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Looking Ahead To A New Year

Economy Faces A Difficult Year - But Markets May Rebound In Latter Half Of 2009

2008 has finally ended and the best we can say is – good riddance! The past year has been like no other in modern economic times. Virtually none of the Wall Street pundits or economic mavens came anywhere near predicting a scenario where the financial turmoil of early 2008 would cascade into a full-blown, worldwide crisis by year’s end. In early 2008, many forecasters saw a slowdown in economic growth, but probably not large enough to register as a recession. A weak dollar and its corresponding increase in exports helped mask the weakness of the domestic economy early in the recession and many economists refused to declare a recession without a corresponding negative GDP. Many felt that with the Fed cutting interest rates and a sizeable stimulus package of tax rebates, the economy would turnaround quickly. Even in the face of continuing falling employment numbers, a majority of analysts believed the data reflected nothing more than the continued efforts by companies to reduce labor costs and shore-up productivity.

Lehman Brothers’ Bankruptcy Nearly Tipped Global Markets Over The Edge

The debate amongst forecasters continued until September 15, 2008 - the day Lehman Brothers Holdings Inc. filed for bankruptcy and set off a series of events which nearly tipped the world’s financial markets into collapse. The Dow Jones average dropped like a stone – falling from 11,388 in mid September to 8,450 by the 10th of October. Terrifying headlines and the actual loss of wealth shocked investors and consumers alike as they watched nearly every asset class being hammered. The confidence index, as measured by the Conference Board, tumbled as sharply as the stock market – falling from 61.4 in September to 38.8 in October. The entire economy was at risk unless the hemorrhaging of the financial markets could be halted quickly. When the dust settled, only Goldman Sachs and Morgan Stanley remained of Wall Street’s big five securities firms. The damage was so widespread and severe that some actually penned the obituary of the “old Wall Street.”

The Wall Street Financial Crisis Drove The Market Down 26% In A Three Week Span

We conclude this gloomy year with the Bernie Madoff 50 billion dollar investment scandal and a nearly universal bleak outlook for the overall economy in 2009. Consumer spending has contracted severely, and corporations are cutting costs and hunkering down in survival mode. Unemployment numbers will probably worsen significantly and most economists see no improvement in employment figures until 2010. Numerous segments of the economy are lining-up for federal bailout funds from the government: automakers, real estate developers, retailers, state and local governments – and there is no end in sight.

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“Annus Horribilis” (Horrible Year) Is How Some Forecasters Are Describing The Economy For 2009

2009 Outlook

There is a growing consensus that 2009 will be as bad for consumers as 2008 was for investors. Make no doubt about it, many experts see the economy of 2009 as being best described as grim, with some economic seers even resorting to the Latin phrase “annus horribilis” (horrible year) to express their opinion. At the heart of most of these dire predictions is the question of how the consumer will behave in 2009. Many analysts see a quickly deteriorating economy pushing an already battered consumer into a shell and hence driving the nation into a very deep and long recession. But while the overall economy may be experiencing a very rough time, a good number of economists see some signs of hope for markets in the latter part of 2009. Investors should keep in mind, the stock market usually shows gains long before the overall economy begins to recover. Don't forget that in the current recession, the market began heading south in October of 2007, several months before the economy showed any real signs of trouble, and we expect the recovery to follow the same pattern – the stock market should begin to show significant gains while newspaper headlines are still echoing a tone of doom and gloom for the economy. There is currently a record amount of cash sitting on the sidelines anticipating an improvement in the economy. When market forces begin to move, we expect stock prices to rise significantly and quickly.

It's Difficult To Foresee Anything Except Time And Market Forces Solving The Housing Crisis

Housing Sector

Sales and prices of homes continued their tumble in 2008. Attempting to solve the downward spiral in the housing market has become akin to unraveling the Gordian knot. The best efforts of politicians and planners have been impotent in halting the free fall. The latest data at year end shows the national average for home prices declining 13.2% in 2008 (the largest drop since the survey group began in 1968) and the inventory of unsold homes remains at a stubbornly high 11.2 month supply. And while mortgage rates have fallen - tighter credit standards, larger down payments and a weakening economy have driven off as many if not more potential home buyers than the lower mortgage rates could attract. Today's typical home buyer faces a credit environment that has been transformed from one of “buy-now, pay-later” into a world of “no-credit, no-way” unless you have a credit score in the 700s and a 10% to 20% down payment. The news on the foreclosure front isn't much better – intensified efforts by lenders and government has had little progress in mitigating foreclosures. More than 50% of the defaulted loans modified in Q1 of 2008 have slipped back into delinquency within six months. With unemployment rising, home values declining, and tight credit conditions it is difficult to foresee anything except time and market forces which will correct the housing crisis – and that correction is not likely to culminate in 2009.

Corporations Are Cutting Jobs, Wages, And Benefits As They Hunker Down For 2009

U.S. Economy

There are a multitude of problems and uncertainty facing the economy in 2009 and it is understandable why so many economists are pessimistic about the overall economy for the near future. **Jobs:** Employers eliminated nearly two million jobs in 2008, and there is no relief in sight – the job market for 2009 looks very grim. Economists are projecting unemployment to hit somewhere near 8.5% to 10% before we put this recession behind us. Industry surveys disclose anywhere from 25% to 35% of employers are very likely or somewhat likely to layoff employees in the next 12 months. Beyond the employment figures are increased warnings from various companies, that in an effort to cut costs, they will be implementing plans to reduce benefits and wages through pay cuts, reduced health-care

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benefits and/or increased employee paid insurance premiums, suspension of 401(k) matching program and pension plans. Any reductions in wages and/or benefits will impact the economy the same as unemployment – it will place further pressure on contracting consumer spending.

Latest NFIB Survey: More Than 25% Of Small Businesses Say Downturn Threatens Their Survival

Retailers/Small Businesses

Even with price-slashing and extended shopping hours, the recent holiday season was terrible for retailers. Virtually every sector of retail sales demonstrated a major contraction in consumer spending. Sales were down significantly in electronics, appliances, women's apparel, luxury goods, and even e-commerce showed a decline. Many retail analysts fear the combination of poor holiday sales and a tight credit environment will result in a steady stream of retailers entering bankruptcy proceedings in 2009. There are disturbing indicators in the most recent survey from the National Federation of Independent Businesses concerning the health of small businesses. In the NFIB's latest survey, more than 25% of small business owners said the current economic downturn is threatening their ability to survive. Beyond slow sales, many small business owners are suffering a one-two punch of slow-paying customers combined with a loss of credit lines and bank loans. In October, the Federal Reserve Board reported 90% of U.S. banks had tightened lending standards on small businesses in the last quarter. Most small businesses don't have large cash reserves, and the impact of any interruption to their cash flow combined with a credit squeeze will push them out of existence. The importance of small businesses to the health of the overall U.S. economy is critical – more than 50% of all Americans are employed by a small business and in the last ten years, small business have created anywhere from 60% to 80% of the nation's new jobs each year.

Geopolitical

For the first time since WWII, almost all the world's developed countries will be in a recession at the same time. Governments around the world are initiating stimulus plans of varying sizes and designs to support their economies. The global economic insecurity may further deteriorate the political stability of certain nations and regions. The collapse of commodity prices has impacted oil exporting nations severely. Many of these nations have based their future budgets on oil prices being in the \$65 to \$75 a barrel range, and any severe revenue shortfall may fuel social and political unrest. Russia's oil-fired economy is contracting at a great pace, and the Kremlin is spending billions of dollars attempting to prop up the falling ruble. There have been early reports of protests in Russian cities by residents unhappy with reduced subsidies for public transportation and other forms of assistance. It should be noted that the downfall of both the Gorbachev and Yeltsin administrations occurred during periods of low oil prices and social discontent over cuts in social spending.

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What may be most disturbing about Russia's current economic troubles is a series of speeches by Mr. Putin blaming Russia's financial woes on "economic and financial authorities in the U.S." for "infecting" the global economy. Europe's economies are contracting, and forecasts of rising unemployment rates are worrisome. The recent riots in Greece were sparked by a shooting but were fueled by a stagnant economy which has resulted in a large percentage of Greek youths unable to find employment. Proof of where the discontent was directed was seen in the large number of banks and financial institutions which were burned or attacked by the rioters. In China, the contracting global economy has coincided with a slump in the property market and construction industry causing the World Bank to forecast China's weakest growth in nearly twenty years. Most China analysts feel China must maintain a very high rate of growth to mitigate social and political volatility - it remains to be seen if China's falling growth rate will fuel their social ills. In India, investor confidence has been shaken with the massive fraud investigation at Satyam Computer Services. Analysts report the fraud may involve hundreds of other companies across India. International investors also question the ability of the government to finance a stimulus package large enough to stimulate India's flagging economy due to the nation's already perilously large budget deficit. In conclusion, international investors should remain keenly alert to geopolitical events during this global recession to help guide their investment decisions.

SUMMARY



- **Crisis in the financial system and the related credit crisis continues to undermine the global economy**
 - **Stock market volatility to remain elevated**
 - **Prefer large cap stocks over small cap stocks**
 - **Prefer domestic stocks over non U.S. stocks**
- **Stock valuations are attractive but prices will remain under pressure until some sign of stabilization in the financial system**
- **Stock investors must maintain three to five year time horizon and be aware the next twelve to eighteen months may be exceptionally volatile**
 - **Emphasize high quality assets such as companies with secure dividend payouts and employ defensive strategies such as covered call writing**
- **Investment grade corporate bonds and government backed mortgages are attractive but continue to avoid junk bonds**
 - **Emerging markets and commodities have declined to very attractive levels but avoid them until some sign of stabilization in commodity prices**

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