

MARKET UPDATE: OCTOBER 7, 2008

By John Blood, CFA, Chief Market Strategist

The Emergency Economic Stabilization Act of 2008, which was signed into law on Friday, October 3, was not the panacea for ailing financial markets that some had hoped. The plan was a necessary, albeit insufficient, step to addressing our current economic malaise—but apprehension about its long-term effectiveness, as well as fears of broader economic weakness, brought markets to their knees in recent days. The Dow Jones Industrial Average (DJIA), which had been up for most of the day on Friday in anticipation of the legislation's passage, reversed course and closed the day sharply lower, down by roughly 1.5 percent. On Monday, the index dropped precipitously before rebounding slightly, finishing off the lows but still losing nearly 3.6 percent on the day. On Tuesday, October 7, the DJIA declined by another 5.1 percent to close the day at 9,447.11—a level not seen since August 2003.

Recent developments, and the market's reaction to them, foreshadow the likelihood of additional monetary and fiscal policy responses by U.S. officials, either with or without the cooperation of other central banks around the world. They also serve as a reminder to those who have thus far ignored the enormity of the current situation; the credit-fueled momentum that propelled the recent boom has now reversed itself with equally dramatic force. A strong reaction from government may be required to help the economy regain its footing.

Key developments:

- Amid much political posturing, the U.S. House of Representatives reversed its earlier rejection of the proposed rescue plan and voted to pass an amended proposal on October 3. The centerpiece of the legislation, which had already passed the Senate, remained the same—authorizing the Treasury to purchase up to \$700 billion of troubled mortgage-related assets from financial institutions as a means to remove bad assets from their books and provide stable, long-term capital, which the institutions can use to make new loans. Details on just how the plan will be executed are sparse, since its complexity and scope are unprecedented and time was of the essence in its passing. The rescue package's main objective, however—to improve the availability of credit to mainstream America and ensure that qualified businesses and individuals can borrow funds at reasonable rates—is the key to stemming the credit crisis that has spread from its origins on Wall Street and now weighs on the economy at large.
- Another element of the plan provides for raising the limit on the FDIC's insurance coverage on bank deposits to \$250,000 from \$100,000. The move is intended to restore faith in the banking system and prevent mass withdrawals by fearful depositors, which would further weaken banks' balance sheets, tighten credit, and exacerbate the current problems. Other provisions and amendments to the legislation focus on ensuring bipartisan Congressional oversight of the program, providing the government with some flexibility in modifying the mortgages it purchases, and giving taxpayers some protection on the funds they invest. Lastly, the law provides for the extension of roughly \$150 billion of various tax cuts—although they are mostly unrelated to the issues of the day.

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- On October 7, the Federal Reserve (the Fed) announced yet another measure to provide liquidity to short-term credit markets via a Commercial Paper Funding Facility. The Fed will use a special funding facility to buy unsecured, asset-backed commercial paper for three-month terms from eligible issuers. The announcement does not include a dollar limit on purchases, but it does state that the program will cease on April 30, 2009, unless it is extended. The plan essentially means that the Fed will immediately begin to fill the current void where other lending institutions are either unwilling or unable to lend via the short-term commercial paper markets. This is a major new initiative to restore normal functioning to credit markets, and, like many other initiatives we have witnessed, it calls for the government to step into the breach, giving private financial institutions time to heal.
- Restoring liquidity is a critical step in helping the global economy extricate itself from the mire, but other monetary and fiscal policy measures seem likely as well before all is said and done. For example, the Reserve Bank of Australia announced a surprise rate cut of 100 basis points on October 7—dropping its target “cash rate” to 6 percent from 7 percent. The move is likely the first volley by economic leaders to provide a jolt to the sluggish global economy. The expectation, one with which we concur, is that, absent a noteworthy turnaround in economic conditions, interest rate cuts in the U.S. are probable—either at the next scheduled Fed meeting on October 28–29 or before. There is much speculation that the move will be a coordinated effort by major central banks around the world, such as the European Central Bank, the Bank of England, and the Bank of Canada. While inflation fears were a legitimate concern not too long ago, the current landscape of deleveraging and asset deflation lessens the inflation threat considerably and gives central banks much additional leeway.
- While the Troubled Asset Relief Program (TARP) will purchase bad assets from financial institutions and provide some measure of additional capital, it may yet be insufficient to provide the levels of capital needed to fully heal the financial system at large. Should the current policies and programs fall short, and with private capital seemingly not on the horizon, the government may well be needed to step in and provide more direct injections of capital into ailing financial companies—in similar fashion to Warren Buffett’s Berkshire Hathaway buying \$5 billion worth of preferred stock in both Goldman Sachs and General Electric.
- In addition to monetary policy measures, such as liquidity injections, interest rate cuts, and preferred stock purchases, another round of fiscal stimulus by Congress will likely gather support if the economy fails to stage a meaningful rebound as more time passes. This may include Depression-era-type spending programs to create jobs domestically—possibly to rebuild infrastructure or perform other projects for the public good—and to create wealth and restore consumer spending.

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Recent market developments have been unsettling to say the least. At difficult times, even the most experienced investors can have their resolve tested. In my August 27 commentary, I asserted that we appeared headed for a consumer-led recession and mentioned that it was not inconceivable for the S&P 500 Index (S&P 500) to drop as low as 1,025 by year-end. And yet when it dipped to an intraday low of 1,008 on October 7, I was surprised. Simply put, I thought such a scenario was a possible, but fairly improbable, outcome. With losses of roughly 37 percent from the October 2007 high, the current bear market has been less severe, but much more condensed in time frame, than the period from 2000 to 2002, during which the S&P 500 gave up 43 percent. History teaches us that bear markets for stocks do not last forever, and such declines only serve to reinforce the benefits of holding well-diversified portfolios.

With the much-anticipated rescue legislation now passed, and the markets mostly shrugging off any positive effects and instead posting sharp losses in the immediate aftermath, the next step is to closely monitor its execution, assess its effectiveness, and scrutinize unfolding economic developments. One thing seems a near certainty at this juncture—the quite necessary interventions we have seen by the government thus far are unlikely to be the last.

***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 Dow Jones Industrial Average is a price-weighted average of 30 actively traded blue-chip stocks. 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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