

Quarterly Market Review

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Perspective

The first decade of the 21st century will be a period that is studied in great detail by finance and economic students far into the future. There are a number of factors that have combined to create the current financial crisis. Foremost was a substantial and rapid climb in the values of both the residential and commercial real estate markets. The creation and expansion of the credit default swap market made packaging the real estate loans easier, which in turn made it possible for the lending institutions to lend even more. The owners of those properties were able to re-finance, take the increased equity out and either invest or consume, either way pushing the equity markets higher. Like a skyscraper, each level building on the one before, pushing the markets ever higher. In this case, however, the foundation was not quite as solid as imagined. A few slight shocks to the credit markets in the third quarter last year forced de-leveraging by a few hedge funds and debt pools, and a slowing domestic and foreign economy all combined to bring the house down.

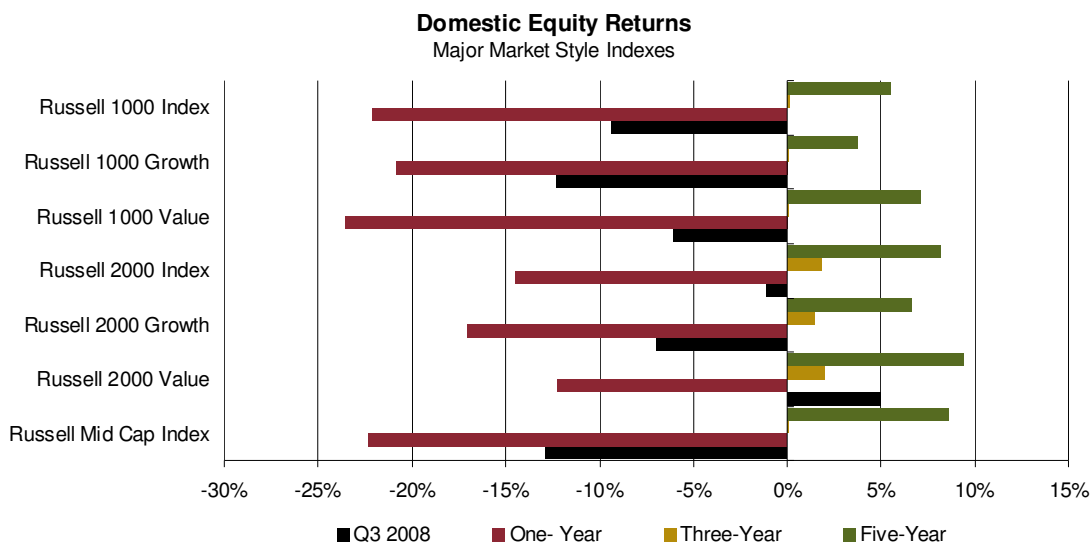
The government intervention into this crisis here at home has been slowed by a combination of politics and ignorance. There is no doubt that Congress has been slowed in its reaction due to the simple lack of understanding, even by the experts, of what measures need to be taken to prevent a systemic collapse, or what form those measures might take. Fannie Mae and Freddie Mac, as “government sponsored entities” were somewhat naturally rescued. However, there was a curious disconnect in the Fed’s behind the scenes involvement in the rescue of Bear Stearns, and lack of same in the fall of Lehman Brothers, which was allowed to go bankrupt. The rescue of several other banks, Washington Mutual and Wachovia has already begun, and it is excessively hard to imagine that these two will be the end of the bank failures. The public’s impression of the surviving institutions and the government intervention will determine just how deep this crisis will be, and just how many failing grades history will assign to our leaders.

Domestic Equity Markets Overview

We noted in our review of the second quarter that the positive index returns were hiding the significant losses in June. The third quarter was very similar to the second quarter, in that the domestic indexes had generally positive returns at the end of August, but significant losses in the final month sent all but one of the indexes negative for the quarter. There was a strong reversal during the quarter, as the Energy sector, which had driven returns for much of the year, was off sharply as oil and natural gas prices fell. Surprisingly, given several bank failures and takeovers, it was the Financial sector that led to the outperformance of value stocks during the quarter. It is clear that the sector was hurt in the final month along with the rest of the market, but a sharp rebound in the sector during the first two months was enough to make it one of the positive contributors for the quarter

Looking at the Russell Indexes, there was a large disparity in value and growth, a reversal of the trend we noted in the second quarter. The Russell 1000 Value outpaced the 1000 Growth by more than 4% and the 2000 Value was nearly 12% ahead of the 2000 Growth. The Russell 2000 Value Index was a substantial outlier in the quarter as the only segment of the domestic equity market with positive returns. Only four sectors within the index had negative returns, and of those only Technology was more than 6% of the Index. The Index’s positive quarterly return was due to the 18% return in the Financials sector, which makes up more than a third of the Index. The Russell Midcap Growth Index was the worst performer for the quarter, down 17.7%. Only two sectors within the Index had positive returns, Consumer Staples and Healthcare, while Materials and Industrials were down more than 20% and Energy and Utilities more than 40%.

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International Markets Summary

The international equity markets were down slightly more than their domestic counterparts (10-13%) during the third quarter in local terms. However, the sharp strengthening of the dollar added to the losses for U.S. investors, pushing index returns down 18-20%. The impact of the U.S. housing market is being felt worldwide as the MBS securities are now owned worldwide. Exacerbating this issue has been housing issues in several countries, the U.K most prominent among them. The global tightening of the credit markets continues to have an impact as well. There were very few bright spots across the developed markets. Switzerland was the best performing single market, down more than 13%, with Austria, Ireland and Norway bringing up the rear, all down more than 40% in dollar terms. The bulk of the losses overseas, like the domestic markets, came in the last 30 days of the quarter.

Although falling energy prices during the third quarter were a slight positive for the developed markets, it was a significant drag on many emerging market economies. As a result of slowing global growth, and an increasing aversion to risk, the emerging markets were down more than 26% in the quarter and more than 35% for the year in dollar terms. The year's leader among the regional markets, Latin America, was down more than 32% in the quarter, 19% in the final month alone. Russia was a special case during the quarter, as trading was halted several times due to the precipitous nature of its market decline. By the end of the quarter, the index had fallen 45%. All of the BRIC countries struggled, with Brazil down 37%, China down 25% (and 45% for the year) and India down just 14% for the quarter, but nearly 50% for the year.

Fixed Income Summary

Once again, the Fed left rates unchanged during the quarter, but focused closely on providing liquidity to a market that continued to tighten up. Treasury rates fell across the yield curve, but most of the action was at the short end. Rates on 90-day Treasuries dropped nearly 1% over the course of the quarter and roughly 60 basis points for maturities from 6 months to three years. Beyond three years, the changes were much smaller, dwindling to just 16 basis points on 20-Year bonds. In the taxable markets, it is no surprise that Treasuries were the leading sector as investors continued to drive down yields in the search for safety. This trend has continued into the first week of the third quarter, as very short term Treasury yields have been pushed to unprecedented levels. 30-day Treasuries have traded with a yield as low as 15 basis points, and 90-day T-bills as low as 50 basis points. This is causing increased problems for money market funds, when much of their investable universe is trading below the fund's expense ratios. Added to the problems of counter party risk with the failed or acquired institutions, the Treasury has been

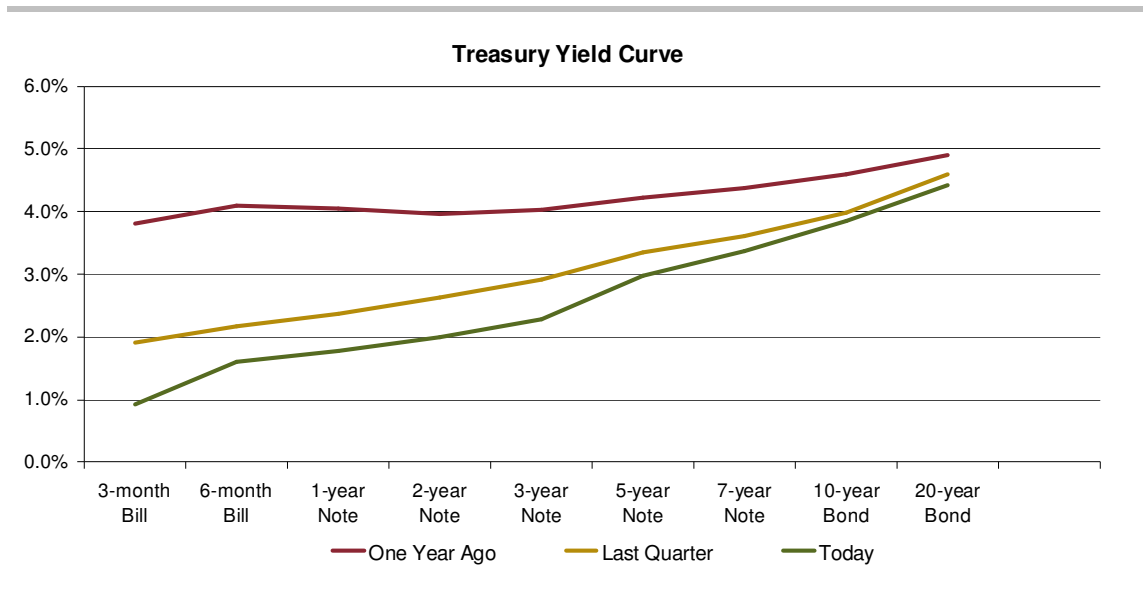
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forced to come out with a guarantee program. This was necessary as there has been a run on funds after the Reserve Primary Fund fell below a \$1 NAV. Estimates are that more than \$44 billion has been pulled from these funds. In the broader market, Mortgage-Backed Securities (MBS) were the second best performing sector, up 1.9%. Breaking down the Lehman Aggregate Index by credit quality, AAA-rated securities (including Treasuries) were up 1.3% while AA rated securities were down 5.0% and A-rated securities were down 10.0%.

The municipal bond market was mixed during the quarter, with maturities less than five years turning in slightly positive returns, ranging from 60 bps to 95bps, and the long end of the maturity spectrum turning in significant losses, ranging from 5.0% at 15 years to more than 7.7% at 22 years. Similar to the taxable market, credit quality was another defining measure for returns in the quarter. AAA-rated securities were down 1.7%, while BBB-rated securities were down 7.8%. There remains a high level of supply in the markets, one that may take well into 2009 to absorb.



Outlook

Those advisors and investors that remain focused on a long-term investment plan, that is risk appropriate, will have more opportunities to reach their goals than those that chase performance, or exit the market altogether.

With the domestic indexes down 10-20% (excepting small cap value), and the general environment and sentiment present at the beginning of the fourth quarter, it is a relatively safe assumption that we will see the first negative year in the domestic markets since the end of the last bear market in 2002. With the fixed income indexes, both taxable and municipal, either well into the negative range or just barely positive, we may see the first negative year in the fixed income markets since 1999. In fact, other than very short term fixed income, there may be few if any asset classes with positive returns for the year. But one year or several years, bear markets are cyclical. Those advisors and investors that remain focused on a long-term, risk-appropriate investment plan will have more opportunities to reach their goals than those that chase performance, or exit the market altogether.