not returned to normal as yet and the prospects for the economy would deteriorate if credit were to freeze up again. Thus, it remains very likely that policymakers will continue to add liquidity to credit markets and purchase assorted securities to improve the flow of credit. It is most likely that these efforts will achieve success over time. And as credit conditions improve, prospects for the economy should follow suit. The recent rally in the stock market seems to anticipate the recovery, thus we think these gains are just the beginning of what should prove to be a very strong year for equities. Still, it must be emphasized that credit market conditions must improve for these expectations to be realized.

How Did We Get Here?

Government officials (and private sector analysts) failed to appreciate how the subprime mortgage problems would metastasize across the credit markets, even though policymakers were well placed as regulators and supervisors to see the mistakes being made and the rot beneath the surface. The initial problems were confined to the smallish subprime markets and should never have been allowed to spread throughout the financial system. Policymakers failed to act early or forcefully enough to contain the problem.

As subprime mortgages started defaulting, confidence was undermined in other borrowers. But the credit markets really fell apart after Treasury took control of AIG, Fannie Mae and Freddie Mac and then allowed Lehman to fail. Instead of standing behind these firms, government stoked investor fears by taking these businesses over and rendering shareholder investments worthless by design. Treasury actively sought to punish shareholders. But as a direct consequence, investors turned fearful about lending to anyone, risk spreads blew out and everyone cut back on discretionary spending until they could see how these problems were resolved. The huge rise in risk spreads increased the cost of credit dramatically and the lack of trust in borrowers curtailed the availability of credit to all but the most creditworthy. Both consequences weakened spending. The cutback in spending quickly

worsened the recession and a bad situation became worse.

How Can the Situation be Improved?

The freezing up of the credit markets was the most significant development that exacerbated the recession that must now be overcome. And, indeed, policymakers recognize this point. Treasury's aggressive response has been to use TARP funds to recapitalize financial institutions and the Federal Reserve's strong actions include increasing liquidity, lowering interest rates and buying assets in some of the markets that have stopped functioning. Other confidence building steps have included guarantees of money market funds, an increase in the insurance guarantee on bank deposits and even guarantees of bonds issued by banking institutions. All these steps have improved liquidity and are helping credit markets return to normal, even if they still have some way to go before conditions are fully back to normal.

Progress in the credit markets can be monitored by tracking risk spreads and new loan volumes. For example, three-month LIBOR, the rate at which banks lend to one another for periods of 90 days, widened from a typical 25 basis points to as much as 480 basis points after Lehman was allowed to fail. That surge in funding costs rendered bank loans unprofitable or forced banks to charge more even to creditworthy borrowers. So, bank lending virtually halted. As conditions improved following the Fed's actions, these spreads have shrunk to roughly 100 basis points, still above normal, but dramatically improved and no longer an insurmountable hurdle to new lending. Mortgage rates have declined from roughly 6% to nearly 5% for prime borrowers. Jumbo loans remain costly, which continues to discourage home purchases in high cost regions, including both coasts and many major cities. Corporate bond issues nearly ceased as risk spreads widened. Borrowing activity has picked up sharply in recent weeks, although risk spreads still remain above normal. So, these spreads must decline considerably further to enable companies to roll over maturing obligations.

Prospects are quite good for continued improvement in unfreezing the credit markets. Most importantly, the need for the credit markets to be unclogged is very well appreciated by policymakers, who are

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EVENTS & ANNOUNCEMENTS

ACM Account Minimums to Change

Due to market conditions, advisors and clients have requested that we reduce our minimum account sizes for our Private Account and Mutual Fund portfolios. As of January 1, 2009 ACM's minimum account sizes are as follows:

Mutual Fund/ETF Portfolios: \$25,000
Separate Account Portfolios: \$100,000
Private Account Portfolios: \$250,000

We're Moving

We are moving on January 26, 2009 to a newer, larger office down the road. Please note the following changes:

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Reviewing Portfolios for the Economic Recovery

Believe it or not, there will eventually be an economic recovery. We are currently positioning our existing clients with securities we feel will benefit from the unprecedented fiscal policies of the government. Now through the Spring of 2009 we are also providing a no cost comprehensive analysis of stock and bond portfolios for advisors and investors who are not currently utilizing ACM's portfolio management services. Meet with our investment committee and they will provide suggestions on how to properly position your investments for an aggressive Federal Reserve, new administration and U.S. Treasury.

ACM's Quarterly Reports through Q4 2008 are available on our website at www.advisorscenter.com. Form ADV are available upon request.



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fixated on the problem. While they have shown a predisposition to do something wrong before they get it right, it seems reasonable to assume that they will continue making every effort to restore credit markets to normal working conditions. And it is unlikely they will stop before this outcome is achieved. Critics may object to the dollar outlays being expended to fix the credit markets, but it is doubtful policy will be deterred until normal functionality has resumed. Thus, the question is more of how long will it take, not whether it will occur.

Policy is also focused on other actions that may be taken to help the economy recover. A very sizeable fiscal stimulus program is expected to be unveiled as soon as the Obama Administration assumes power. That is just weeks away. Behind the scenes, intense debate on the programs, size, and cost of the package is being debated. Numerous voices are expressing the need for the fiscal stimulus to be large enough to do the job of reinvigorating the economy. A stimulus package worth \$600 to \$800 billion, as is being talked about, would be a very powerful stimulant to the economy.

Less attention has been paid to an almost equally powerful stimulant to the economy that has already occurred. Within three months, crude oil prices declined from a peak of \$147 per barrel to around \$45, which frees up a huge amount of household cash flow for other purposes, roughly \$500 billion in after-tax dollars according to my ballpark estimate. No further policy action is needed. This has already occurred. And it is almost as large as the fiscal stimulus package that is expected to be approved over the course of the next month.

A third important element to the recovery is the impending turnaround we expect from the housing sector, despite market expectations that housing will remain weak at least until 2010. Housing is weak. But it will change in the near future precisely because it is so weak now. New construction activity of about 650,000 units at an annual rate is running less than half the rate of new household formation of roughly 1.5 million.

Thus, vacant existing homes and unsold new home inventories are falling rapidly. By spring 2009, further declines in new housing construction should come to an end. But this is not enough. New construction starts cannot remain around 650,000 units for any sustainable period. They must rise towards 1.5 million, or unsold housing inventory will continue to decline until it is depleted and where will these new households live then? Thus, shortly after new construction stops falling, it will begin a sizeable rise towards underlying demographic demand of 1.5 million units. At that point, housing will no longer be a drag on GDP growth or job creation, but will add to both. And the ongoing decline in mortgage rates will make financing this recovery feasible. While pinpointing the turnaround with precision is very difficult, it appears likely that housing will be adding to GDP by the third quarter.

Investment Implications

Just as stocks and all risk assets were crushed by the credit freeze and the economic recession, a turnaround in the economy implies that prevailing cheap valuations present an exceptional base for a recovery in stock prices. Bonds, especially risky bonds, are also attractive. Oddly enough, the safest of investments, Treasury bonds, are the investment most likely to lose money in the coming year, a view expressed in this week's issue of Barron's. We do not share the view of some that inflation is sure to become a major problem, as such a possibility depends critically on mistaken policy decisions that may not be made for several quarters in the future.

Stock market valuations suggest that stocks are exceptionally cheap, essentially at once in a lifetime levels. Depressed stock valuations reflect the fear embedded in the market that the freeze in the credit markets will prevent firms from being able to refinance their bonds or loans when they mature. If firms cannot roll over debt routinely, defaults and bankruptcies will occur across many industries and the economy could melt down into a severe decline. But, that's precisely why policymakers are so

fixated on repairing the credit markets. So we proceed on the assumption that these policymakers will succeed and credit flows revert to normal.

All risky assets should benefit from a restoration of normal credit market conditions and an end to the recession. For example, investment-grade borrowers have had to pay unusually high interest rates of roughly 8% to 10% to issue new bonds. But in the past few weeks, these rates have fallen by at least 100 basis points, rendering such borrowing less costly. For some of our accounts, where we have bought such high quality bonds, we have seen the price of these bonds surge in the last few days. And the availability of such high quality bonds for new accounts has diminished considerably. Risky junk bonds yielded more than 20% and these have also rallied nicely in recent weeks. Higher quality junk bonds now yield more than 15%, still too high for such firms to comfortably roll over existing maturing debt.

There are three possibilities for the equity market: stocks could fall, they could remain unchanged, or they could rise. The least likely possibility is that stocks remain unchanged. Stocks will fall, if policymakers are unable to reduce risk spreads, the credit markets remain frozen and consumers are deterred from spending. For this outcome to be realized, policymakers must fail in their effort to unfreeze the credit markets, an outcome I think is worth betting against quite strongly. Treasury and the Fed very clearly have the bit between their teeth and will stop at nothing to ensure a return to more normal conditions. This is as it should be. Thus, a stock market recovery should accompany a reversion to normalcy in credit market conditions. While a full recovery could take some time and volatility may remain high, a sizeable rise in stock prices is the most likely outcome for 2009, where stocks outperform other asset classes by a considerable margin.

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