

## Quarterly Market Review

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### Financial Markets and Economic Analysis, Third Quarter 2007

#### **Perspective**

*There were two major drivers to returns in the third quarter for U.S. Investors, the increasing and broadened impact of the sub-prime crisis and the Fed's reaction to it late in the quarter, as well as the continued weakening of the U.S. Dollar in world markets.*

There were two major drivers to returns in the third quarter for U.S. Investors, the increasing and broadened impact of the sub-prime crisis and the Fed's reaction to it late in the quarter, as well as the continued weakening of the U.S. Dollar in world markets. As we noted in our commentary after the close of the second quarter, headline inflation continued to be a concern for the Federal Reserve and those worries kept the Fed on the sidelines during the first half of the year, despite falling GDP growth. However, during the third quarter, the impact of the sub-prime crisis began to spread beyond the direct mortgage lenders and buyers and the regional housing markets to impact large money center banks (internationally and domestically) and other financial institutions. Interest rates began to rise in the open market and lending dropped drastically as banks sought to limit further damage. The Fed, in conjunction with the European central banks attempted to inject more liquidity into the markets by dropping the discount rate rather than the Fed Funds rate. The response was several billion dollars injected over the course of two weeks. However, as the data for August began to show a severely weak economy, including a net loss of jobs for the month, the Fed did cut the Fed Funds rate, effectively the second rate cut of the quarter, by a half-percentage point, igniting a sharp market rally for the final weeks of the quarter. The domestic equity indexes rallied 1.5% to 4% during the final month, pulling many of the indexes out of the red for the quarter. The fixed income markets also rallied strongly during the final month.

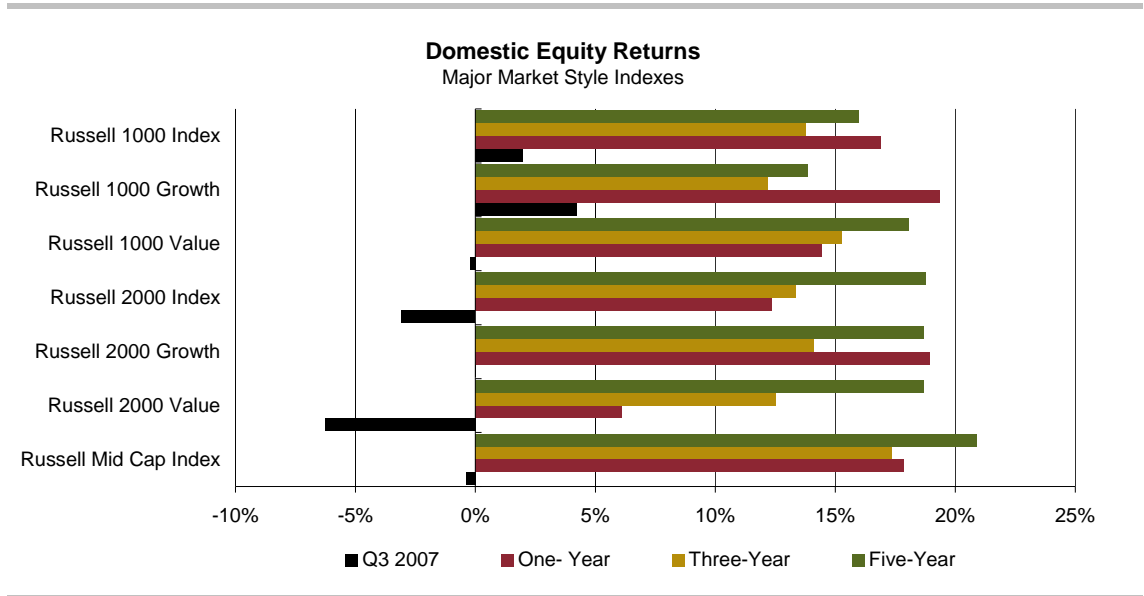
The second major contributor was the continued fall of the dollar in the international markets. During the final month of the quarter, the dollar reached new lows against the Euro, pound sterling and fell into parity with the Canadian dollar, a level not seen since the late 1970's. This has not been unexpected as it is a natural consequence of the continued trade deficit with the rest of the world. The sharp decline within the third quarter boosted returns for U.S. Investors with assets overseas. Global returns were -1.5% to -4.0% for the third quarter in local terms, with the exception of the Pacific Rim countries. However, in dollar terms, the same returns were up 1.0% to 4.0%. This will continue to impact domestic multi-national companies, as their exported products should continue to be cheaper and more attractive over the coming year. This will also likely mean increases in many products with significant overseas materials or production. With continued weak GDP growth in the U.S., and the expectation that the sub-prime issues will not fully resolved for several quarters to come, domestic investors may decide that increased international exposure will benefit their portfolios.

#### **Domestic Equity Markets Overview**

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The third quarter was decidedly mixed in the domestic markets, and followed the trend noted in the second quarter with large cap stocks significantly outperforming small caps and growth dominating value across all market caps. Large cap stocks, represented by the Russell 1000 Index, were up 2.0%, with the value segment down 0.2% and the growth segment up 4.2%. The Russell 2000 Index was down 3.1% for the quarter, with the value segment down 6.2% (and now down 2.7% for the year) and the growth segment flat at +0.02%. The dominant position of the Financials sector within the value segments was the major contributor across market capitalizations. Not only were many of the mortgage lenders impacted by the ongoing sub-prime crisis, but the money center banks and brokerage firms, who packaged and sold many of the mortgage backed securities are expected to take significant charges against earnings in the third quarter and likely for the fourth quarter as well. The Fed's rate cut in mid-September, while not unanticipated, pushed all of the major market indexes higher for the month, providing all of the quarter's return in the last 30 days.

The large cap segment of the market, represented by the Russell 1000 Index, showed widely mixed results. Disparate sectors Energy, Materials and Technology all had greater than 5% returns, while Financials was down nearly 4%. The loss in the Financials sector had an outsized impact in the Russell 1000 Value Index, as that sector represents more than a third of that index. In the Russell 2000 Index, only the Healthcare and Technology sectors had positive returns, while there were significant losses in the Consumer Discretionary, Energy and Financial sectors.



**International Markets Summary**

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The international markets were broadly lower during the third quarter, with the exception of the Pacific Rim countries. The MSCI EAFE Index was down 2.5% during the quarter in local terms, but the weakening dollar added nearly 5% to the return for domestic investors, with the Index up 2.2% in dollar terms. Among the developed countries, Hong Kong was the top gainer, up nearly 24% for the quarter. In Europe, Finland (19%), Greece (11%) and Denmark (9%) were the strongest contributors. Similar to domestic returns, the growth segment of the Index far outperformed the value segment, and large caps outperformed small caps.

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The rally continued in the emerging markets during the third quarter, as the MSCI EAFE Index was up 12.6% in local terms, with a slightly higher return, 14.5%, for U.S. Investors as the dollar weakened. The pattern in the domestic and international markets was reversed in the emerging markets as the value segment continues to outperform the growth segment. China continues to lead the way among the emerging markets, up nearly 42% on a dollar basis in the quarter and more than 72% for the year. Turkey (+24%) and India (+20%) were also among the leaders. Latin America had mixed results for the quarter with Brazil (21%) and Peru (22%) up strongly, while Mexico (-4%) and Chile (-3%) were off slightly.

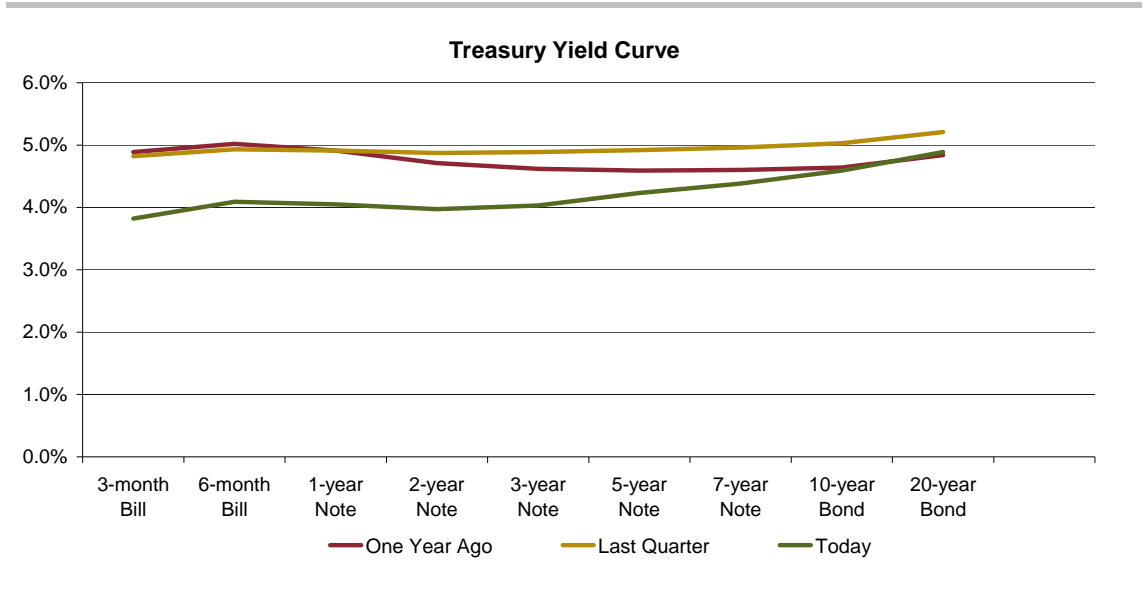
**Fixed Income Summary**

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A cut in interest rates from Fed was widely expected during the first quarter of 2007, and thought improbable at best near the end of the second quarter. When it did arrive in September, it kept the rally going in the fixed income markets. The Lehman Brothers Aggregate Index was up 2.8% for the quarter, with returns spread out in all three months. Long before the rate cut however, the general tone of the market was set by broader macro events, particularly the sub-prime write downs. A preference for quality was obvious, especially in the first two months of the quarter, as Treasuries (3.8%) outperformed both Corporate (1.8%) and Mortgage-backed issues (2.6%). Longer maturities and better credit qualities

were favored across all of the asset classes. Long Treasury (20+ years) was the best performing group up 5.4%. As was the case with the international equity market, the international bond market strongly outperformed the domestic market, led by the Canadian (9.1%) and Asian-Pacific (8.0%) markets.

The municipal market experienced more volatility than usual during the third quarter, but finished with a strong month of September. Relative valuations reached a peak during August, as the flight to quality in the taxable market pushed Treasury rates down and municipals were yielding 90% of Treasuries. The September rally pushed the ratio back to 83%, still historically high. Maturity selection was critical during the third quarter, as the middle of the yield curve produced the best results. Returns peaked in the Lehman Brother’s 7-year Index at 2.8%, but fell rapidly to just 0.6% for the longest dated maturities and 1.3% for the shortest. Like the taxable market, credit quality was a significant factor as well with the AAA segment of the Lehman Brothers Municipal Index up 2.1% and the BBB segment down 2.5%.



**Outlook**

After a relatively quiet second quarter the volatility in the third quarter created quite a bit of noise in the domestic capital markets. During the first two months, we observed a sharp flight to quality and an increase in risk premiums in both the fixed income and equity markets. However, a “rescue attempt” by the Fed during September ignited a sharp market rally and a slight easing of those same risk premiums. Further Fed action may keep the fixed income markets strong, but could have an adverse affect on the equity markets, depending on the tone and the timing of any such action. There is little doubt that the current slide in the dollar relative to the other major currencies will continue, though the magnitude should be less severe than the last six months. For the moment, the markets and the Fed seem to be in a wait and see mode. In the longer term, corporate earnings in the third quarter will need to be strong to keep the market rally moving, although even a modestly down quarter will leave most of the domestic indices in the black for the year.

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