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Market Update: November 14, 2008

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After a relatively upbeat start to November—the S&P 500 was higher by 3.82 percent in the month's first two trading days—renewed uncertainty surrounding the government's rescue plans, as well as a confluence of worrying economic news, dragged the market lower in recent days. Yet even amid those unsettled conditions, a bright spot may have revealed itself to those watching closely.

Stock markets staged a drastic midday reversal on Thursday, November 13, shaking off even more bad economic news and turning what was headed for a fourth consecutive day of significant losses into a surprising gain—with the S&P finishing the day higher by 6.92 percent. The sudden turnaround is noteworthy, as it occurred close to the price levels from which the recent bull market began in March 2003. The occurrence marks the second time prices have fallen close to the 2003 lows, only to sharply reverse and move higher, without any accompanying and explanatory good news. As such, some believe it could represent a signal that investors have overshot the mark in their pessimism, and that stock valuations have already priced in a worst-case scenario.

Key developments:

- Housing market conditions have yet to show meaningful signs of improvement on the surface, but there may be some slight cause for optimism in the underlying data. On the downside, nearly 280,000 homeowners nationwide received a foreclosure filing in October, a 25-percent jump over October 2007 levels and a 5-percent increase over September. As political pressure has mounted, however, major lenders like JPMorgan Chase, Bank of America, and Citigroup have each initiated programs to more proactively assist troubled borrowers and stem the ever-growing number of foreclosures. Also, sales of existing homes rose by 5.5 percent in September over the previous month—a hopeful sign that prices have fallen enough to lure qualified buyers from the sidelines.
- The FDIC, for its part, unveiled a proposal to use an estimated $24.4 billion of the $700 billion rescue package to modify mortgages for delinquent borrowers who qualify for the program. First, the plan would cap housing payments at 31 percent of gross monthly income, through a combination of cutting interest rates to as low as 3 percent—a level that would increase over time back to prevailing market rates—and extending the term of the mortgage to up to 40 years. Also, to provide some incentive and protection to lenders, the government would agree to share in the losses for any borrowers who subsequently fell delinquent again after receiving the initial modification. The plan did not receive a warm initial reception from the Treasury, but it has drawn some early support from Congress—in part because it does not include reducing the principal balance on the loan, but instead allows part of the balance to be carried interest-free and tacked on to the back

end of the loan. This aspect of the plan has raised some eyebrows, however, as it does not seem to offer much relief to owners whose homes are now worth less than the amount owed.

- On November 12, Treasury Secretary Henry Paulson addressed concerns that the Treasury's use of funds from the Troubled Asset Relief Program (TARP) had deviated from its initial intent, causing some consternation among media, lawmakers, and taxpayers. Amidst the political rhetoric, however, I believe the key point is that the law provided appropriately broad flexibility to the Treasury to direct the funds so as to most effectively and expeditiously promote stability in the financial system. The chosen implementation—to make direct equity investments in nine of the nation's largest banks, as opposed to creating an auction process through which it would buy illiquid assets from those banks—appears to be a more targeted, direct, and streamlined approach than the original proposal. History will judge the success of the ultimate decision, but, to date, the move appears to have helped restore confidence in the financial system and improve short-term borrowing conditions.
- Secretary Paulson also reiterated that the three primary goals for any subsequent policy actions will remain strengthening the capital positions of financial institutions, supporting the normal functioning of other securitization activities crucial to the broader economy—such as credit cards, student loans, and auto loans—and providing support to the housing market by stemming the tide of mortgage foreclosures. While that would seem to preclude any rescue package for troubled domestic automakers, Congress will certainly have its say before the final chapter is written.
- The linkages between housing, credit, and the broader economy continue to warrant attention as the economic picture unfolds. Consumer retrenchment poses a real risk to a domestic economy already at a potential tipping point, and yet consumers facing foreclosures, job losses, and loan delinquencies are probably unlikely to show an increased penchant to spend. Retail sales in the U.S. fell by 2.8 percent in October, a record monthly decline and the fourth month in a row of slower spending. By comparison, retail sales had not declined in four consecutive months since 1974. Sales at bars and restaurants were a lone bright spot, however, as thirsty, or possibly commiserating, patrons increased sales at those establishments by 0.3 percent.
- Employment results brought more sobering news, however, as the first estimate of October payrolls fell by 240,000 jobs, worse than many had expected. Meanwhile, the initially released estimate for September was revised to a deeper loss of 284,000 jobs for that month. Thus far, the U.S. economy has shed 1.18 million jobs in 2008, and payrolls have now fallen for 10 consecutive months. The unemployment rate now stands at a 14-year high of 6.5 percent.
- Though times are difficult here at home, we are certainly not alone. Conditions abroad are equally, if not more, glum—reminding us how closely intertwined the global economy remains. Ireland, which had experienced two consecutive quarters of economic contraction in the first and second quarters of 2008, was the first country in the Eurozone to meet that common definition of a recession. Other European economies have followed suit, and the region as a whole saw its gross domestic product (GDP) shrink in the second and third quarters of the year to dip it into recession.

Bad news . . . and more bad news

On one hand, there have been very few welcome developments on the economic front recently. On the other, more optimistic hand, stock indices have remained somewhat resilient. When continued bad news fails to push stock prices lower, the potential is that the actual news cannot be any worse than the future expectations already priced into the market. While it's impossible to say with any certainty exactly when the bottom will come, there are at least some signs that there's a lot of bad news already baked into this cake.

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.*

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