

December 2008 CAPITAL MARKETS COMMENTARY

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“Good design can’t fix broken business models.”

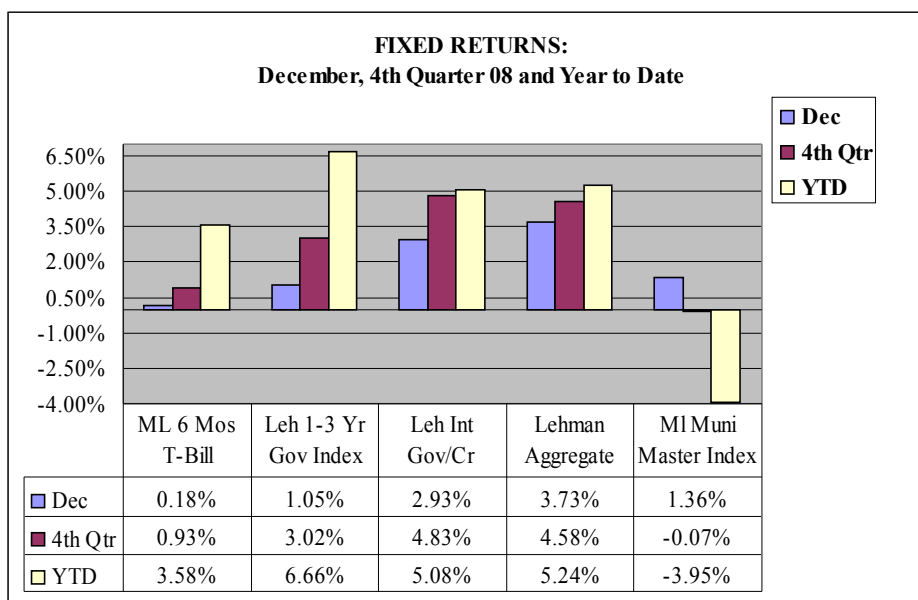
Jeffrey Veen

Fixed Income

The Treasury curve rallied sharply in December as 10 and 30 year bond yields fell by 52 and 54 bps respectively. This was due in most part because market participants have been convinced of a prolonged economic downturn with a deflationary tilt. The short end of the curve fell by about 20 bps and T-Bills continued to hover around zero.

Bond market performance was the tale of two different markets in 2008. The Treasury market registered double digit total returns. This was a combination of a flat yield curve and market participants’ reluctance to purchase corporate and structured product, along with the demand for non-callable government debt. On the opposite side, spread products had their worst year on record as participants shied away from anything related to credit.

Returns were positive for the 4th quarter 2008 along the whole Treasury curve. The short end of the curve was a positive 3.0 % return for the quarter, with the intermediate and longer end of the curve having even stronger returns of around 4.50%. During the quarter yields fell by 120 bps on the 2-year Treasury (the 2-year Treasury yield started the quarter at 1.96% and ended at 0.76%) and 143 bps on the 5-year Treasury (the 5-year Treasury yield started the quarter at 2.98% and ended at 1.55%). Yields on the longer end of the curve also fell, with the 10 year Treasury down 161 bps, (the 10-year Treasury yield started the quarter at 3.82% and ended at 2.21%).



Fixed Income Markets - Looking Ahead

As the year ended investors sold the long end of the Treasury curve. This caused longer Treasury yields to rise.

As the fixed income markets enter 2009 many of the same problems from 2008 remain. Although the markets can take some solace in the fact of outlasting a near collapse in September and October, there continues to be uncertainty as to the state of the markets and the solutions the Government has put into place to stem the tide of a total meltdown.

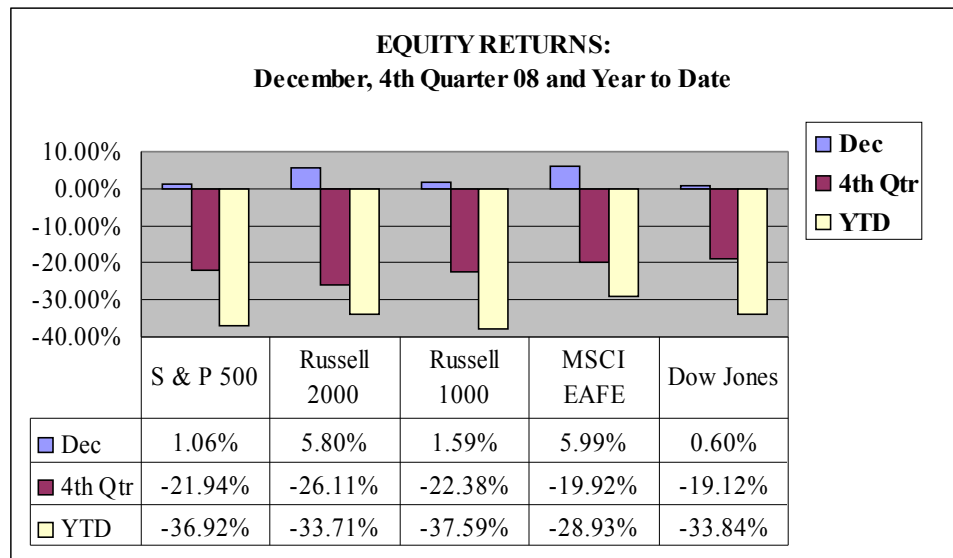
The Fed, having lowered rates to 0 to 25 bps, spent their last bullet on forcing rates down. Now they have to fund the programs they put into place. There is going to be an unprecedented amount of debt coming to market in the upcoming months, not only from the Treasury, but from the GSE’s as well. With this amount of supply coming to market in very short time there is a worry that yields will start to slowly rise. If that happens, returns will be hurt due to principally declines and low coupon returns.

Equity

Last year everything went against equity ownership and the Equity markets ended the worst year since the depression. Profits plunged, corporate interest rates surged, and economic fears heightened. And, even though the Fed added money to the system using every acronym they could find (TARP, TGLP, etc) and cut rates to 0 to 25 basis points, the markets could not take the stress.

Although major equity indices posted positive returns in December, the quarter and the year were negative. For the 4th Qtr the Russell 2000 Index led the downward charge with a return of -26.11%. Other indices fared equally as bad. The return for the S & P 500 was -21.9%, the Dow was down -19.1%, the Russell 1000 was down -22.4%, and the International markets weren't spared as the EAFE returned -19.9%.

The Y-T-D returns were even worse as returns for the year hovered around -35.0%, and even the International sector posted an almost -30.0% return.



Equity Markets - Looking Ahead

2009 should not be as bad as 2008. I'm really going out on a limb on this. OK, let's be serious. The good news is 2008 is behind us. There is a new President and a bold stimulus plan in place, along with some action on the war front. However, the economy seems to be stalled and no amount of incentive is helping.

However, looking ahead further out in 2009, we continue to believe that cheaper stocks should outpace more expensive ones and good momentum stocks should do better than poor momentum stocks. Fundamental research analysts are becoming more positive and companies that are profitable, have sustainable earnings and use their capital to enhance shareholder value should hold value.

The Economy

The Fed ended the year with their target rate on Fed Funds at 0 to .25%. This last ease, along with the infusion of money to the financial sector, possibly helped to hold off a complete market collapse. On the other hand the Fed played their last card, using money supply, and also possibly exhausting traditional monetary policy. Most market participants believe that the Fed will try and preserve a near "**Zero**" target rate for an extended period of time.

The Federal Reserve minutes conveyed a bleak picture of the economy in the 4th Qtr of 2008. The minutes discussed implementing an inflation target to better target a deflationary period in the near future. Current Fed Chairman Ben Bernanke has desired the use of this inflation target similar to other countries like the United Kingdom and Canada.

The Economy - Looking Ahead

Expectations are that the combination of policy stimulus and private sector adjustment will help the economy start growing again, but probably not until late 2009. For now, economic momentum is still negative. An article in “Pensions & Investments” quoted Jay Feldman, director of economics at Credit Suisse Securities. He said, “The good news is that fiscal and monetary authorities are throwing their kitchen sinks at the crisis”. However, he cautioned, “the policy medicine is also very experimental and there are no guarantees it will work. Any outcome will be determined more by the political process than by the underlying economic process than at any time in recent history.”

With that said, most market participants agree that the wild card will be how the efforts of federal government will pan out. How much money the government hands out, and how the other stimulus additives, will be received, still is yet to be determined.

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