

Quarterly Market Commentary – Q308 October 2008

Sea of change on Wall Street

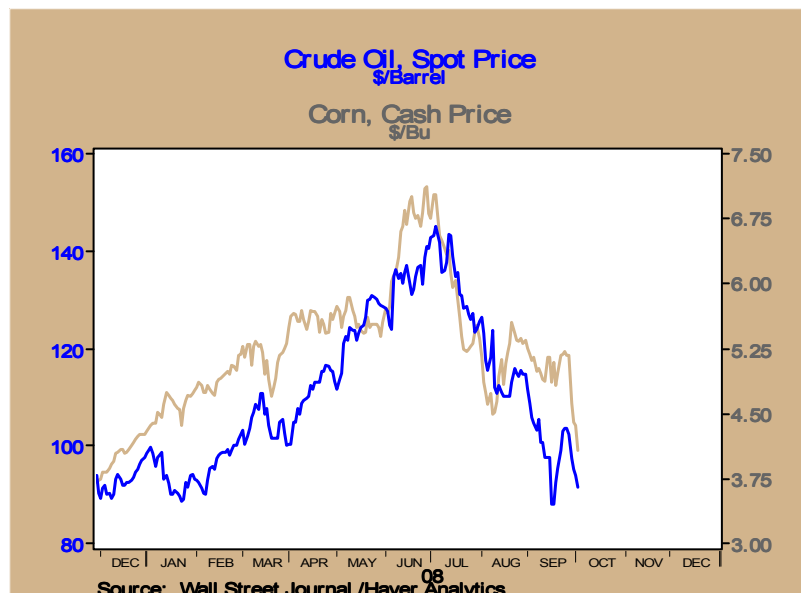
The summer months were a rough stretch for most investors, as financial assets of almost every sort gave ground, and headlines screamed of drastic events on Wall Street. Several major financial firms—Lehman Brothers, Washington Mutual, AIG, Wachovia, and Merrill Lynch—disappeared or needed to be rescued after buckling under the weight of illiquid mortgage-related assets, which have declined sharply in value in the wake of falling home prices. Fannie Mae and Freddie Mac, the pseudo-governmental agencies that are key cogs in our nation’s mortgage market, became wards of the state when large losses in their own mortgage portfolios put their solvency at risk.

The financial turmoil that began in August 2007 entered a new phase in September as the focus shifted from financial regulators to the halls of Congress, where a debate raged about how best to prevent Wall Street’s problems from cascading onto Main Street. As the quarter closed, Congress was poised to pass a \$700 billion rescue package targeted at buttressing an ailing banking system. Its goal, rather than to bail out financial firms or their shareholders, is to stabilize the nation’s credit markets, to ensure that qualified consumers and businesses can still get access to loans at reasonable rates and to preclude more dire conditions from gripping the American economy.

Seeking shelter from the storm

Stocks, bonds, real estate, and commodities—the main ingredients of most investment portfolios—have each taken their share of lumps this year. The third quarter in particular saw many major developments, and markets yo-yoed sharply in response to unfolding news. Overall, the Dow Jones Industrial Average (DJIA) fell by 3.7 % for the quarter, extending its loss for the year to 16.6 %. The S&P 500 Index (S&P) lost 8.4 % for the July–September period and is now off 19.3 % year-to-date. From their peaks, reached in October 2007, the DJIA and S&P have shed 21.4 % and 23.9 %, respectively.

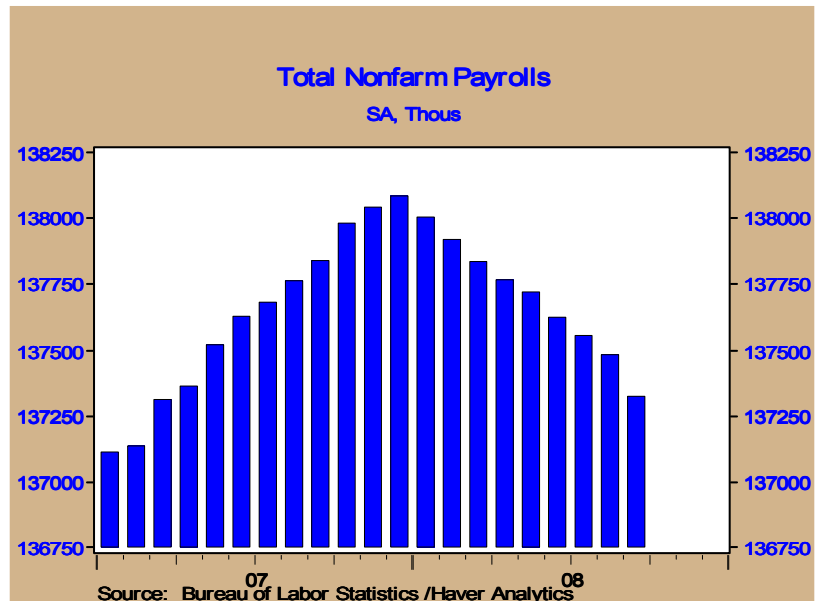
Small company stocks in the U.S. fared slightly better, as the small-cap Russell 2000 Index suffered a drop of only 1.1 % for the quarter. But losses around the globe were in general more acute than here at home, as the threat of U.S. financial turmoil spreading into a global economic slowdown became more credible. The MSCI EAFE Index of more mature economies dropped by 20.6 %, while the MSCI Emerging Market Index fell by a striking 27.6 % for the quarter. The prices of many energy and food-related commodities, like crude oil and corn, reversed their rapid ascent from earlier in the year and fell sharply throughout the quarter. Crude oil prices dropped by 32.1 %, while corn plunged by 35.2 %—meaning big losses for investors who had bet that prices would continue to rise.



Investors looking to take cover flocked in droves to the perceived safety of U.S. Treasuries, sending yields on a range of maturities sharply lower. For example, the yield on a 3-month Treasury bill fell from 1.9 % on June 30 to 0.92 % on September 30—a 52-% reduction in cash flow for income-seeking investors.

Economic concerns, policy response

There is much room for debate on the root causes of the present situation, as well as the best policy response to help us most effectively emerge from it. To be sure, opinions run very passionately on all sides of that discussion. There are, however, some clear signs that government intervention, in some fashion, is a necessary step in helping to prevent a more dire economic outcome—one of depressed business activity, rising unemployment, and falling prices on assets of all kinds. The employment picture, in particular, has already begun showing signs of weakness, as the economy has now lost jobs for nine consecutive months. American households run the risk of a triple-witching effect of reduced incomes, falling home values, and reduced investment wealth, which would put further downward pressure on an already ailing economy. The risks of governmental inaction appear very real, and the potential consequences—which would include social ramifications as well as economic—are too great to bear, especially at this fragile juncture.



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. The Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index. 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 MSCI Emerging Markets Index is a market capitalization-weighted index composed of companies representative of the market structure of 26 emerging market countries in Europe, Latin America, and the Pacific Basin.

Authored by John Blood, CFA, chief market strategist, at Commonwealth Financial Network.

