

Market Update: December 5, 2008

By John Blood, CFA, Chief Market Strategist

“I wish there was one action that we could take, and all this would end, and the financial system would turn around . . . but that is not the world we live in today. We are dealing with a historic situation that happens once or twice in a hundred years.”

— Treasury Secretary Henry Paulson, November 25, 2008

Secretary Paulson’s wish likely echoes the sentiments of a good number of people these days—many of whom have grown weary of the nightly barrage of dire financial reports by the mainstream media. What used to be a brief, and forgettable, business segment wedged in the middle of a local newscast is now frequently the lead story, quite often with prominent placement of accompanying graphics like “crisis” and “meltdown.”

Investors of all sizes and experience levels have suffered this year, and many have had their resilience put to a stern test. Even the Harvard University endowment fund, often hailed as the epitome of shrewd investing, experienced a steep 22-percent drop from July to October of this year, according to Harvard Management Company. By contrast, the fund’s worst previous *annual* loss had been just over 12 percent, back in 1974.

Diversification, a cornerstone of modern investment theory for investors large and small, has also come under scrutiny this year, as most investments—whether stocks, corporate and municipal bonds, or real estate and commodity-linked investments—have absorbed losses. Among the few bright spots this year have been U.S. Treasuries—to which many investors have flocked as a low-risk, though admittedly low-return, option—and some types of active trading strategies, such as managed futures funds. For most types of investments, however, it has been a difficult stretch indeed.

News of recession not a surprise

While the unfolding economic data is unambiguously dreadful at present, in many cases the media coverage seems equal parts information and hyperbole, sometimes slanting a bit too far toward the latter. For instance, the declaration on November 28 by the National Bureau of Economic Research (NBER) that the U.S. officially entered the current recession in December 2007 was hardly a stunning development to anyone who’s been watching closely—as it merely represents a backward-looking categorization of past economic conditions. Contrary to the headlines surrounding that announcement, however, it did not signal any ominous new turning point on the economic landscape.

We are, as happens periodically, in a recessionary environment—whereby a prosperous period of economic expansion is inevitably followed by a phase of economic contraction. But by historical

standards—the average recession post-World War II has lasted approximately 10 months—the current retrenchment is already growing long in the tooth. Coincidentally, the two longest and deepest recessions we have experienced in the post-war era—November 1973 to March 1975 and July 1981 to November 1982—each lasted for 16 months, which would imply that the current slowdown would reverse in April 2009, should it follow a similar path.

That said, we are not so naïve as to think it impossible that the current slowdown could last longer and be deeper than those historical averages. Our economy and financial markets continue to face very real and unique challenges and to exhibit severe stress from a number of interrelated forces:

- Home prices and sales activity that are continuing to retreat from their previous unsustainable levels
- Tightened lending standards by financial institutions that have suffered large losses on mortgage-backed securities
- A lack of trust among financial institutions due to a heightened vulnerability of failure among trading partners
- Deleveraging, or forced selling, of financial assets by leveraged investment vehicles and financial institutions in an effort to raise cash or strengthen balance sheets
- Reduced global demand for goods and services due to slumping consumer spending
- Rising unemployment

This undesirable combination of forces has simultaneously put downward pressure on financial asset prices, as well as depressed global consumer demand to a degree that the likelihood of deep and prolonged global recession has become less remote. The role of governments under such a scenario is to implement policies that seek to counteract these negative forces, and so each of the myriad steps taken thus far by the Federal Reserve (the Fed), the FDIC, and the Treasury here at home—as well as those taken by other central banks around the world—has been aimed at addressing one or more of these core issues.

We expect the programs enacted thus far to continue to gain traction in helping avoid a deep and extended recession. Further, future policies and programs enacted under the leadership of President-elect Obama are likely to continue along the same vein, providing additional governmental support to the challenges at hand. Finally, we expect the cycle of forced selling of financial assets to abate in the coming months, relieving one negative influence on the prices of many investments.

Key developments:

- On November 25, the Fed announced the creation of a Term Asset-Backed Securities Loan Facility (TALF) to help improve credit availability to households and small businesses. The program will lend up to \$200 billion to support the issuance of asset-backed securities collateralized by student loans, auto loans, credit card loans, and loans by the Small Business Administration. As lenders became increasingly fearful, the market for these securities had basically dried up through September and October, exacerbating already tight consumer credit conditions and contributing to the slowdown in economic activity.

- In attempts to help stabilize the housing market, the Fed also announced a program to purchase up to \$100 billion in direct obligations from Fannie Mae, Freddie Mac, and the Federal Home Loan Banks, plus up to \$500 billion of mortgage-backed securities from Fannie Mae, Freddie Mac, and Ginnie Mae—with the goal of reducing the cost of borrowing and increasing the availability of funds for the purchase of houses.
- Separately, reports of a preliminary Treasury plan to help support the housing market surfaced on December 4. While not yet formalized, the plan calls for the Treasury to utilize the financial wherewithal of Fannie Mae and Freddie Mac to reduce market mortgage rates to as low as 4.5 percent—about one percentage point less than prevailing market rates. The lower rates would be made available only for new purchases—not for refinancing transactions—but would serve to both increase housing demand and also increase the loan amounts for which buyers would qualify, each helping to prop up falling home prices. Recent price data has shown that the housing market continues to weigh on the economy; the median selling price for sales of existing homes fell 11.3 percent in October 2008 as compared to a year earlier, while the median price for new homes slid by 7 percent for the same period.*
- As leaders of the Big Three domestic automakers continue their urgent requests to Congress for financial assistance, their business prospects continue to worsen. The companies reported that sales of cars and light trucks in November fell by 34 percent in aggregate as compared to a year earlier, with Chrysler (down 47 percent) and General Motors (down 41 percent) faring a bit worse than Ford's 31-percent decline. Automakers are being particularly hard hit by consumer reluctance to spend on big-ticket items, as well as reduced availability of credit for those looking to finance a new vehicle purchase. It appears that there is sufficient support in Congress to eventually provide some type of financial assistance to the domestic auto industry—if not in the current lame duck session then likely after the inauguration of President-elect Obama, who has publicly stated his support for the concept.
- The spending slowdown has not been limited solely to big-ticket purchases, however. Overall personal consumption fell by 1 percent in October as compared to the previous month; this marked its largest drop since a 1.2-percent decline in September 2001—reflecting that consumers are less willing to continue the free-spending ways of their past. Correspondingly, the national savings rate as a percentage of disposable income rose to 2.4 percent in October from 1 percent in September.*

Crisis can breed opportunity

In the words of famed value investor Sir John Templeton, “Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria.”

For those with memories long enough, think back to September 2002. The S&P 500 Index had lost 23.2 percent from June through September of that year and was down 43.8 percent from its March 2000 peak.* Investors were still experiencing the sting from one of the worst bear markets in history, and many had had their resolve tested beyond the breaking point. As a result, they pulled a record amount of money out of stock investments in July 2002—very near the time when stocks began their next bull market upswing.

Today, the S&P 500 is down 31.9 percent since June 30 and has declined 44.4 from its October 2007 peak.* There is not much good news to be found, the media machine is in full swing, and most forecasts are calling for gloomy economic conditions as far as the eye can see. As a result, investors are once again pulling money to the sidelines en masse.

Today's news—that the economy shed an astonishing 533,000 jobs in November, the largest monthly payroll decline since 1974—is yet another dour reminder of the seriousness of the current situation. Who could blame someone for saying, “I just can't take it anymore; it's time to move to cash”? Those feelings are very legitimate and very real—and it's important to make sure your investments always stay aligned with your time horizon and risk tolerance. And yet with such bleak consensus expectations and many household-name stocks currently yielding more than 6 percent, it may also be a time when Sir John Templeton would embrace a more contrarian view.

***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. *Source: Haver Analytics*

© 2008 Commonwealth Financial Network®