

A Flight to Cash – The Great Deleveraging Continues

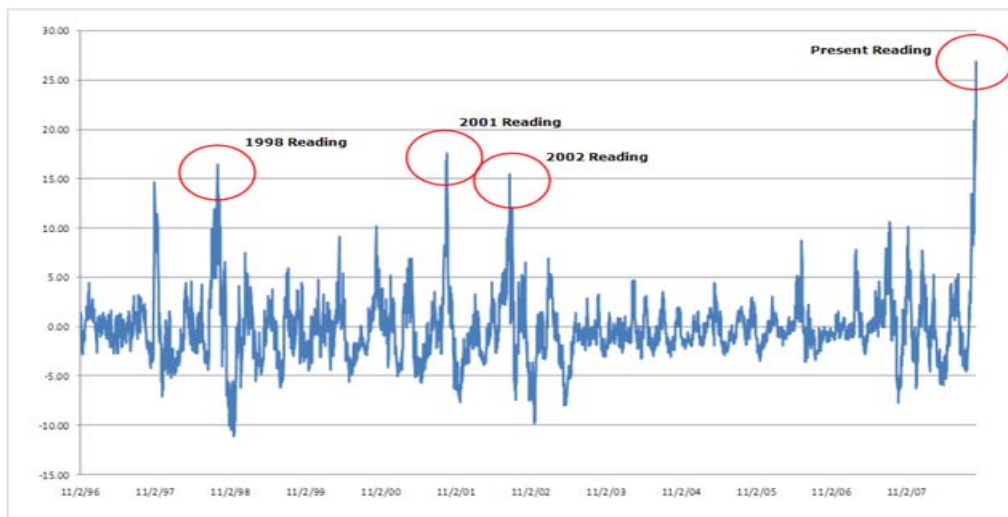
In Review

It is an understatement to say that this was a most difficult third quarter. The returns below are as of quarter end, and the selling has continued into October. The week ending October 10th was the worst week in stock market history with the S&P losing over 22%; surpassing the previous record in July of 1933. At the intraday low on Friday October 10th, the market was down over 46% from its 52 week high, a punishing decline especially given its democratic nature; few equities escaped. Needless to say, fear was at historic highs (as measured by the VIX index evidenced below), far surpassing the level reached after the terrorist attacks in September 2001 and the Asian and Russian debt crises in 1997 and 1998.

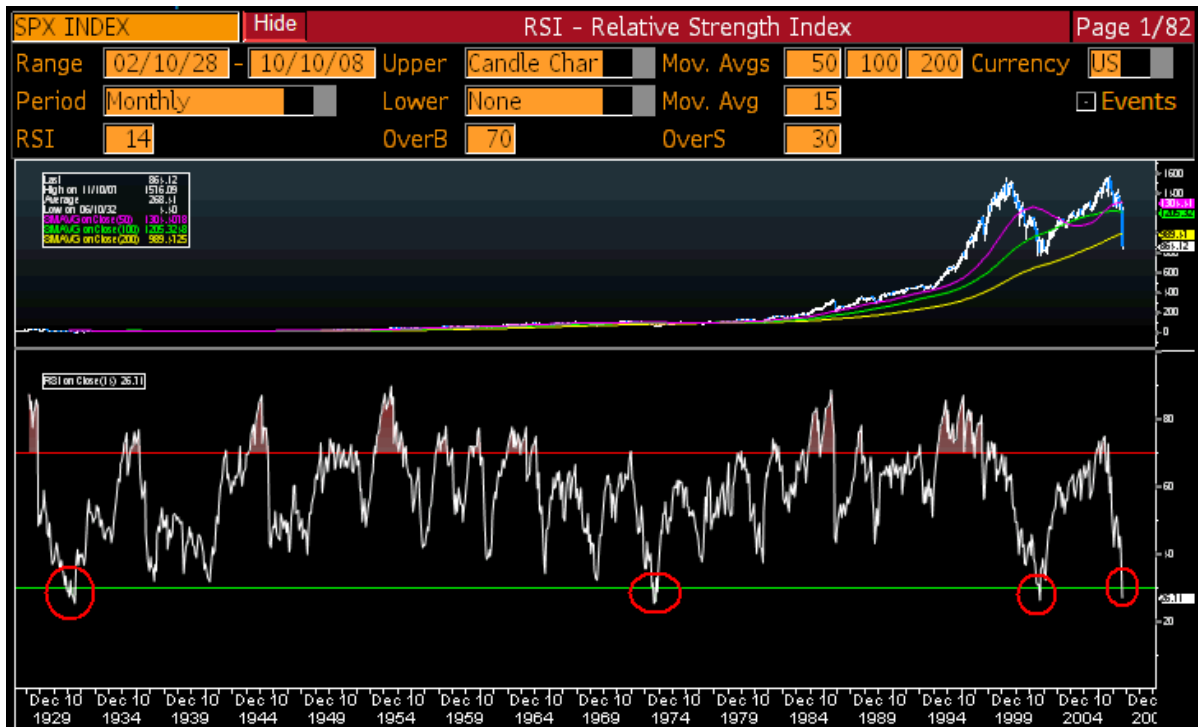
Benchmark Performance						
Data as of September 30, 2008						
	<u>QTR</u>	<u>YTD</u>	<u>1 Year</u>	<u>3 Year</u>	<u>5 Year</u>	<u>7 Year</u>
Lehman 5 Year Muni	0.66%	1.78%	3.71%	3.51%	2.80%	3.80%
Lehman Aggregate	-0.48%	0.64%	3.66%	4.15%	3.79%	4.69%
S&P 500	-8.37%	-19.29%	-21.98%	0.22%	5.17%	3.50%
Russell 1000	-9.35%	-19.50%	-22.10%	0.13%	5.49%	4.00%
Russell 2000	-1.11%	-10.38%	-14.48%	1.83%	8.15%	9.03%
MSCI EAFE Net	-20.56%	-29.26%	-30.50%	1.12%	9.69%	7.79%
MSCI Emerging Markets Net	-26.95%	-35.54%	-33.20%	8.37%	18.67%	20.54%

Source: PSN Informa

VIX Deviation from 50-Day Moving Average



The selling was relentless and has been attributed to hedge fund deleveraging, liquidations, redemptions and the need to reallocate capital out of prime brokers whose future was uncertain. Hedge fund performance has been disappointing with many of the largest and most respected funds down between 10% and 40% for September. Given the size of the hedge fund universe (roughly \$2 trillion on an unlevered basis), and with redemptions running at 10% to 30%, the amount of selling pressure placed upon the market was enormous, and volume for the second week of October was over 42 billion shares, with a record 11 billion shares traded on the Friday of that week. The lower band of the 80 year chart below provides some historical context for the level of selling pressure on the S&P 500 as measured by the RSI or relative strength index, a measure of the velocity of directional price movements.

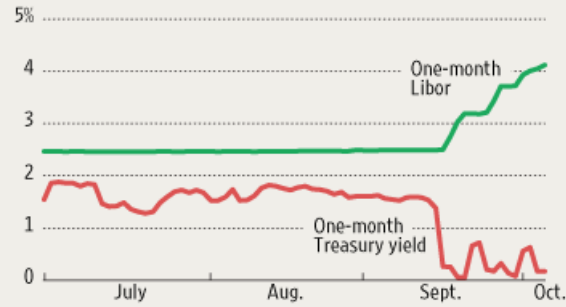


This index (on a monthly basis) has traded below 30 only three other times in the last century: 1932, 1974 and 2002, all at or near market lows.

While most of the media focus has been on equities, the credit markets were essentially frozen. The chart below displays one month Libor versus the equivalent maturity T-bill; the widening spread exhibits banks' unwillingness to lend to one another overnight.

High Anxiety

Extreme nervousness in the credit markets has pushed up the London interbank offered rate (Libor) that banks charge each other—and pushed down the yield on super-safe Treasury bills.



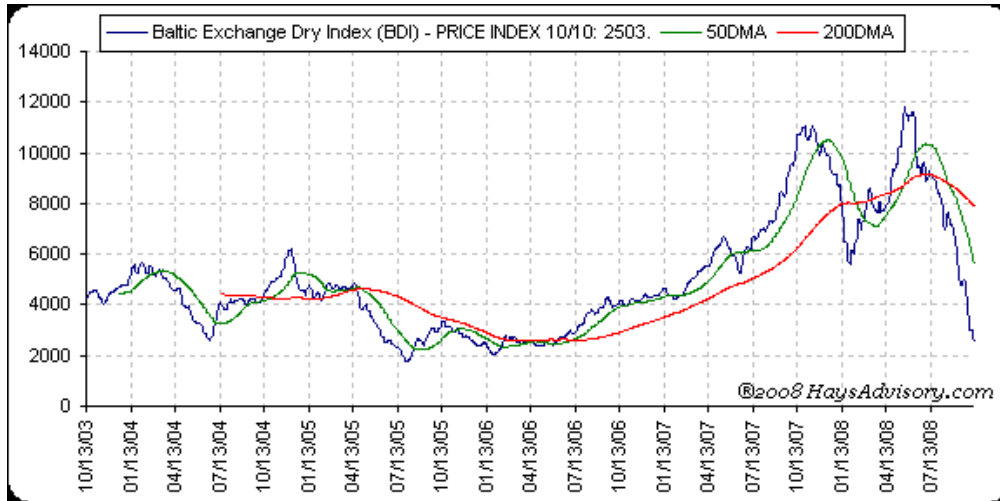
Sources: Ryan ALM, Thomson Reuters via WSJ Market Data Group

The unwillingness to lend is typical of the dysfunction that still exists in the banking system. The hoarding of capital by banks deprives the economy of its lifeblood and further limits the availability of credit to consumers and businesses.

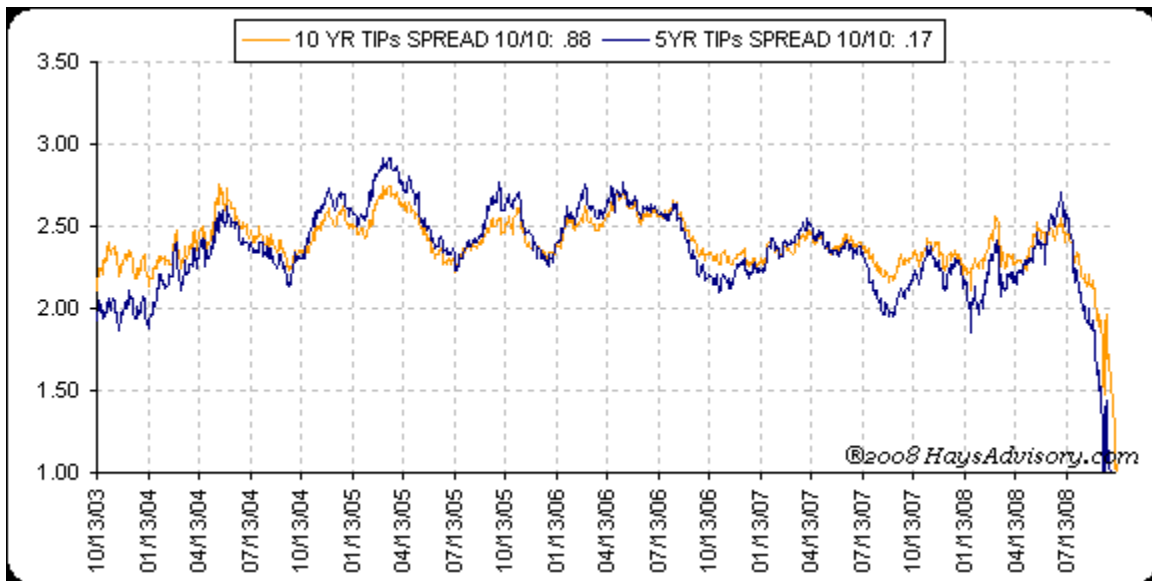
Recently released economic data is beginning to reflect the effects of the credit crunch on the U.S. economy as many key indicators are in recessionary territory, including the ISM manufacturing index which registered a reading of 43.5 (a reading below 50 is evidence of contraction) and weekly jobless claims (shown below).



The previous spikes above occurred in 1981-82, 1991 and 2001; all recessionary periods. The Baltic Dry Index, an indication of the cost of shipping dry bulk commodities in various international shipping routes, is a coincident measure of economic activity and global trade and it has fallen by 75% over the past six months.



The positive side to the economic weakness has been a steep drop in commodity prices, particularly in the price of oil which has traded down over 50% from its peak. With this decline, and the recessionary economic data, came an associated drop in inflation expectations priced into the market. The chart below shows the spread between inflation adjusted and non-inflation adjusted treasuries.



Falling inflation expectations and the destruction of roughly \$10 trillion in wealth between home values and stock market declines, gave the US and world central bankers the leeway to ease interest rates to help the flow of money and relieve pressure in the credit markets. A coordinated rate cut was announced on October 8th with participation as follows:

Coordinated Global Rate Cuts		
	<u>Change</u>	<u>Rate</u>
Federal Reserve	-50bp	1.50%
European Central Bank	-50bp	3.75%
Bank of England	-50bp	4.50%
Riksbank	-50bp	4.25%
Bank of Canada	-50bp	2.50%
Swiss National Bank	-50bp	2.50%
People's Bank of China*	-27bp	6.93%

* Also lowered reserve ratio -0.5%

In addition to cutting rates, the Federal Reserve along with the U.S. Treasury has provided a tremendous amount of liquidity and assistance to the system as outlined below:

Term Auction Facility	Federal Reserve	\$900 billion
Emergency Econ Stabilization Act	U.S. Treasury	\$700 billion
Total US Currency Swaps	Federal Reserve	\$620 billion
Other Loans: Primarily Dealer Credit	Federal Reserve	\$409.5 billion
Hope for Homeowners Act of 2008	U.S. Treasury	\$304 billion
Fannie Mae & Freddie Mac	U.S. Treasury	\$200 billion
Term Securities Lending Facility	Federal Reserve	\$200 billion
AIG Bailout	Federal Reserve	\$122.8 billion
Commercial Paper Funding Facility	Federal Reserve	\$100 billion*
Bear Stearns Backstop	Federal Reserve	\$29 billion
	Total	\$3.585 trillion

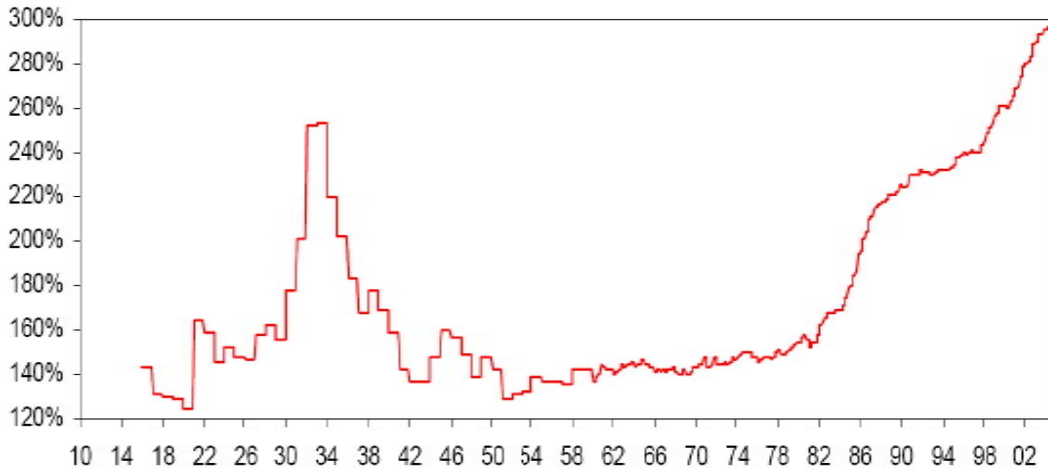
* Estimated value

Needless to say, this is unprecedented, and is being accompanied by similar moves in Europe and the U.K. totaling roughly \$2.5 trillion.

The Outlook

While the lower rates and coordinated central bank and Treasury actions should eventually alleviate the frozen credit markets, the effect on the real economy has yet to be determined. Those actions may mitigate the coming recession; however, there remains much work to be done. Over the past decade, the American consumer has increased his debt load dramatically and it has reached unprecedented levels as shown below.

Total Debt as % GDP



Source: Bridgewater

With the rise in debt has come a commensurate rise in the percentage of household income dedicated to debt service, an unsustainable rise in the level of home ownership and a decline in personal savings. These trends need to be reversed, and the process of balance sheet repair at the consumer level will take some time.

Additionally, the housing overhang needs to be worked through as the inventory of unsold homes is still far above historic norms, and roughly 10% of current homeowners are struggling to maintain the status quo.

Existing Home Sales Inventory



The news is not all bad; the positive second quarter GDP for the U.S was due entirely to trade, proving that we remain a fiercely competitive global player. Our corporations, aided by a currency that is somewhat

undervalued, can take market share in a fair fight. No doubt the U.S. consumer may play a smaller part in the world economy in the near future, but barring bad policy decisions in Washington, trade may mitigate the depth and duration of the current downturn.

The Fed and the U.S Treasury are determined to do all they can to address the known problems, and the recent tweak in the bailout package to have the government inject capital directly into the largest banks is a plus (as long as they stay out of management of the business). The governments and central banks of the U.S. and Europe have added over \$6 trillion of liquidity, and have demonstrated to investors their determination to stand behind the financial system. While this may create another problem down the road (future inflation), it should begin to plant the seeds of confidence needed to attract new money to the market, although it could be a slow process. It strikes us that for all the frustrations we have with the government and its various players, sometimes they eventually get to a viable answer in a relatively short period of time.

We remain in territory that is somewhat unprecedented, and as a result, investors are demanding a higher risk premium because of the diversity of outcomes. Stocks and other financial instruments are being sold because they have to be, not because of fundamental reasons, which creates tremendous near term pain, but may also create great value and opportunity. Eventually, investors with a longer time horizon and a higher appetite for risk step in and avail themselves of the opportunity and a bottom is formed. Howard Marks, founder of Oaktree Capital Management, did a great job of summarizing the current situation in his last letter:

“In the third stage of a bear market....everyone agrees things can only get worse. The risk in that - in terms of opportunity costs, or forgone profits – is equally clear. There’s no doubt in my mind that the bear market reached the third stage last week. That doesn’t mean it can’t decline further, or that a bull market is about to start. But it does mean that the negatives are on the table, optimism is thoroughly lacking and the greater long-term risk probably lies in not investing.”

We couldn’t agree more. Thank you again for your trust and confidence.

A copy of Constellation’s Form ADV Part II is available upon request by calling Philip Frank at (212) 697-2500 or e-mail philip@constellationva.com.

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