MARKET UPDATE: SEPTEMBER 30, 2008

By John Blood, CFA, Chief Market Strategist

Congress has failed us on this one. Unable to put the potential economic ramifications ahead of partisan sniping, members of Congress on both sides of the aisle failed to pass the proposed $700-billion Troubled Asset Relief Program, which was widely reported to already have garnered the necessary support. The markets reacted predictably to the negative surprise, with the Dow Jones Industrial Average (DJIA) plummeting by 777.68 points, or 6.98 percent, on September 29. The drop was one of the DJIA's worst single-day losses in history—although, put into perspective, it pales in comparison to the 20-percent one-day drop in October 1987.

It appears that Congress has failed to grasp the urgency of the current situation. What our economy is experiencing could be likened to a heart attack—with no symptoms yet visible to Main Street but the long-term effects of which are no less dire. There will be plenty of time in the future to discuss preventive measures and a healthier lifestyle—in the form of new regulation—to help avoid a recurrence of the condition. But right now, the patient requires stabilization; it is a time for emergency treatment, and Congress has left the patient dying on the table.

Key developments:

- On September 29, the U.S. House of Representatives voted down the proposed stabilization package by a vote of 228–205, despite widespread reports that the measure had sufficient support from both parties to pass. The majority of Democrats voted for the plan—just under 60 percent of members were in favor—while only 33 percent of Republicans voted to approve the package.
- In addition to political grandstanding, substantive differences of opinion still swirl around issues such as tighter regulation of financial markets, executive compensation limits, mortgage relief for homeowners, and the assurance of repayment of taxpayer-supplied funds. Few, if any, of these issues are vital components of the steps needed to immediately stabilize the credit markets. Rather, they fall into a category of considerations that are well worth additional discussion and debate, but only after the emergency treatment is put into place. Unfortunately, these ancillary considerations are also key leverage points that each side can use to win concessions from the other. This political gamesmanship and the resulting delays put the health of the broader economy at risk and increase the likelihood that noncritical, partisan measures will find their way into the final legislation.

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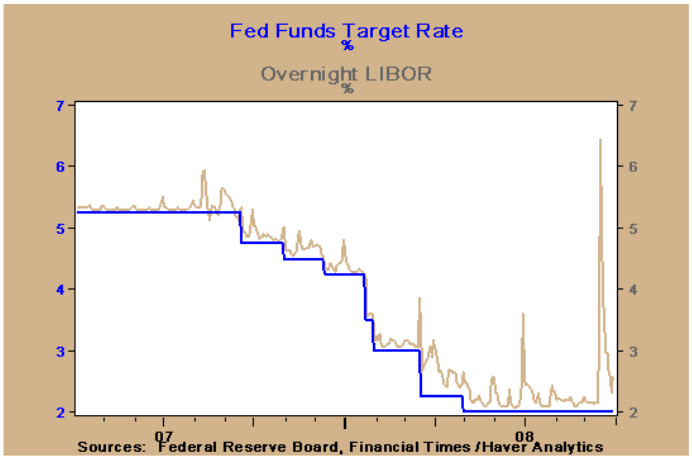
- The credit markets paint a stark picture of the reaction to recent developments. The London Interbank Offered Rate (LIBOR)—the rate banks around the globe charge each other for overnight loans—typically tracks closely to the target federal funds rate set by the U.S. Federal Reserve (the Fed). When the rates diverge, it is generally a signal that credit conditions are tight and that banks are either unable, due to lack of capital, or unwilling, due to concerns about the solvency of the borrower, to lend capital even to each other. Recently, overnight LIBOR rates skyrocketed to 6.43 percent, a level not seen since 2001. More importantly, the amount by which LIBOR exceeds the federal funds rate, an indication of the degree of fear and risk in the credit markets, recently reached an all-time peak of 4.43 percent. The previous maximum spread, in the immediate aftermath of the 9/11 attacks, was 1.86 percent. Make no mistake, credit market conditions—which have deteriorated both in real terms as a result of mortgage-related losses and write-downs, and less tangibly through increased fear and mistrust throughout the financial system—lie at the heart of current economic risks. Without a quick fix, credit conditions may begin to restrict day-to-day business operations and consumer access to credit, further exacerbating the economic challenges we're now facing.



- Recent developments in Congress and the credit markets have overshadowed the news that major financial institutions around the world continue to buckle under the weight of financial market stress. Washington Mutual, which had plunged headlong into the mortgage boom and become a household name in recent years, was seized on September 24 by federal regulators in the face of imminent collapse, becoming the largest bank failure in U.S. history. Simultaneously with the seizure, the FDIC sold the majority of Washington Mutual's assets to JPMorgan for $1.9 billion. Only days later, Wachovia—another firm whose forays into nonconventional types of mortgage financing ultimately cost it its independence—announced that it was selling its banking operations to Citigroup for $2.1 billion in a deal also brokered by the FDIC. In addition to orchestrating the agreement, the FDIC agreed to absorb any losses above $42 billion in Wachovia's $312 billion loan portfolio, insulating Citigroup from losses above that number. The moves highlight the attempt by federal officials to intertwine policy decisions with private market solutions, whereby weak links are removed from the chain but without giving the appearance of a bailout for shareholders, and without the entities becoming wards of the government. While that solution has proven feasible in the cases of Wachovia and Citigroup, Lehman Brothers and AIG represent the other potential outcomes when those attempts fall short.

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- In other parts of the world, the governments of Belgium, Luxembourg, and the Netherlands committed a combined $16.4 billion to purchase a 49-percent interest in banking and insurance giant Fortis, partially nationalizing the firm after public confidence in it had deteriorated. The Icelandic government purchased a 75-percent stake in Glitnir, the country's third largest lender, and the government of the United Kingdom fully nationalized mortgage bank Bradford & Bingley, which becomes the second such UK bank to be nationalized, following the collapse of Northern Rock in February.
- In response to the Congressional shocker, the Fed, working in concert with central banks around the world, injected up to $620 billion into short-term credit markets—a massive liquidity injection designed to offset the negative implications of both Congress' decision and deteriorating credit conditions. The move helped to cushion the blow in the short term and to delay, at least for now, an immediate worsening of credit. In the long run, however, Congressional action is required to provide sufficient capital for financial firms to emerge from the swamp of illiquid mortgage-backed assets.

I ended my last commentary with the prediction that there was little doubt that legislative relief would come quickly, as it was at least a marginally appealing choice from an otherwise uninspiring list of options. My optimism has been muted somewhat—and my frustration with politicians restored—by Congress' failure to act. Nevertheless, the consequences of inaction at this juncture appear so overwhelmingly clear to me that I continue to believe that action, especially in a year when reelection considerations may play a role, will come quickly. I believe the final legislation will include provisions that have little or nothing to do with addressing immediate needs, and each party will likely be compelled to accept unwanted provisions in the final amended proposal.

By doing so, Congress can hopefully stem the tide of worsening credit and provide a boost to underlying economic conditions that could surely use it. Behind the current headlines, we still have an economy that has lost jobs for eight consecutive months; a housing market where prices continue to decline in areas where speculation had reached the most dizzying heights—but where prices have leveled off or even risen slightly in other areas—and where consumer spending has shown recent signs of weakness.

On a brighter note, consumer confidence actually rose last month for the third consecutive month, potentially signaling that consumers really think things can't get much worse. And oil and energy prices have continued to retreat as fears over a global economic slowdown have put downward pressure on the expected demand for energy. By Congress quickly enacting a stabilization package—and stabilization is the right word, as it will not bail out Wall Street firms that have seen their equity go to zero—we may dodge the most dire economic outcome and let the financial system renovation work commence.

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.*

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WALTHAM OFFICE
29 SAWYER ROAD
WALTHAM, MA 02453-3483
TOLL-FREE: 800.237.0081
PHONE: 781.736.0700
MAIN FAX: 781.736.0793

SAN DIEGO OFFICE
110 WEST A STREET, SUITE 1800
SAN DIEGO, CA 92101-3706
TOLL-FREE: 877.347.1982
PHONE: 619.471.9700
MAIN FAX: 619.471.9701

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