February 2010 Market Recap

A lackluster start to 2010

There has been little to inspire investors so far in 2010 and that is reflected in the major U.S. market indices. Despite the monthly gain of 2.85 percent for February, the S&P 500 Index is down 0.95 percent for the year. The Dow Jones Industrial Average (DJIA) was essentially flat for the month, but it, too, is lower year-to-date, down 0.47 percent. Stocks were buoyed in February by strong merger and acquisition activities, as cash-rich companies looked for opportunities.

It was a different story for international stocks, as overseas equities continued to face headwinds. The MSCI EAFE Index fell 0.68 percent during February and is down 5.05 percent for the year. European equities have been particularly hurt by the troubles reported in Greece and concern about the potential for a debt default. This has been further exacerbated by the strengthening U.S. dollar, which has decreased the value of overseas investments when measured in dollars.

When we look at the fixed income spectrum, we see somewhat of a contrast in performance, again highlighting the benefits of diversification. The Barclays Capital Aggregate Bond Index added to gains, up 0.37 percent in February and 1.91 percent for the year. Money continued to flow into bond funds, as investors shunned the stock market. Yields for the average corporate bond held up, at 4.60 percent by month-end, while high-yield bonds yielded around 9 percent at this writing. While the potential risk of price declines on default concerns remained, and while much of price appreciation may be behind us, bondholders continued to look for yield.

The Federal Reserve raises the discount rate

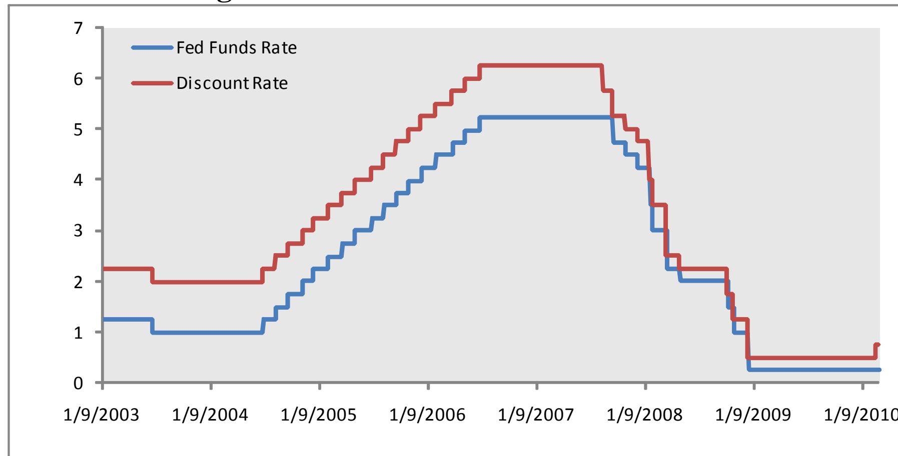
In the second half of February, the Federal Reserve (the Fed) made a surprise announcement, increasing the discount rate 0.25 percent, to 0.75 percent. The announcement came after the market closed on Thursday, February 18, driving bond futures prices sharply lower and corresponding interest rates higher. Interestingly, trading the next day left bonds mostly unchanged, and the yield on the 10-year Treasury actually dropped 20 basis points during the rest of the month.

Equities were also little changed on the next day's trade, though they fell sharply lower in the futures market after the announcement. This was due in large part to comments from the Fed, asserting that "economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period."

It is also important to note two critical points. First, the discount rate is designed as a last-resort measure for banks to obtain capital, while the federal funds rate is used to benchmark lending. Before the crisis, the discount rate was 1-percent higher than the federal funds rate, and the Fed lowered it to provide emergency funding to banks. Second, the Fed has returned borrowing conditions to overnight status from the 28-day condition it had applied during the crisis. It did this to encourage banks to seek funding from private sources rather than from the government in the hope of spurring additional lending opportunities.

The Fed also closed several extraordinary credit programs earlier in February, but, again, the market seemed to accept these, as the Fed had warned of plans to remove some stimulative programs.

Historical Changes in Interest Rates



Source: Bloomberg, Commonwealth Research

Will bank lending increase?

Some observers are skeptical that banks will seek outside capital and incur credit risk after having access to guaranteed government funding; time will tell whether Fed action actually spurs additional lending. This is particularly relevant, given that there has been rhetoric in Washington that the government is looking to limit the ability of banks to foreclose on delinquent loans. This could add to reluctance among banks to lend, as bankers may fear that government policy could actually restrict their recourse to foreclose loans out of line with the contractual guidelines of loan documents. The critical factor to remember, however, is that there will be no change to the federal funds rate for the foreseeable future and that the target rate of 0 percent to 0.25 percent has been a significant factor in stemming economic decline.

A mixed bag of economic data

Throughout February, the market showed resilience in its ability to shrug off a mixed bag of economic data. It was uplifting to see gross domestic product (GDP) revised upward, to 5.90 percent in the fourth quarter, from the preliminary release of 5.70 percent. Some investors are looking for future follow-up to these strong growth figures, citing that most of the gains resulted from government stimulus and from companies rebuilding depleted inventories.

The January jobs report showed a loss of 20,000 jobs, after the economy had added 150,000 new jobs in December. These numbers are by no means going in the right direction, but, nonetheless, the market managed to see past the figures.

The third important component of this recovery is housing. Data for January showed new home sales slipping to 309,000, from 348,000 in December, and prices edging lower as well. The jury is still out on whether housing can gain momentum, as the impact of the tax credits appears to be waning. There is likely some pent-up demand, given that many consumers have been delaying home purchases based on the economy and the hope for lower prices in the future. For now,

however, the housing market remains at very sluggish levels, as buyers stay on the sidelines. Again, markets were resilient to the mixed data on housing released in February.

Keep an eye on volatility

As we look ahead, we should note some inconsistencies in the recent readings of market volatility. The VIX, a measure of volatility for the S&P 500, is back down to recent lows, hovering around 19 percent at this writing. It had, for the most part, been edging lower throughout February. During this same time frame, however, we saw 8 days with moves greater than 100 points—or approximately 1 percent for the DJIA. We saw only 6 days of 100-point moves in January, and, for the second half of 2009, we averaged only 4.3 days of 100-point moves per month. While this is not a scientific study, it does indicate that there could be more market volatility than measured by the VIX.

Some see this as the calm before the storm; others look at the market's resiliency and its ability to hold up in the face of mixed economic news. But a well-diversified portfolio still proves to be the best strategy to add value for investors in the current market.

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 MSCI EAFE Index is a float-adjusted market capitalization index designed to measure developed market equity performance, excluding the U.S. and Canada. The Barclays Capital 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 Barclays Capital government and corporate securities, mortgage-backed pass-through securities, and asset-backed securities. There is no guarantee that a diversified portfolio will enhance overall returns or outperform a nondiversified portfolio. Diversification does not ensure against market risk.*

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