

BEYOND THE HORIZON

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Inside This Issue:

Market Update—The Financial
Crisis Page 1

MARKET UPDATE - A “Q&A” ON THE CURRENT FINANCIAL CRISIS

We are dedicating the entire issue of our quarterly newsletter to answering questions or concerns that may be on our clients’ minds regarding the crisis plaguing our financial markets and economy.

The financial crisis on Wall Street seemed to catch us by surprise. How did we get into such a serious crisis so quickly?

In the President’s first address to the Nation on September 24th, we feel he did a good job of explaining how we got to this point. The following are excerpts of his speech:

“Most economists agree that the problem we are witnessing today developed over a long period of time. For more than a decade, a massive amount of money flowed into the United States from investors abroad... This large influx of money to U.S. banks and financial institutions - along with low interest rates - made it easier for Americans to get credit... Easy credit - combine with the faulty assumption that home values would continue to rise - led to excesses and bad decisions. Many mortgage lenders approved loans for borrowers without carefully examining their ability to pay. Many borrowers took out loans higher than they could afford ... Optimism about housing values also led to a boom in home construction. Eventually the number of new houses exceeded the number of people willing to buy them. And with supply exceeding demand, housing prices fell... Borrowers with adjustable rate mortgages... began to have trouble making their mortgage payments and began to default on their loans... These widespread defaults had effects on “mortgage-backed securities” held by investors around the world (and in particular, Wall Street firms), such as Fannie Mae and Freddie Mac.... Many investors assumed these (mortgage-backed) securities were trustworthy and asked few questions about their actual value. The decline in the housing market set off a domino effect across our economy. Borrowers defaulted on their mortgages and investors holding mortgage-backed securities began to incur serious losses. Before long, these securities became so unreliable that they were not being bought or sold. Investment banks such as Bear Stearns and Lehman Brothers found themselves saddled with large amounts of assets they could not sell. They ran out of the money needed to meet their immediate obligations. And they faced imminent collapse. Other banks found themselves in severe financial trouble. These banks began holding on to their money, and lending dried up, and the gears of the American system began grinding to a halt.”

Why is the Government using taxpayer dollars to help the failed institutions and will it help solve the crisis?

Due to the size and extent of the crisis, the U.S. Treasury is the only entity that has enough money to inject into the financial system quickly enough to make a difference. The immediate problem and threat to our economy is that lending institutions either do not have the available resources to lend or that they are not willing to lend in order to preserve the capital they currently have. So the immediate issue that must be addressed is to free up lending again. As of October 3rd when we sent this issue to press, Congress had not yet finalized the details of the economic rescue plan. However, the basis of the plan is for the Treasury to buy the troubled assets (bad loans) from institutions in order to free lenders to get back to lending money. This will help businesses with their daily liquidity needs, as well as help consumers buy cars, pay college tuition, buy homes, etc., thereby greasing the wheels of our economy. The Treasury will collect payments on the loans then gradually sell them back into the financial system once it has improved. In doing so, there is potential the Treasury will buy these assets at distressed prices and sell them later at higher ones. The rescue plan, in our opinion, is not the ideal solution nor will it solve all the problems in the financial markets or the economy. Its intent, however, is to keep us out of immediate and severe economic danger and to restore consumer and investor confidence.

How will this crisis in the credit markets affect me?

Many of us will feel little to no impact from the credit crisis. Most likely to feel the pinch will be those who are borrowing (through loans and credit cards) or businesses who rely on lending. However, the media has sensationalized this crisis, causing many to be concerned, including those who have no reason to be.

If you hold deposits at a bank, you may eventually see the interest rate you are earning be lowered and/or account fees you pay increase. It is important to note, however, that roughly 98% of all banks are financially sound, as widely reported. If you have deposits with a bank that exceed the insurance limits, consider making adjustments to fall within those limits. Consult your bank officer or the FDIC at (877) 275-3342 or www.fdic.gov if you have questions regarding coverage.

Why is this credit crisis having such a negative impact on the stock market?

The current crisis has been in the credit markets, not necessarily the stock markets. However, consumer and investor confidence plays a major role on the direction of the stock market. Recently, fear instilled by the crisis on Wall Street has caused investors to panic and sell stocks, which in turn has driven stock prices down.

The health of the economy also has a major impact on stock prices. As the economy slows, business slows and corporate earnings fall. This makes stocks less desirable to investors, which also drives stock prices down.

Because fear has such a profoundly negative impact on both the economy and the markets, it is important for investors to exercise sound judgment and patience. Reaction out of fear will only exacerbate market declines.

Is my money safe?

The issue of safety is determined in two ways - how assets are invested and where the assets are held. As we all know, assets invested in stocks, bonds and mutual funds are subject to fluctuations in market value. Neither the principal nor investment return are guaranteed. However, as an investor, your assets may be protected in the event the institution holding your accounts fails. For example, depositors who hold accounts at financial institutions, such as banks who participate in the FDIC program, are given protection by the FDIC in the event the bank would fail. Account holders with assets held by a brokerage firm, such as TD Ameritrade, who participate in SIPC have protection in the event their securities are lost due to failure of the brokerage firm. Lastly, policyholders of life and annuity policies are protected under the Guaranty System provided by the State in which they reside, such as the PLHIGA for Pennsylvania residents. For details regarding the protection provided by the FDIC, SIPC, or PLHIGA visit their websites at www.fdic.gov, www.sipc.org, or www.ins.state.pa.us.

What impact will this crisis have on our economy?

It is unlikely that the Government's economic rescue plan will turn around our already slowing economy. In fact, it is now likely we will slip into a recession, if we haven't already begun to do so.

What happens in a recession?

Periodic recessions are a natural part of any nation's economic cycle. During this period, overall business activity slows. As a result, we see rising unemployment and personal income (i.e. wages) fall. Additionally, the stock market generally does not perform well during a recession. However, stock returns following a recession have historically been very good. The following chart shows our most recent recessions and the returns of the S&P 500 index in the period following the recession:

<u>Recessionary Period</u>	<u>Gains in S&P 500 Thereafter</u>
Early 2001 into late year	+28.7% in 2003; +10.9% in 2004
Mid 1990 to early 1991	+30.4% in 1991; +7.6% in 1992
Mid 1981 into late 1982	+21.5% in 1982; +22.6% in 1983
Early 1980 into mid-year	+32.5% in 1980
Late 1973 into early 1975	+37.2% in 1975; +23.9% in 1976
Late 1969 into late 1970	+14.3% in 1971; +19.0% in 1972

When will things get better?

From an economic standpoint, it is likely that the effects of the financial crisis will linger for quite some time. Historically, recessionary periods last an average of 6 to 24 months. If you re-visit the chart on the previous page, you will see that has been the case. In any event, it will likely be late 2009/early 2010 before we see improvements in the economy. Without government intervention and a rescue plan, however, the current crisis could result in a severe and sustained recession.

What changes should I be making with my investments? Should I consider selling my stocks or mutual funds?

If you are properly allocated and diversified based on your goals and risk tolerance, you should not need to take action at this time. We continually monitor and review our clients' accounts to make sure they are allocated properly on an ongoing basis. However, a changing economic environment moving forward may warrant allocation changes for certain clients.

Getting out of the stock market now, however, could be the worst action to take. If you are a longer-term investor with money in the market, it doesn't matter what it's worth today. That number will change by tomorrow anyway. With time, the markets will recover. To date, stocks have made money during every 10-year period in history.

How will the downturn in the stock market affect my goals for retirement?

It depends on when you plan to retire. If you have assets invested in the stock market, those account values have most likely fallen. Anyone planning to retire in the near future should already be allocated with a smaller exposure to stocks. Besides, you don't cash in all your investments the day you retire. You may, on the other hand, start to take distributions or income from them. Individuals with five or more years before retirement will most likely not have to change their goals. If we have not yet prepared a financial projection for you or you are not able to answer this question, call our office to get started on your retirement plan projection.

If you have additional questions or concerns that we have not addressed, please call our office. We will continue to monitor developments in the financial markets and the Government's rescue plan and respond to those developments as needed.

Sources: Text of President's speech obtained from marketwatch.com; Howstuffworks.com/recession; 2007 Andex Chart by Andex Associates; 2007 ICA Guide by American Funds; www.fdic.gov; www.ins.state.pa.us.

Disclaimer: The opinions expressed within this newsletter are not necessarily those of Trustmont Financial Group, Inc. or

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