

## **Market Update: October 16, 2008**

*By John Blood, CFA, Chief Market Strategist*

Stock markets around the world continued their sharp movements this week, darting higher and lower as sentiment swung between ebullience and despair. On Monday, October 13, stock markets staged one of their biggest single-day rallies on record, as both the S&P 500 Index and the Dow Jones Industrial Average (DJIA) rose more than 11 percent for the day. The move marked the DJIA's largest one-day percentage increase since 1933. The surge was in response to a global economic summit that had occurred over the weekend between financial leaders from the International Monetary Fund (IMF) and seven industrialized nations (the G-7). The summit resulted in an agreement in principle for a coordinated, multinational response to global credit market turmoil. The Monday rally was short-lived, however, as economic concerns resurfaced and two consecutive down days on October 14 and 15 erased nearly all of the gains, putting us back near the multiyear lows reached on Friday, October 10.

Investors who bought on Friday's declines had an initial burst of joy on Monday before having it quickly extinguished. Those who decided Monday's surge was just the beginning of the next bull market similarly experienced how cruelly the market can treat active traders.

The key question on most investors' minds is, "What should we do?" A key tenet of investing in times of turbulence is maintaining a long-term focus and a disciplined approach, as no one can consistently and repeatedly call tops and bottoms to the market. That ideology is being stress-tested now, but for investors with long time horizons—say, longer than 10 years—periods of extreme pessimism have tended to be good buying opportunities when examined with the benefit of hindsight. We had advised in August that investors should maintain a focus on long-term asset allocation, but that a posture more defensive than usual was warranted in the present environment. We continue to maintain that view.

### **Putting things in perspective**

The global economy has been a lot like a bicycle race. In the beginning, all participants were speeding along smoothly on the wheels of easy credit. Race officials—the Federal Reserve (the Fed) and Treasury here at home, as well as other central banks around the world—maintained their place on the sidelines while everything appeared to be running efficiently. The team at the head of the pack—let's call them Team Real Estate—suddenly began to suffer one fall after another, bringing down rider after rider in a domino effect. At first contained to a narrow group, the entire race was quickly put in jeopardy as riders from other teams became mired in the worsening pileup and could find no way to successfully navigate around it. There was real risk of the race grinding to a halt without intervention.

Race officials at first dealt with the isolated crashes, but, seeing the logjam forming behind them, they have now moved to a more systemic approach. They have stepped into a more active role, providing new equipment (capital) to teams in need to allow them to continue the race. Some teams have dropped out altogether, while others have been pulled to the sidelines and are being given time to repair themselves so that they may soon get back in the race as well. And longer term, once the near-term crisis has been averted, officials will establish new rules and regulations to lessen the likelihood of a recurrence.

The key focus for central banks remains restoring a more normal functioning of credit markets, without which economies around the world—and therefore all citizens who are participants in them—would suffer the repercussions of lessened business activity, higher unemployment, and reduced access to loans and credit. Lending standards in the current environment remain tight, and governments continue to take steps to recapitalize financial institutions and coerce credit market functioning toward normalcy.

Despite well-publicized economic challenges, however, many companies outside of the financial sector—particularly those like Intel and Coca-Cola, which have significant activities in foreign markets—have posted good earnings results for the third quarter of 2008. It is important, therefore, to make certain that our investment outlook expands beyond just today’s headlines and to realize that some parts of the economy remain in good health.

**Key developments:**

- As part of the \$700 billion Emergency Economic Stabilization Act of 2008 (EESA), the Treasury announced plans to use \$250 billion to take direct stakes in an array of U.S.-controlled banks, savings and loans, and other financial institutions. The program is voluntary on the part of financial institutions, but in a high-level meeting on Monday, October 13, government officials strongly encouraged nine of the largest banks to participate, including the soon-to-be-combined Bank of America/Merrill Lynch. As a result of the meeting, the Treasury will buy senior preferred shares in companies in the following amounts:

Bank of America	\$25 billion	Goldman Sachs	\$10 billion
Citigroup	\$25 billion	Morgan Stanley	\$10 billion
JPMorgan Chase	\$25 billion	Bank of NY/Mellon	\$3 billion
Wells Fargo	\$25 billion	State Street Corp	\$2 billion

The remaining \$125 billion is available to small and midsize institutions that apply to participate by the November 14 deadline.

- The preferred shares will pay the government a 5-percent dividend for the first five years, at which time the dividend will increase to 9 percent. Participating firms are prohibited from increasing their dividend to common shareholders for three years without the approval of the Treasury, and they also cannot exit the program for three years without approval. In addition, the program places restrictions on the types of outside capital the firms can accept, mandates limits on executive compensation and the elimination of golden parachutes, and gives the government the option to purchase additional shares in

the future at its discretion—an insurance policy to help taxpayers earn a reasonable return on their original investment.

- The Fed’s October “Beige Book”—a summary report of economic activity in September across the Fed’s 12 regional districts—contributed to the market’s decline on October 15. The report showed reduced economic activity across all 12 districts in the form of lower manufacturing activity, slowing consumer spending, and reduced access to credit for both financial and nonfinancial companies. Sectors that bucked the trend and showed signs of strength included mining, agriculture, and energy-related businesses.
- The Commerce Department’s September retail sales report indicates that U.S. consumers have slowed from their previous spending pace. Overall sales fell by 1.2 percent, the third consecutive monthly decline and the largest monthly drop since August 2005. The report reflected weakness across many sectors, but sharp declines for automobiles, furniture retailers, and clothing stores highlighted the report.
- In a speech on October 15, Fed Chairman Bernanke appeared to set the stage for an additional cut in the target federal funds rate at the Fed’s next scheduled meeting on October 28–29. Bernanke, concluding a broader discussion of the economic challenges we now face, indicated that the recovery will be a slow process and that it will surely include other setbacks along the way. He also asserted that policymakers now have sufficient tools at their disposal to deal appropriately with any future shocks and that they stand ready to use all tools at their disposal to promote price stability and economic growth. As such, we expect another rate cut will come on October 29.
- The FDIC announced that it will provide a 100-percent guarantee on all non-interest-bearing transaction deposit accounts until December 31, 2009. This applies to deposits not already covered by the provision in the EESA that raised the deposit insurance limit for checking and savings accounts to \$250,000 from \$100,000. The move is intended to restore depositor confidence and prevent widespread withdrawals from financial institutions, which would further weaken their capital position.
- On October 27, the Fed will commence its operations to purchase three-month commercial paper directly from high-quality issuers, which will assist both financial and nonfinancial firms in securing short-term funding for their day-to-day operations. Repairing this crucial link between financial markets and Main Street businesses is an important step in preventing more dire economic conditions from taking root.

### **Looking forward**

There have simply been no places for investors to hide thus far in 2008. The S&P 500 has fallen roughly 37 percent year-to-date, many natural resource investments—the high-flying market darlings of recent years—have gotten walloped by up to 60 percent or more, and even fixed income investments have fallen slightly, as measured by the 2.5-percent decline in the Lehman Brothers Aggregate Bond Index. So many have sought the safety of U.S. Treasuries that yields have been driven toward historic lows, meaning investors are presently willing to accept near-zero yields in exchange for that safety.

A 2.5-percent loss is a far cry from 37 percent or 60 percent, and short-term market risk is something we have to accept as investors in exchange for the potential to realize higher long-term returns. As we are painfully reminded at times, the markets are not one-directional animals, but well-diversified portfolios have tended to weather the storm better than those without at least some exposure to less volatile types of investments. I believe history will eventually judge the fall of 2008 (and quite possibly 2009 as well) as an attractive entry point for long-term investors. The road will not be smooth and solely upward-sloping—it never is—and so now is also a great time for frank and honest discussions between advisors and clients to reassess their true risk tolerance and time horizon and to make certain that portfolios are positioned such that everyone can financially and emotionally withstand the future market ups and downs that will inevitably befall us.

The steps the government has taken thus far have been bold and at times unprecedented, and their impact will be felt over years as opposed to weeks or months. To be sure, we still face economic challenges in the near term. I also believe, however, that the government's intervention will help us to successfully emerge from the current crisis and that now is a time to look forward as opposed to back.

***Disclosure:** Certain sections of this commentary contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance is not indicative of future results. All indices are unmanaged and investors cannot invest directly into an index. The S&P 500 Index is a broad-based measurement of changes in stock market conditions based on the average performance of 500 widely held common stocks. The Dow Jones Industrial Average is a price-weighted average of 30 actively traded blue-chip stocks. The Lehman Brothers Aggregate Bond Index is an unmanaged market value-weighted index representing securities that are SEC-registered, taxable, and dollar-denominated. It covers the U.S. investment-grade fixed-rate bond market, with index components for a combination of the Lehman Brothers government and corporate securities, mortgage-backed pass-through securities, and asset-backed securities.*

© 2008 Commonwealth Financial Network®