



Economic and Market Update

November 26, 2008

Recent Positives

Spur to consumer credit – The Federal Reserve and New York Fed announced an \$800 billion plan to increase the availability of consumer credit. That's positive but, even with lower interest rates, will consumers worried about their jobs actually borrow? Merrill Lynch says consumer loans have declined at an annual rate of 5.5% over the last four weeks. Household debt and debt service ratios are near all-time highs. And last week mortgage applications touched their lowest levels in eight years.

Still more stimulus – This week the government infused Citigroup with another \$25 billion and President-elect Obama promised infrastructure spending equivalent to 2%-5% of GDP over the next two years, according to International Strategy & Investment. Mr. Obama also introduced his economic team to mostly positive reaction.

Have stocks fully discounted recession? JP Morgan says it's possible, noting that 61% of S&P 500 stocks have price/earning ratios below 10, a level not seen since 1982. The market also may be pricing in too much inflation. The firm points out that single-digit price/earnings multiples occur most often when inflation is high. But, right now there's actually a whiff of deflation in the air.

Of volatility and spreads – The VIX volatility index has posted several new record highs and, according to Macro Mavens, yield spreads between Baa rated corporate securities and U.S. Treasuries is the widest since the Great Depression. Ned Davis Research says that nine of 10 bear market lows since 1928 have been reached around the time volatility and spreads peak.

Time to give bonds a look? High yield credit spreads imply defaults will rise to 21% over the next 12 months, says Credit Suisse. That seems overly-pessimistic, considering the previous all-time peak was 14% back in 1933 and Moody's expects corporate defaults to peak at 11.5% this time.

What Else?

Savings up, but not by much – The U.S. savings rate is 1.3%, according to JP Morgan. That's an improvement from the bottom of 0.7% in 2005. But it's still a long way from the 8% level common from the late 1980s into the '90s. On the other hand, according to 13D Research, U.S. household cash savings now amount to \$11.5 trillion. That's greater than the capitalization of the Wilshire 5000 Index.

Holstering the plastic – 60% of shoppers told Reuters they will use credit cards less this season to purchase gifts, and Wal-Mart reported its credit card transactions have fallen for the first time in three years.

Staying home for the holidays – AAA says that for the first time in six years, Thanksgiving travel is expected to decline. Meanwhile, even after cutting 200,000 seats per day and discounting fares for the holidays and beyond, airlines still struggle to fill their planes.

Another reason to close your eyes under the mistletoe – Beauty sales are down 1% heading into the holidays, according to the NPD Group. This marks the first negative trend recorded at this point in the season.

Recent Negatives

Financial sector employment hit hard – Remarkably, U.S. financial sector employment is 1.2 million higher today than in early 1997, when the stock market was at the same level it is now, according to Merrill Lynch. World-wide sector job losses are expected to accelerate to 350,000 by mid-2009, according to search firm C.T. Stevens Partners.

Joblessness begets higher state taxes – Adding insult to injury, 11 states have raised taxes to replenish funds necessary to pay unemployment benefits, reports Merrill Lynch.

Big slump for vehicle sales – Vehicle sales in the U.S. are down 35% year over year. No nation has seen a bigger drop-off, according to Strategas. Edmunds.com's forecast for November auto sales is in the same range. Those who buy cars are in trouble, too. Merrill Lynch says 1.6 million vehicles have been repossessed over the past year. Reportedly, GM has shut off clocks to save on electricity.

How far is down? Home prices fell by a record 17% in October. It's hard to see pent-up demand coming to the rescue soon. Today 68% of Americans own their homes, versus 64% in the pre-bubble days.

The next shoe? Merrill Lynch suggests that the next problem area in this financial crisis could be commercial real estate, much of which is financed by thousands of banks that probably are not too big to fail.

Volume argues against bottoming – Sharp daily sell-offs such as we've seen on some recent days often signal that a bottoming process has begun. We believe the market is in a bottoming process but, as Dudack Research points out, panic selling volume at bottom lows usually is 3-4 times the daily average, a level we have yet to reach.

Traders rule – So far this year, stocks have turned over at a rate of 176%, compared to an average 132% during this decade, according to Miller Tabak. The trend has been in place for decades. Turnover averaged 24% in the '70s, 51% in the '80s, and 74% in the 90s.

Implications/Outlook

Time to give thanks – Tomorrow, some grumpy investors may be asking what they have to be thankful for this year. We can think of a few things. Start with the cooperative global effort to address the financial crisis. Add to that the new \$800 billion plan announced this week to facilitate consumer borrowing. This is a welcome shift to stimulation versus mere stabilization. It's also possible that the stock market already has priced in most of the foreseeable bad news. Housing is bad and the banks are weak. But everyone knows that. Ditto the potentially-lengthy recession we seem to find ourselves in. Small wonder that, as Deutsche Bank notes, from September to October consensus S&P 500 earnings estimates dropped by a draconian 11%. That trend has gone global, with earnings for the MSCI World Index scaled back by 12% over the same period, by far the biggest decline in 20 years. Finally, as economist Ed Yardeni said, we can all give thanks that we're not turkeys.

Santa, when you get to town, we sure hope you'll put a year-end rally under our tree.

Past performance is no guarantee of future results.

Views are as of November 26, 2008, and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security.

Mutual funds are subject to risks and may fluctuate in value.

S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.

VIX: The ticker symbol for the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility.

The MSCI World Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. As of June 2007 the MSCI World Index consisted of the following 23 developed market country indices: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom, and the United States.

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