FOR PRIVATE WEALTH MANAGEMENT CLIENTS
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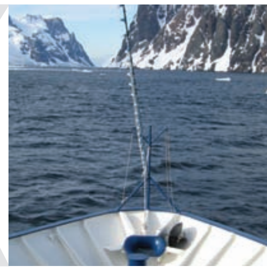
OUTLOOK

INVESTMENT STRATEGY GROUP



FORECAST 2009

Uncertain But Not Uncharted

As we put the finishing touches on our 2009 outlook for capital markets and world economies, we are struck by the irony of our task. In normal times, forecasting correctly and consistently is hard enough. In such uncertain and volatile times – where so much is reported as "unprecedented," "uncharted," "never experienced before," and "never seen before," you may well wonder why we would even attempt such a task. Best-in-class economists, including our colleagues at Goldman Sachs, started the year forecasting 2% to 3% annualized US GDP growth for the fourth quarter of 2008; those numbers were repeatedly revised during the year and now stand between negative 6.5% and negative 5% for this period. If these GDP estimates have changed by 7 to 9.5 percentage points over the course of last year, what confidence can we have in forecasting the next 12 months?

Well, perhaps things are not as unprecedented or uncharted as they appear.

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Uncertain But Not Uncharted

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It's hard not to accept that the current financial crisis and its economic repercussions are unprecedented when so many credible – and not so credible – researchers, journalists, and television commentators now characterize most any development as unprecedented. Last month alone, we counted about 4000 reports or articles describing some economic news as "unprecedented." With so much reinforcement, how can one resist the fear and panic?

It seems to us, though, that "unprecedented" and its equivalents have been overused; a little jog to the memory, a dusting off of old reports, and some research were called for. First, we approached our 93-year old private wealth advisor, Al Feld, who has worked at Goldman Sachs for 75 years and has witnessed a cycle or two or three. We then met with Jim Grant of *Grant's Interest Rate Observer*, who has written about the financial markets with great clarity and perspective for over 25 years. We dug up our old Salomon Brothers, Inc. *Analytical Record of Yields and Yield Spreads*. We reviewed the list of the big financial bubbles all the way back to the Dutch Tulip Bulb Bubble of 1636 and the South Sea Bubble of 1720 in an excellent book by Charles Kindleberger and Robert Aliber first published in 1978, *Manias, Panics, and Crashes: A History of Financial Crises*. We brushed up on our understanding of the "Minsky Moment" (named after the economist Hyman Minsky) when the virtuous cycle of easy credit, greater leverage, and greater risk and higher returns turns to a vicious cycle of de-leveraging, a free-fall in speculative assets, and further drop in the value of all assets – good and bad.

We concluded that while the use of such terms as "unprecedented" make for captivating press, much of what we have experienced in the last year or so has, in fact, been *with* precedence (and much of it within the last 40 or so years), notably the level of volatility, the "seizing" of capital markets, the rapid and sizable downdraft in equities, the hit to high quality corporate bonds, the complexity of mortgage-backed derivative securities, the fall of several Wall Street firms, the leverage in private equity, the drop in GDP – the list goes on.

It's hard not to accept that the current financial crisis and its economic repercussions are unprecedented when so many credible – and not so credible – researchers, journalists, and television commentators now characterize most any development as unprecedented.

What *is* unprecedented today is the scale and speed of monetary policy response by the Federal Reserve (a zero to 0.25% interest rate policy, 12 different liquidity facilities, and the expansion of the Federal Reserve balance sheet to about $2.3 trillion), and the scale of government action so far and in the coming months through the Troubled Asset Relief Program and an expected $700 billion-plus fiscal stimulus.

In light of significant similarities between this and prior cycles, we feel that history does provide some guidance as to the range of probable outcomes for 2009.

Let's start with the epicenter of this crisis: easy credit to the residential and commercial real estate markets and the subsequent carving up of mortgage-backed securities. We dug up press reports on this topic. From *The New York Times*: "Derivatives are complex securities whose returns are based on – or derived from – other investments. In this case, these derivatives started life as everyday home mortgages.... But in Wall Street's derivative laboratories, they are diced and sliced and reassembled into what can turn out to be a Frankenstein's monster." Likewise, in an article in *Barron's*, certain fund managers were reported to be too greedy, investing in "kitchen-sink bonds, instruments collateralized by mortgage derivatives." Wait a minute: These articles appeared not in 2008, but in the summer of 1994!

These "kitchen sink bonds" led to the blow-up of several mortgage-based hedge funds. Such complex derivatives, including COFI floaters (floating rate securities based on the Federal Home Loan Bank's 11th district cost-of-funds index), also led to significant problems in the money market sector at that time, and one fund after another was kept whole by sizable capital infusions from their sponsors. In 1994, BankAmerica injected $67.9 million into its funds, and PaineWebber spent over $268 million on its short-term funds. Others with smaller infusions included Merrill Lynch, First Boston, Piper Jaffray, and Fleet Financial.

Esoteric mortgages, in fact, date back to the mid-1880s when various railroad companies enticed settlers to Kansas, Nebraska, and the Dakota Territory by offering a menu of mortgages including, for example, an 11-year mortgage with interest only for the first three years and only 10% down. Sound familiar? Such easy credit led to a peak in land prices in 1887; in real dollars, those prices are still 5.5 times higher than the price of farmland in the region today after 110 years.[1]

This is not the first time that mortgage derivatives, hedge fund debacles, or the bursting of a credit bubble have taken down major financial institutions.

The easy credit of the 2004-2007 period and the subsequent global boom in real estate, as well as in public and private equities, emerging markets, and commodities, among others, is reminiscent of the easy credit of the mid-to-late 1980s that led to the savings and loan crisis with somewhat similar repercussions. Several banks and insurance companies were brought to their knees in 1990 and 1991, and investors were debating which banks were too big to fail. At the time, Citicorp, the predecessor to Citigroup, was at the top of the list of banks that were deemed "too big to fail." In late 1991, Citicorp's share price hit a trough of $8.50, which in split-adjusted equivalent shares, is a mere $0.93. In August 1990, the *American Banker* reported that the then-director of the Cato Institute suggested that "you have to sit the Fed and the Treasury and the FDIC down and say, 'How do we deal with a Citi or Manufacturers Hanover failure? You have to have a plan in place.'" Well, 18 years later in November 2008, the Fed, the Treasury, and the FDIC did put a plan in place to avert a crisis at Citigroup. The parallels are uncanny.

Another trend purported to be unprecedented today is the high debt-to-equity leverage ratios and size of private equity deals. But it might surprise you to know that the amount of leverage in the late 1980s was significantly greater than the peak leverage ratios of private equity deals in 2006 and early 2007. In 1988, equity as a percentage of total capital in leveraged buyout deals averaged a mere 10%. The lowest level of equity contribution in the most recent credit cycle was 32%, reached in 2005. Similarly, the size of deals in the late 1980s certainly rivals the size of deals done in the last couple of years. Kohlberg Kravis Roberts & Co.'s leveraged buyout of RJR Nabisco Inc. for $25 billion in February 1989 was achieved with $2 billion of equity (i.e., only 8% equity); in today's equivalent dollars, the RJR deal is still the second largest leveraged buyout deal in US history.

What about the unprecedented collapse of several Wall Street firms and the merger or acquisition of financial institutions such as Lehman Brothers, Bear Stearns, Merrill Lynch, Wachovia, and Washington Mutual? This is not the first time that mortgage derivatives, hedge fund debacles, or the bursting of a credit bubble have taken down major financial institutions. Where are the likes of Kidder Peabody, Manufacturers Hanover, Bank of New England, First Executive Corp, MCorp, Financial Corp of America, and Drexel Burnham Lambert? Financial Corp of America ran the largest savings and loan operation in the US. At its height, Drexel was the fifth largest investment bank in the US and had a 75% share of the high yield market. At the time of its demise, high yield securities were not only referred to as junk bonds but as "toxic waste."

Neither is the volatility nor the rapidity of the equity market downdraft unprecedented. On October 19, 1987, known infamously as Black Monday, US equities dropped 20.47%, and shortly thereafter, 30-day volatility reached 92. For the two months ending in November 1987, the equity market had declined 28.4%, and for the three months ending in November 1987, the market had declined 30.2%. In the current cycle so far, the peak in 30-day volatility has been 88.7, the worst two-month return is negative 24.5%, and the worst three-month return is negative 30.1%.

What about the seizing up or freezing of credit markets? Is this unprecedented? During the 1973-74 period, the credit markets fared much worse. While we are amazed by the recent high levels of the TED spread, (the incremental yield between 3-month Libor and 3-month Treasury bills, which peaked at 4.64% on October 10, 2008), these spreads pale in comparison to 1974 levels. After the Arab Oil Embargo of October 1973, the TED spread reached 6.22% and stayed above 5% for four months in 1974. Longer-dated corporate securities also exhibited worse performance in 1974 than in 2008. Our best estimate of the price drop in BBB-rated long corporate utilities and industrial bonds from peak to trough in 1974 is about 23%, while BBB-rated long corporate bonds have dropped about 16% in price so far in this cycle.

In the 1973-74 period, the US economy had a cumulative decline in GDP of 2.7 percentage points, equities dropped 48%, and unemployment increased from a low of 4.6% to 9%. Interestingly enough, unemployment troughed at 4.4% in this cycle, and is expected to peak around 8.5-9.5%. But to really compare the current crisis to the early 1970s, you may want to envision cars lined up at gasoline stations, big "no gas" signs plastered over hundreds of gasoline stations, and depending on the state you lived in, having to check your license plate because motorists with even-numbered license plates were allowed to buy gas only on even-numbered dates and those with odd-numbered plates were allowed to buy gas only on odd-numbered dates. Now that was unprecedented!

Federal Reserve concerns about the seizing up of the commercial paper market and subsequent intervention to prevent a breakdown of the financial engine are also not without precedent. It is well known that Federal Reserve Chairman Ben Bernanke is a student of the Great Depression and the Lost Decade of Japan; but judging by his recent actions, he must have also studied the commercial paper crisis and eventual bankruptcy of Penn Central Transportation Co. in 1970. At the time, Penn Central was the largest transportation company in the world and a major issuer of commercial paper. As Penn Central's financial condition deteriorated, there was an appeal to the federal government. The Nixon Administration was supportive. Congress, however, opposed a $200-million loan guarantee (they didn't call it a bailout then) and the Federal Reserve Board denied a loan to help Penn Central roll over the firm's commercial paper.

On June 21, 1970, Penn Central declared bankruptcy, which, at the time, became the largest bankruptcy in US corporate history. To prevent widespread fear and panic in the markets and the consequences of further failures, the Federal Reserve, under the chairmanship of Arthur Burns, announced four measures:[2]

1 It explicitly allowed member banks to go to the discount window to borrow funds for the purpose of helping clients roll over their maturing commercial paper;
2 It suspended Regulation Q ceilings on interest rates on large-denomination CDs to encourage the flow of funds into commercial banks;
3 It expanded its balance sheet to increase the money supply; and
4 It committed that it would use standby procedures if necessary to make loans, directly or indirectly, to worthy borrowers who were otherwise unable to secure credit.

Again, the parallels to the liquidity measures undertaken by the current Federal Reserve are astounding. In July 1970, *Time Magazine* wrote: "The nation's largest railroad succumbed last week to a lethal combination of politics, tight money, mismanagement, and fumbled Government rescue." This sounds like some recent press coverage about Lehman Brothers, now the largest bankruptcy in US corporate history. We should note that prior to the current crisis, Al Feld, our 93-year-old private wealth advisor, thought that the Penn Central crisis was the worst experience of his financial career. He now believes that the current crisis, post the Lehman bankruptcy, holds that dubious honor.

We also question the claim that this cycle is unique because of the global contagion of the crisis. All financial crises, wherever they emanate from, have a pattern of transmitting to all corners of the world through trade, financial flows, commodity prices, and panics that beget panics. After the Arab Oil Embargo, while the US had a peak-to-trough drop in GDP of 2.7 percentage points, world GDP growth declined from a peak of 6.1% to a trough of 1.2%; US equities dropped 48%, and other developed equities (as measured by the MSCI EAFE Index) dropped 41%. In the 1980 through 1982 downdraft, the US had a peak-to-trough GDP decline of 2.3 percentage points and global growth reached a low of 0.6%; US equities dropped 27% and MSCI EAFE equities dropped 25%. The 1998 crisis that emanated from emerging markets – more specifically, Russia and a handful of Asian countries – similarly dragged down returns in all markets. Ditto in the 2000-2002 bursting of the Internet bubble; while the economic impact was muted, US equities fell 49%, other developed equities fell by 51%, and emerging market equities as measured by the MSCI EM Index were down 50%. In an April 2008 National Bureau of Economic Research working paper, *This Time is Different: A Panoramic View of Eight Centuries of Financial Crises*, Carmen Reinhart and Kenneth Rogoff demonstrate how "shocks emanating from the center countries" have often led to financial crises worldwide over centuries.

And finally, for those who are now sounding the death knell of American capitalism, the end of the US dollar as the reserve currency of the world, and the end of the American century, we offer the paragraph below. It appeared in *The Economist* in 1908 following the panic and crash of 1907, courtesy of Jim Grant's 1992 book, *Money of the Mind*: "From one point of view, credit may be defined as the power to attract gold; but public credit really depends on public confidence, just as private credit depends on private confidence. The financial crisis in America is really a moral crisis, caused by the series of proofs which the American public has received that the leading financiers who control banks, trust companies and industrial corporations are often imprudent, and not seldom dishonest. They have mismanaged trust funds and used them freely for speculative purposes. Hence the alarm of depositors, and a general collapse of credit."

Nearly 100 years later, in the December 16, 2008 issue of *The New York Times*, Thomas Friedman wrote: "we don't just need a financial bailout; we need an ethical bailout." We are reminded of Jean-Baptist Alphonse Karr's quote: *plus ça change, plus c'est la même chose* – the more things change, the more they stay the same.

All financial crises, wherever they emanate from, have a pattern of transmitting to all corners of the world through trade, financial flows, commodity prices, and panics that beget panics.

Our goal here has not been to minimize the depth or breadth of the current crisis. On a global basis, the value of public equities alone has dropped by over $30 trillion. Banks have recognized about $850 billion of losses, and our Goldman Sachs bank analyst estimates that total losses may reach $1.7 trillion over a full cycle. This has been a seismic shift; it feels even more drastic after a period of moderation in economic cycles and a lull in corporate and sovereign debt defaults. And as with any cycle, there have been some winners and many losers. Our goal is to provide some perspective as global policymakers chart a course towards recovery – and we attempt to find investment opportunities among the rubble.

It is therefore with a heightened sense of perspective, awareness of the cyclicality of economies and financial markets, awe at the sheer size of the monetary and fiscal measures both implemented and forthcoming, and a strong dose of humility that we put forth our outlook for 2009.

[1] See *Grant's Interest Rate Observer*, November 4, 2005, for a more detailed discussion on railroad bonds.

[2] For further details on the Federal Reserve measures, please see the National Bureau of Economic Research working paper by Charles Calomiris: *Is the Discount Window Necessary? A Penn Central Perspective*, December 1993.

2009 Economic Outlook

The economic deterioration witnessed at the end of 2008 unfolded with a swiftness and severity not seen in decades. In a matter of months, there was a sharp pullback in manufacturing, a spike in job losses, a further weakening of the housing market, and a palpable erosion of consumer sentiment – all against the backdrop of a crippling credit crunch. And those are just the headlines. With each indicator released, the environment seemed to weaken by the day. What's more, the pain, which at one point was thought to be fairly contained within the US, spread to economies at every corner of the globe.

An economic malaise as serious as this naturally conjures images of soup lines and shantytowns. Although we by no means dismiss the challenges facing the global economy, we note that this is not 1929. Economic growth should slow significantly in 2009, declining in many major regions, but the combination of fiscal stimulus and monetary policy should help pull the global economy out of the depths of its slowdown.

US OUTLOOK: THE DOWNTURN CONTINUES

While we do not believe the US is entering a second Great Depression or an economic dead zone such as Japan of the 1990s, the US economy is experiencing what appears to be its deepest recession since 1973-74. We expect to see contraction through late 2009, mainly driven by negative investment and consumption growth. In all, we expect real GDP to shrink about 2.6%, peak to trough.

In spite of the gloom, we see bright spots for the year ahead. Some positive economic influences should help the economy slowly recover in late 2009. The corporate sector entered the downturn in relatively good shape with low debt and inventories. As the credit crunch eases, corporations should be able to resume investing.

Additionally, energy prices have declined significantly in recent months, with gasoline prices being cut by more than half. While this reflects in part slowing global growth, lower energy prices should give a boost to real disposable income and eventually help lift consumer confidence and corporate profits.

Exhibit 1 shows three scenarios for the US economy. In our central case scenario, to which we assign a 60% probability, we call for negative GDP growth in the fourth quarter of 2009 of 1.25-0.75% from the year before. In the worst case scenario, to which we give only a 10% probability, GDP growth would decline even further, below negative 1.25%.

Exhibit 1: ISG US Economic Scenarios – Year-End 2009

	Good Case (30%)	Central Case (60%)	Bad Case (10%)
Real GDP Growth Q409/Q408	>(0.75%)	(1.25)-(0.75)%	<(1.25%)
Monetary Policy (Fed Funds Rate) Year-End 2009	0.25-0.75%	0-0.25%	0-0.25%
10-Year Treasury Yield Year-End 2009	>2.75%	2.25-2.75%	<2.25%
Inflation (Core CPI) Q409/Q408	1.5-2.0%	1.0-1.5%	<1.0%
Inflation (Headline CPI) Q409/Q408	0.5-1.0%	0-0.5%	<0%

Data as of December 18, 2008
Source: Investment Strategy Group

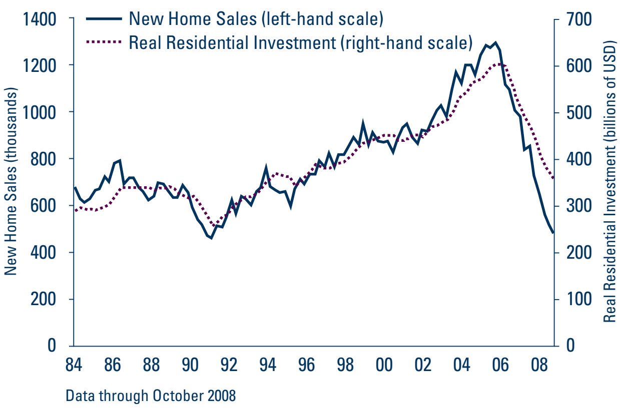
Fixed investment is likely to plummet near term. We expect a severe drop in business investment due to the credit crunch. Both supply of and demand for credit will likely fall. Banks can be expected to supply less credit as they mend their balance sheets, and companies will probably demand less credit as business prospects, both at home and abroad, darken.

The near-term outlook for residential investment is also bleak. With some 1 million vacant homes on the market and expectations of an additional 10-15% decline in home prices in 2009, we expect the contraction in residential investment to continue to decline well into 2009.

That said, it is encouraging that several housing measures have now reached levels that have traditionally heralded a trough in housing activity. New home sales, for example, adjusted for the size of the population, are at 50-year lows (the relationship between new home sales and residential investment can be seen in Exhibit 2). Similarly, incoming supply of newly constructed homes has been dramatically curtailed, and we expect that policy will remain a vital lever to remedying the housing market.

Exhibit 2: New Home Sales vs. Residential Investment

Investment has been contracting for more than three years at the same time that home sales have declined.



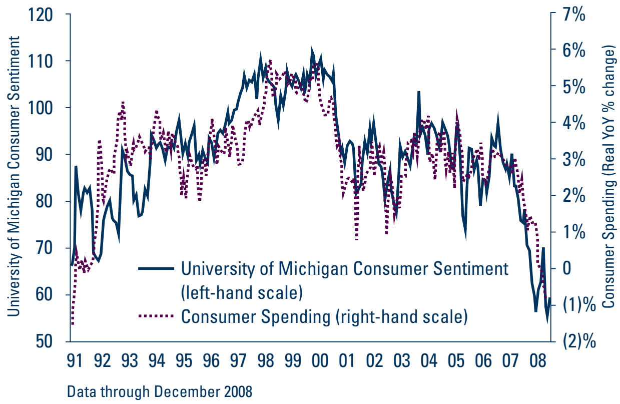
Source: Datastream, Investment Strategy Group

Finally, in trying to determine where we stand in the crisis, it's helpful to remind ourselves that the housing market itself has been in a correction for more than three years already, having peaked in late 2005. Historical housing cycles have lasted around four years, so on that basis one could argue we are already three-quarters of the way through this cycle.

Households remain under strain. We see household consumption on a persistent downtrend through at least mid-2009, as it faces significant headwinds. We believe the unemployment rate will exceed 8.5% in 2009, which translates to, at minimum, a four-percentage-point increase from the cyclical bottom in early 2007, one of the sharpest increases in post-war history. A weak labor market also limits wage growth, further dampening disposable income. Moreover, households are experiencing a dramatic decline in net worth, reflecting the fallen real estate and equity prices of the past year. Faced with declining net worth and sharply tighter credit conditions, households are likely to increase their historically low rate of savings via reduced spending. Exhibit 3 shows the relationship between consumer sentiment and consumer spending, and how dramatically both have declined in recent months.

Exhibit 3: Consumer Sentiment vs. Consumer Spending

Consumer sentiment and spending have declined in lockstep. We forecast that spending will continue to contract through 2009.



Source: Datastream, Investment Strategy Group

Fading export growth should pressure net trade. Trade had been a net contributor to GDP growth in 2007 and 2008, thanks to strong world growth and a weak dollar. Slowing global growth will likely limit the positive impact of net trade in 2009.

We also don't think that faster growth among BRICs – the large emerging markets of Brazil, Russia, India, and China – will help prop up growth in the US (and around the world) in 2009. The main channel through which emerging markets can boost US growth is by importing ever larger amounts of US goods and services. However, US exports to the major emerging markets are too small to have a significant impact on US GDP in the near future. A 10% increase in exports to China, for example, would contribute only about 0.06% to US GDP (total US exports are about 12% of GDP; China accounts for only 5% of total exports, or 0.6% of US GDP). Expand that 10% increase to all BRICs, or even all emerging markets, and the GDP effect is only about 0.1% and 0.5%, respectively. Since we don't expect export growth of anywhere near 10% in 2009, we think the BRIC/emerging market effect will be negligible.

Inflation is expected to fall sharply. All CPI components face downward pressure in the year ahead. We expect to see fuel prices fall, continued weakness in home prices, and wage growth kept in check by a soft labor market, helping suppress core inflation. Our colleagues in the Goldman Sachs US Economics Research group expect headline CPI to turn negative on a year-over-year basis in the first quarter of 2009 and remain there through the third quarter.

It's all in the policy. The policy response on the part of US authorities has been swift and aggressive. By the end of 2008, the Federal Reserve had cut the federal funds rate to a historic low range of 0 to 0.25%. As this rate cannot fall below zero, we expect the Fed to continue supporting the economy and the financial sector through various liquidity measures. For example, the Fed has recently enacted a program to purchase up to $100 billion of debt issued by Fannie Mae, Freddie Mac, and the Federal Home Loan banks as well as up to $500 billion in mortgage-backed securities issued by the housing-related government sponsored enterprises (i.e., Fannie Mae, Freddie Mac, and Ginnie Mae securities). As a result of these and other liquidity measures, the Federal Reserve's balance sheet stood at $2.31 trillion as of December 17, 2008, an expansion of over $1.4 trillion since September.

The Treasury's Troubled Assets Relief Program (TARP) should, in our opinion, also contribute to a recovery in late 2009. The Treasury's redirecting funds to help recapitalize financial institutions will bolster banks' balance sheets; lending to corporations and households should eventually resume as a result.

Finally, as the headlines proclaim every day, the incoming administration has made it clear that further fiscal stimulus – estimated to be in excess of $700 billion – may well be implemented shortly after inauguration.

As we explained in detail in a November 2008 note to clients, it is primarily for these reasons that we do not believe we are heading for another Great Depression or a repeat of Japan's crippling economic torpor of the 1990s. While there are indeed some similarities to both – and therefore lessons to be learned – the differences in monetary and fiscal policy responses significantly outweigh them. We believe that the policy actions already well underway will help quell the market's fear and panic, and allow the underlying trend growth of the US economy, the value of flexible and efficient labor markets, the entrepreneurial nature of US businesses, the impact of extensive research and development expenditures, and the subsequent rate of innovation and technological change to assert themselves.

Looking for signs of a turnaround Although we expect the economic downturn to continue throughout much of 2009, we will be watching throughout the year for signs of recovery – or at least for a slowdown in the pace of decline. Exhibit 4 shows some key leading indicators that we'll be tracking closely in the months ahead.

We mentioned earlier that we see some bright spots for 2009. Although we do not expect these positives to outweigh the economic negatives until at least late in the year, that does not mean the investment landscape is barren. As discussed below, equity markets often tend to trough well before GDP, meaning the US market outlook could well be more positive in 2009 than the economy as a whole.

Exhibit 4: Leading Indicators We Are Monitoring

The following indicators are not only highly correlated with GDP growth on a leading basis, but have also proven to be very good at predicting major turning points. The second column shows how accurate these indicators have been. The Conference Board Index (CBI) of Leading Economic Indicators, for instance, has led 11 times in the past 14 major turning points in GDP.

Leading Indicators United States	Predicted Turning Points	Peak Value (Date)	Low Value (Date)	Latest Value	Latest Release
CBI Leading Economic Indicators	11/14	14.5 (Mar-76)	(14.2) (Dec-74)	(3.5)	Oct-08
Institute for Supply Management (ISM) Index	9/14	70.4 (Mar-73)	32.2 (Mar-75)	36.2	Nov-08
ISM Forecasting Index[1]	10/14	134.9 (Dec-72)	65.9 (Jun-80)	67.0	Nov-08
S&P 500 Rolling Annual Return[2]	6/11	55.4 (Sep-83)	(41.4) (Dec-74)	(37.5)	Dec-08

[1] *Includes new manufacturing orders minus inventories*

[2] *Annual percentage change based on quarterly data*

This material represents the views of the Investment Strategy Group of the Goldman Sachs Investment Management Division and is not a product of the Goldman Sachs Global Investment Research Department.

Source: Datastream, Bloomberg, Barclays Capital, Investment Strategy Group

Exhibit 5: ISG Global Economic Outlook Scenarios – 12-Month Forward GDP and Inflation

Country	Latest GDP (Q308)	2009 GDP Q409/Q408	Latest Headline Inflation	2009 CPI Inflation Q409/Q408
US	0.8%	(1.25)-(0.75)%	1.1%	0-0.5%
Eurozone	0.6%	(0.5)-0%	3.2%	0.25-0.75%
UK	0.2%	(0.5)-0%	4.1%	(0.75)-(0.25)%
Japan	(0.5)%	(1.0)-(0.5)%	1.7%	0.0-0.5%
EM Asia	8.7%	4.5-6.5%	6.8%	0.75-2.75%
EM Latin America	5.4%	0-2%	7.6%	6.5-8.5%
Russia	6.2%	(1)-1%	13.7%	9.5-12.5%

Data as of December 17, 2008
Source: Investment Strategy Group

THE GLOBAL OUTLOOK DIMS

As we suggested in the ISG Outlook a year ago when we discussed the "re-coupling" of global markets, economies around the world have not been immune to the US-led financial crisis and economic slowdown. Thus we expect growth to continue decelerating throughout the world in the coming months, with negative GDP growth in the developed economies likely through the first half of 2009 and slower growth, albeit still positive, in the emerging markets.

Eurozone We expect the Eurozone to experience its worst recession since the end of World War II. Investment will likely contract as the credit crunch persists; exports should fall as global growth slows; and consumption can be expected to remain sluggish as employment prospects worsen. Moreover, governments are poised to react less forcefully on the fiscal front than their US counterparts, although we're encouraged that they have begun to step up their policy responses in recent weeks. As Exhibit 5 shows, we predict Eurozone GDP growth will be negative 0.5% to 0% in the fourth quarter on a year-over-year basis.

We see Eurozone inflation falling substantially, reflecting lower commodity prices and reduced demand pressures. The European Central Bank should therefore cut its key policy rate further in 2009. We anticipate some signs of recovery to emerge in mid to late 2009, thanks in part to rising wages (which, in a country such as Germany, for example, are indexed to the previous year's high inflation rate).

United Kingdom Our year-over-year projection for UK growth is negative 0.5% to 0% in the fourth quarter of 2009, although the policy response, particularly interest rate cuts, has been faster and more dramatic than in the Eurozone. We also see economic growth beginning to return slowly to that area late in 2009.

Japan We expect growth in Japan to be negative 1% to negative 0.5% year over year in the fourth quarter of 2009. Japan exports and export-related investment will likely shrink due to a combination of a stronger yen and a sharp reduction in external demand. Although for a while it appeared that Japan's already-reformed banking system might dodge the brunt of the credit crisis, we're beginning to see signs of stress in this area as well. We expect the economy will not grow again until exports and investment recover. We see this as unlikely until late 2009.

Emerging markets Economic growth in the emerging markets is likely to come under additional pressure. Much of Asia relies heavily on exports, which aren't expected to grow much (if at all) in 2009, while many Latin American economies are struggling as a result of the fall in commodity prices. Meanwhile, emerging European countries are grappling with a banking crisis. Even China, now the fourth largest economy in the world, is expected to experience a decline in its robust GDP growth rate. A drop in Chinese GDP growth from 11.9% in 2007 to about 6-7.5% for 2009 is likely. We are biased towards the lower end of that range in spite of a large fiscal stimulus program and much looser monetary policy. The only bright spot for emerging markets is that they could benefit from a rise in real income due to the dramatic decline in inflation now that last year's sharp increases in oil and food prices have reversed themselves.

2009 Financial Markets Outlook

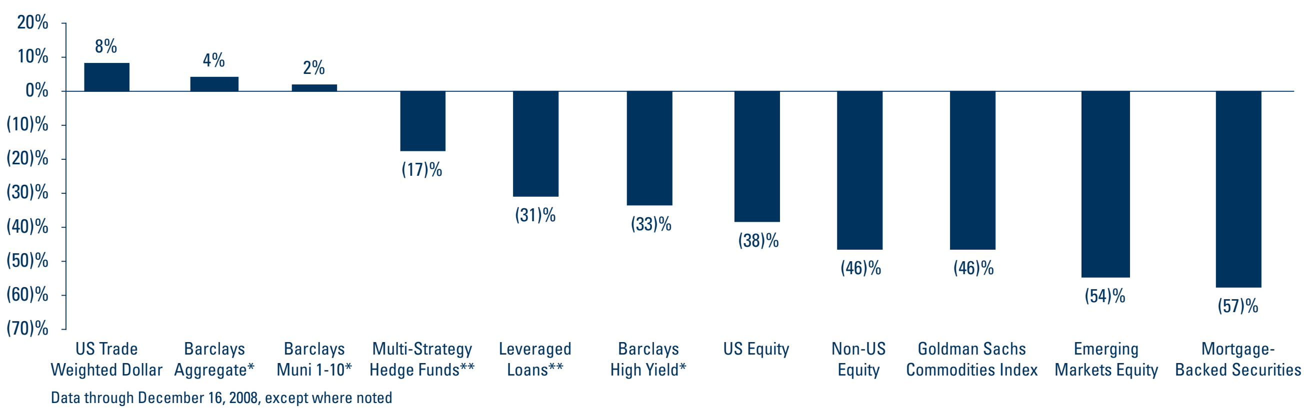
We begin a new year in the thick of the toughest market environment since the Great Depression. The violent unraveling of stock prices alone in the last few months has been nothing short of stunning. Major indexes have lost upwards of 50% from their peaks, with daily swings of 5% to the upside and downside becoming an unsettling norm. The S&P 500, for example, plunged from 1576.1 on October 11, 2007, to a low of 741.0 on November 21, 2008, a decline of 53%. The financial market meltdown, a global economic stall, and sheer panic have fueled a staggering and rapid destruction of equity wealth that has spared virtually no asset class, geographical region, or investment style. (The 2008 returns of major asset classes can be found in Exhibit 6.)

Perhaps just as disheartening, we're not out of the woods yet: The combination of a credit crisis, ongoing de-leveraging in the financial system, and further declines in home prices should continue to take a steep toll on global economic growth in the coming year. What's more, the struggle between the deflationary forces of falling prices and the reflationary forces of extensive global fiscal and monetary policy stimulus will likely affect the performance of all asset classes in ways that are all but impossible to predict.

That said, what is often overlooked in such times of irreducible uncertainty is that opportunities are created. Equity markets, for example, tend to be forward looking, and thus tend to bottom well before the economy does. By that guide, the US equity market should have either marked its low in the fourth quarter of 2008 or be very close to doing so in the first quarter of 2009.

Although it might seem counterintuitive against the current backdrop, the Investment Strategy Group recommends that clients consider adding US equity market exposure to their portfolios. Valuations have fallen to attractive levels, creating a compelling risk/reward entry point. Although stocks may weaken further in the short term, the ISG recommends using such weakness to gradually increase exposure, as equities are priced to deliver attractive expected returns to the long-term investor. To wit, the current equity earnings yield exceeds the real long-term bond yield by a level not seen since the early 1980s. At a time when the world is adjusting to the likelihood of a deep recession, we take a certain measure of comfort from the fact that equities traditionally discount recessions in advance – and that market washouts often produce significant buying opportunities.

Exhibit 6: 2008 Asset Class Performance



** Formerly Lehman Brothers indexes*

*** Performance through November 2008*

Source: Investment Strategy Group, Datastream, Barclays Capital, Credit Suisse, Markit, Bloomberg

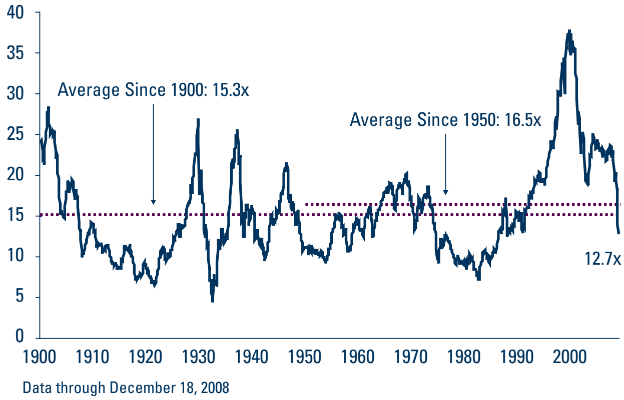
Past performance is not indicative of future results.

US EQUITIES: FIRST IN, FIRST OUT

Although continued fund redemptions and the prospect of a deeper global recession are likely to weigh on stocks in the near term, there are several reasons we find US equities compelling. First, valuations are attractive: As Exhibit 7 shows, the current (as of mid-December 2008) S&P 500 price/trend earnings multiple is around 12.7x – lower than the long-term average of 15.3x since 1900 and the average of 16.5x since 1950. Second, the current earnings yield exceeds the real long-term bond yield by about 7.9 percentage points, a level not seen since the early 1980s.

Exhibit 7: S&P 500 Price/Trend Earnings

The current price/trend earnings multiple of the S&P 500 Index is lower than its long-term averages. Although higher than historical trough levels, we expect the multiple to expand as investors price in an earnings recovery.



Source: Investment Strategy Group, Standard & Poor's, Robert Shiller (Yale University)

Earnings growth, of course, will continue to struggle in 2009. S&P 500 reported earnings have already fallen by around 50% since mid-2007. Importantly, equities have historically bottomed even while earnings are still contracting. More specifically, in the post-war period, the stock market has reached bottom despite a further fall in earnings of around 20%, on average. In the current context, that would imply a peak to trough decline in earnings of around 60%, the worst earnings decline since the Great Depression's 75% contraction. Of course, during the Great Depression, real GDP contracted some 26% from its peak.

Given the extent of earnings erosion already seen in 2008, we estimate operating earnings will be flat to slightly down for 2009. As shown in Exhibit 8, our central case calls for the market to assign a multiple of 15.5x to 18.5x to 2009 trend reported earnings. We prefer this measure, since the underlying long-term trend of reported earnings growth smoothes cyclical highs and lows and has a better track record of predicting forward equity returns. As market participants begin to discount an earnings trough in 2009, they will increasingly shift their focus toward a profit recovery over the subsequent quarters. This should benefit equity prices as investors apply a higher trend multiple to more normalized trend earnings.

Since the US was at the epicenter of the financial-market crisis, it has made further progress employing both monetary and fiscal stimulus than other countries, bolstering our view that a recovery will take root in the United States first. Given the extent of price dislocation across nearly every sector in the

Exhibit 8: ISG US Equity Scenarios – Year-End 2009

By year's end, the Standard & Poor's 500 Index should trade at a price/trend reported earnings multiple of 15.5x to 18.5x and reach a price target of 1150 to 1250, according to our central case.

	Good Case (30% Probability)	Central Case (60%)	Bad Case (10%)
Year-End 2009 S&P 500 Earnings	Operating Earnings $71.50 Reported Earnings $64.50 Trend Rep. Earnings $73	Operating Earnings $60-65 Reported Earnings $51-55 Trend Rep. Earnings $70-71	Operating Earnings ≤ $51 Reported Earnings ≤ $46 Trend Rep. Earnings ≤ $70
S&P 500 Price/Trend Reported Earnings Multiple	18.5-20.0x	15.5-18.5x	9-10x
Year-End 2009 S&P 500 Fundamental Valuation Range	1350-1460	1085-1315	630-700
Year-End 2009 S&P 500 Price Target (based on a combination of trend and forward earnings estimates)	1400	1150-1250	650

Forecast as of December 17, 2008
Source: Investment Strategy Group

market, broadly attractive valuations, and the uncertainty of selecting which sector will lead the market out of this downturn, we believe broad exposure to the US market as a whole via the S&P 500 is the best implementation of our equity view.

There are, however, a couple sectors that bear special attention. The first is infrastructure, an area the Obama Administration has repeatedly mentioned as a key focal point for government stimulus. We believe that industries leveraged to domestic infrastructure spending, such as civil engineering, metals, cement, and materials companies, should hold up well in the coming months.

The second is homebuilding. These stocks, which at year-end 2008 had fallen 80% from their peak in 2006, have already discounted an onslaught of bad news. Moreover, we're seeing some traditional measures of housing activity reach previous trough levels, such as new and existing home sales. In addition, the government is taking explicit measures to lower mortgage rates and stem the tide of foreclosures, both of which should ultimately rekindle housing activity. As such, we believe a bottoming of residential real estate in the second or third quarter of 2009 is quite possible. Homebuilding stocks typically anticipate industry lows about three to six months ahead of time.

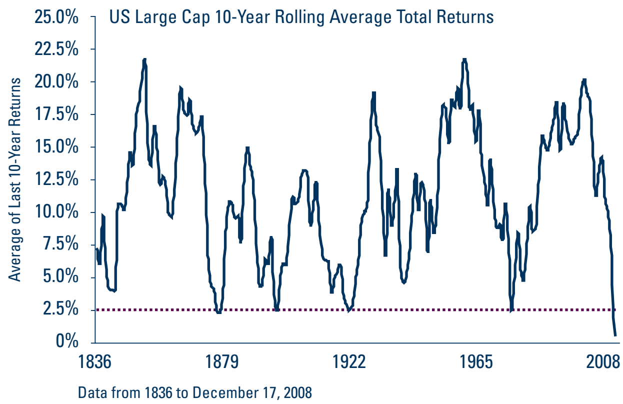
We're all too aware that volatile markets make for an uneasy investment climate, but history suggests that market extremes often present the best opportunities. As the chart of rolling 10-year average total returns illustrates in Exhibit 9, US equities tend to stage "V"-shaped recoveries off the 2.5% level. In every cycle, long-term investors who purchased US equities when the total return dropped this low benefited in the following six to 12 months. As such, we recommend scaling in slowly to US equities as part of a diversified portfolio.

GLOBAL EQUITIES: THE TIES THAT BIND

Despite the recent popular notion of global economies "decoupling" from one another, equity markets tend to move together, particularly during downtrends. In recent months, US and non-US equity markets have moved in virtual lockstep, behaving almost as one market.

Exhibit 9: Extremes Highlight Potential Opportunities

History shows that the rolling 10-year average total return for equities typically experiences "V"-shaped recoveries off the 2.5% level.

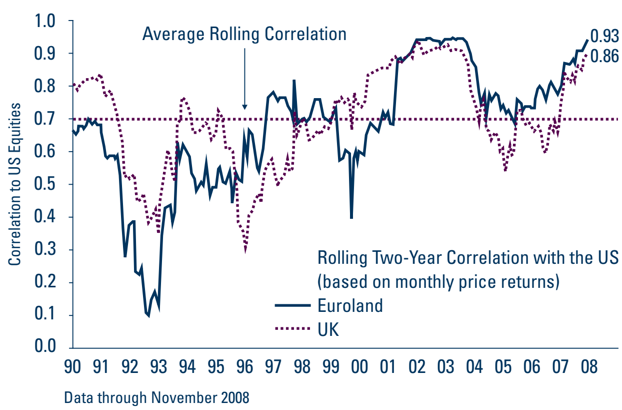


Source: Goldman Sachs Asset Management, Datastream, Investment Strategy Group

As Exhibit 10 illustrates, the equity correlation of Euroland and the UK to the US is about 0.90 (1.0 indicates a perfect correlation). Given this, we believe that in order for global equities to turn higher, the US equity market first has to trough. Although we cannot be certain how global equities will behave in the short run, we believe that the risk/return proposition in US equities is more favorable than other regions. (For a list of regional equity valuations, please see Exhibit 11.) Below we detail our regional views.

Exhibit 10: Equity Market Correlation with the US

The correlation of Euroland and UK equities to US equities, at about 0.90, is higher than the average rolling correlation of 0.70 since 1990.



Source: Datastream, Investment Strategy Group

Exhibit 11: Developed and Emerging Market Valuations

Most equity price/10-year peak earnings ratios in developed markets are currently lower than their historical averages. However, even after a sharp pullback, many emerging market valuations on a price/10-year average cash flow basis are still only at historical averages.

Developed Markets Price/10-Year Peak Earnings Ratios

	Current	Average Since '84	Average Since '95
US	10.4	17.9	20.3
Japan	9.4	29.5	24.2
UK	7.0	14.2	15.3
Germany	7.4	16.2	17.8
France	7.9	15.8	18.2
Italy	6.5	16.2	16.9

Emerging Markets Price/10-Year Average Cash Flow Ratios

	Current	Long-Term Average
Brazil	10.2	10.5
Russia	6.6	11.4
India	17.4	20.0
China	11.0	7.3

Data through December 16, 2008
Source: MSCI, Investment Strategy Group

Premature for Europe and the UK The valuation backdrop in Euroland has improved, with equities now trading at about 8.4x trend earnings – near trough levels in each of last four major economic cycles. European equities appear to be discounting a significant amount of earnings and economic deterioration. However, we know that sentiment – and not long-term fair value estimates – often drives markets in the short run. Therefore, it is important to be cognizant of the downside.

The UK, for example, relied heavily on financial sector growth over the last several years, and consequently is suffering an even worse housing bust and consumption fallout than the US. Meanwhile, exports fuel much of Europe's economy, leaving earnings highly dependent on global economic growth. Finally, the risk of a delayed recovery due to an uncoordinated policy response implies greater near-term volatility. Given the global economic duress, we think it is still too early in the profit and economic cycle for investors to expect a strong and sustained equity recovery in Europe or the UK. Although valuations in Europe are approaching levels that could represent attractive forward equity returns for a long-term investor, we remain cautious in the near term.

Challenges facing Japan Although valuations for Japanese equities remain attractive, we believe several challenges make this region less compelling in the near term. As carry trades (borrowing assets denominated in low-yielding currencies to purchase higher-yielding assets) have unwound in recent months, the yen has strengthened. This firming of the once-weak currency, coupled with dramatically slower global growth, place Japan's sizeable export sector in a particularly vulnerable position. In addition, plummeting oil prices have mitigated some of the comparative advantage that Japan enjoyed as an energy-efficient country and as an exporter of fuel-efficient automobiles. Finally, while no banking system has been unaffected by the current credit crisis, Japan's was thought to be in relatively better shape because it spent the last decade doing balance-sheet repair. However, we're now seeing that instead of sidestepping the subprime malaise, Japanese banks are beginning to face mounting losses from equity cross holdings and widespread credit deterioration. As such, we are cautious on Japanese equities in the near term; we will continue to monitor this region to determine if a long-term opportunity emerges.

After the fall, emerging market valuations are still lofty. Emerging market equities have fallen sharply from their peak in 2007, outpacing declines in US and global markets. While many emerging market countries are in better financial positions than they were during the last major crisis in 1998, the global financial system is much more integrated, leaving these economies vulnerable to the credit crunch and global economic slowdown.

Despite the recent selloff, valuations relative to their own history would need to fall as much as 26% to reach average trough levels of the past two downturns, leaving room for additional valuation compression. While another bout of equity market capitulation could cause BRIC countries (Brazil, Russia, India and China) to underperform, China could better weather the storm if government stimulus bolsters economic growth. That said, overly optimistic growth and earnings assumptions pose another challenge to emerging markets, and China in particular, as political and social risk often rises here when economic growth slows. Given our concerns, we prefer developed over emerging markets.

CURRENCIES LACK CLEAR TRADE

In the current market upheaval, the US dollar has benefited from a flight to quality. The assumption that the US economy will emerge from the downturn first, along with a repatriation of dollars previously invested outside the US, have helped bolster the greenback. However, there's another side to the dollar's muscle: This trade could in part be a safe-harbor move, and as investors become less risk-averse, the dollar might weaken. The currency's strength also is tied to the looming question of whether the US will succumb to deflation, as Japan did in the 1990s – a matter that has yet to be answered definitively. Amid the current economic uncertainty, we do not see any compelling overweighting or underweighting opportunities in the currency markets at the present time.

OPPORTUNITIES IN CREDIT MARKETS

In the wake of the global credit-market meltdown, lending remains tight, and investors still have little appetite for anything riskier than US government bonds. After significant fiscal and monetary policy stimulus, credit markets are showing some tentative signs of relief, as evidenced by the easing of Libor and tightening of the TED spread (the difference between Libor and US Treasury yields). We expect to see a continued slow thawing of credit markets in 2009. (For a list of Goldman Sachs' year-end government bond yield projections, please see Exhibit 12.)

Exhibit 12: Goldman Sachs Government Yield Projections

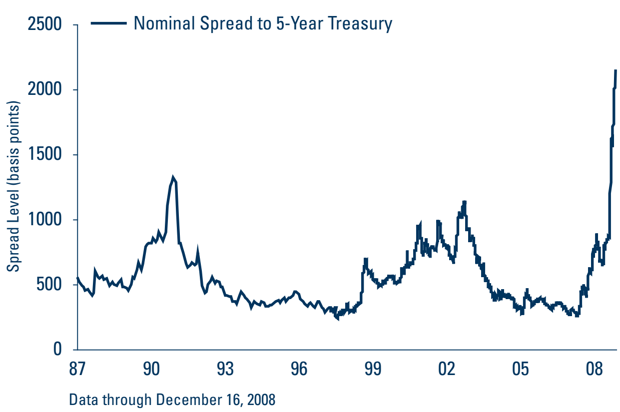
	10-Year Yield (Year-End 2009)
New Zealand	6.0%
Australia	5.2
Norway	3.9
UK	3.8
Canada	3.8
US*	2.25-2.75
Sweden	3.4
Germany	3.3
Switzerland	2.4
Japan	1.6

**ISG forecast, all other forecasts are from Goldman Sachs Global Investment Research*
Source: Investment Strategy Group, Goldman Sachs Global Investment Research

There are some fixed income opportunities that bear mention. The first is US corporate high yield, where, as Exhibit 13 shows, spreads relative to 5-year Treasury yields have widened considerably above their historical peak levels. Owing to a high correlation with US equities, US corporate high yield bonds provide indirect exposure to US stocks but with generally less volatility than a direct equity investment. What's more, because financial companies need to maintain high credit quality in order to obtain ongoing short-term liquidity, these firms generally don't exist in the high yield space. As a result, corporate high yield has less exposure than US equity indexes to the financials sector, which remains a key driver of market uncertainty.

Exhibit 13: Corporate High Yield Spreads

Current corporate high yield spreads relative to 5-year Treasury yields are at historic highs, creating an attractive entry point for investors to start building positions.



Source: Datastream, Barclays Capital, Investment Strategy Group

Additionally, even if high yield spreads remained at current elevated levels, a high yield investor could still break even after funding costs, even if 17% of the firms in the Barclays Capital US High Yield Corporate Bond Index defaulted annually for the next three years, and only 15% of the defaulted amount was ultimately recovered. To put these statistics in perspective, recessions generally witness 10% annual default rates for roughly two years, while the highest single-year default rate was 16.3% in 1933 during the Great Depression. Moreover, typical recovery rates during a recession average around 29%, with the lowest recovery rate of 21% reached in 2001. While high yield spreads could widen further, we think that current levels are compelling enough to continue scaling into a larger position.

Another area worth mentioning is municipal bonds, which have suffered mightily in recent months and are now attractively valued relative to US Treasuries. Although munis generally enjoy low default rates, today's market challenges are not to be dismissed. We recommend high-quality bonds that are one to 10 years in duration. Historically, issues of longer duration have suffered bouts of negative returns amid periods of de-leveraging and risk aversion.

We also see some opportunities in other areas of the credit space, including investment-grade corporate bonds, mortgage-backed securities, leveraged loans, and convertible bonds. Year to date through the end of November 2008, these sectors were down by 7%, 58%, 38%, and 22%, respectively (actual convertible arbitrage indexes are down closer to 40+%). Some of these declines have been driven by fundamental factors such as the economic slowdown and the expectations of much lower earnings and higher default rates. However, some of the declines also have been driven by technical factors, such as supply and demand imbalances created by de-leveraging across banks, hedge funds, and individual/institutional investors, as well as by hedge fund and mutual fund redemptions. We believe some value can be found in each of these sectors. For example, corporate investment-grade bonds, which carry a negligible probability of default, currently yield 7.83%.

Additionally, even with Draconian assumptions about default rates in mortgage-backed securities and significant losses on the value of the collateral due to further decreases in home prices, returns in the 25-30% range for option adjustable rate mortgages (ARMs) are still possible. Moreover, leveraged loans offer an attractive risk/reward profile in a period of continued de-leveraging and higher defaults.

ALTERNATIVES FACE HEADWINDS

Hedge funds A broad array of hedge funds have been negatively impacted by the forced reduction in leverage ratios due to margin calls, the absence of bids from the broker-dealer community, the rash of redemptions, and the significant declines across all asset classes (equities, mortgage-backed securities, convertible bonds, municipal bonds, and leveraged loans). Most hedge funds have produced negative returns: Relative-value hedge funds are down 32.0% year to date, while event-driven, equity long/short, and macro/tactical trading strategies are down by 16.7%, 20.6%, and 4.6%, respectively.

Within each sector, the dispersion among managers has been dramatic. In the multi-strategy sector, for example, returns have ranged from negative 47.5% to positive 20.7% among hedge funds of significant size and credibility. This, combined with the lack of transparency and liquidity, the recent use of "gates" by hedge funds to manage their redemptions, and the revelation of a huge alleged Ponzi scheme have prompted investors to question the role of hedge funds in their portfolios.

However, it is important to note that, in aggregate, hedge funds have outperformed most market indexes (please see Exhibit 6 on page 11 for 2008 returns). In addition, the capital market dislocations, some of them due to technical supply and demand factors, have created significant opportunities in the current environment. We maintain that within every well-diversified portfolio, hedge funds should represent between 6% and 12%.

Private equity With higher credit costs and greater levels of equity required in deals against a recessionary backdrop, the return outlook for new private equity investments depends significantly on what happens to purchase prices. Recent deals have been priced in the range of 8-9x EBITDA (earnings before interest, taxes, depreciation and amortization), which is lower than the peak multiples of about 10x in 2007, but higher than the 6-7x range during 2001-2003. To see private equity's typical 15-20% returns in the coming years, we will need to see lower purchase price multiples near the 2001-2003 levels as well as improvement in the availability and the cost of capital.

We think the greatest opportunities in private equity will be concentrated in two areas: the distressed sector and the secondary market (otherwise known as the vintage sector). With default rates set to rise off 25-year lows, the number of opportunities for investors to take control of companies through the acquisition and conversion of debt to equity is likely to grow substantially over the next several years. We expect to see a similar uptick in the number of portfolios focusing on distressed credit, mortgage, and consumer assets.

The secondary market for private equity is also experiencing considerable growth now due to the historic increase in private equity fundraisings of the last several years. As the size of their holdings has increased, institutional investors have started to actively manage their private equity portfolios in the same way they would holdings of fixed income or equities. This might involve rebalancing between strategies or shedding those managers who are no longer deemed integral to the core investment mandate.

The current environment has also created an overweight to private equity for many institutional and high net worth investors due to the big decrease in the value of their total portfolio relative to the decrease in the value of their private equity holdings. Of course, this apparent over-allocation to private equity could also be due to a lag in the pricing of private equity.

Finally, many investors who were relying on private equity distributions and a better market environment to meet capital calls from private equity funds are now in search of liquidity. Taken together, the abovementioned reasons, coupled with continued pricing and informational inefficiencies in this secondary market, are giving rise to unique investment opportunities for vintage fund managers.

CONCLUSION: CHALLENGES, WITH PRECEDENTS

Calling the current investment environment difficult is, to be sure, a grave understatement. Financial-market distress and economic malaise have tainted asset classes of every type and shaken investor confidence to the core. Global markets, awaiting some sign that various monetary policy and fiscal stimulus efforts are going to right this wayward ship, remain volatile, uncertain, and daunting. Investors are understandably concerned.

But while serious challenges remain and uncertainties abound, much of what we see in the current market environment is not unprecedented. We've experienced financial market dislocations, collapsing asset prices, and wild swings of panic before. What history tells us, and what we've learned from steering through such treacherous waters in the past, is that opportunities are often created during just such times. This one, we believe, will ultimately be no different.

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