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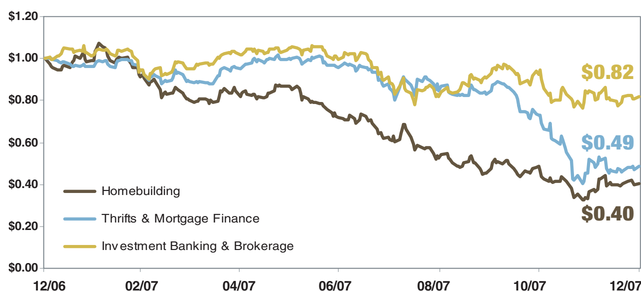
MARKET CONDITIONS

2008 has gotten off to a rough start, with most major stock indexes posting significant declines in the first few weeks of January. To understand the current environment, we need to look back to 2007 when many of these problems emerged.

2007 started off fairly calmly, with some optimistic projections that strong consumer and business spending might offset a weakening housing market. By the end of the year, housing-market woes had spread across the landscape, hitting large banks, retailers, insurance firms, hedge funds, and even bonds. Today, in the early weeks of 2008, losses have spread to other sectors of the economy.

What happened? The problems of 2007 occurred in three waves (see figure 1). In February, home-builder stocks started falling in response to weak data on existing-home sales and new construction. In July and August, mortgage lenders, foreign banks, and hedge funds reported losses on securities tied to U.S. subprime mortgages. The third wave happened in November, when domestic commercial and investment banks revealed their own subprime-related losses. At each stage, the problems spread higher and higher up the food chain.

Figure 1: Growth of Select Industries



In retrospect, investors were too optimistic at the beginning of the year. It became very clear in 2007 that housing is not an isolated market segment that can dip and swoon without affecting the rest of the economy. Gone are the days when the local bank issued a 30-year mortgage and kept that mortgage on its books. Now, there are more players in the game—more companies originating mortgages, more individuals qualifying for loans of various types, more groups repackaging the loans into new securities, and more investors buying mortgage-backed and asset-backed securities.

The layers of complexity make it difficult to evaluate exactly how much exposure any one investor has. That analysis is still going on. For example, when the investment banks announce write-downs, they are not necessarily based on certain losses. Rather, some of the write-downs are based on estimates of how many homeowners might default and the amount that might be recovered on each investment.

FEARS OF RECESSION

The fourth big wave of losses is happening now in 2008, and it is affecting the entire market—not just housing and finance. Market participants fear that the U.S. economy is heading into (or already in) a recession. And, they fear that what happens in the U.S. will spread to global markets.

A recession can be caused by disruptions to the supply of money. Our economy is highly dependent on financing. Individuals need financing for homes, credit cards, and autos, and businesses need financing to continue their operations. When financing options become scarce, consumers and businesses stop spending. At the extreme, some businesses declare bankruptcy if they cannot obtain the finances necessary to continue operations. There was a period when financing was too easy to obtain, and that caused some of the problems we see now. But now, banks are struggling with their own losses from operations and may significantly curtail their lending.

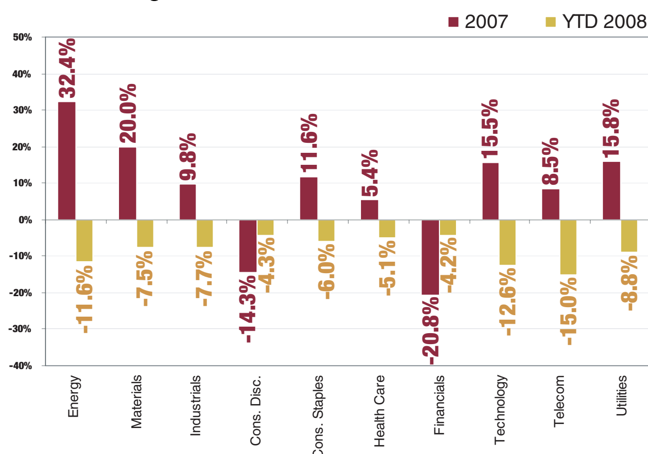
Starting in August 2007, the U.S. Federal Reserve Bank has stepped in on numerous occasions to increase the supply of money. By lowering its targets for two key interest rates, the Fed can increase the supply of funds available to banks. Most recently, the Fed made an unscheduled announcement on January 22, 2008 to cut both the discount rate and federal funds rate by 0.75%, bringing those rates down to 4.0% and 3.5%, respectively. (The discount rate is the rate the Fed charges when it lends directly to banks, and the federal funds rate is the rate that banks charge each other for overnight loans on Federal Reserve deposits.) These lower rates may provide some relief for homeowners and businesses, but the health of the economy is still dependent on commercial and retail banks' willingness to lend.

Recessions are informally defined as two consecutive quarters of negative growth in gross domestic product (GDP). GDP is the government's measure of all goods and services produced in the United States. We haven't seen negative GDP growth yet—the third quarter 2007 GDP growth rate was a healthy 4.9% and fourth quarter GDP estimates will not be available until the end of January. So, in the absence of updated economic data, investors look to stock market performance as the ultimate leading indicator of where the economy might be headed. In many different markets, there is a huge disparity between the performance in 2007 and the performance so far in 2008.

U.S. EQUITIES

Figure 2 shows sector performance for U.S. stocks. In 2007, only two sectors posted negative returns—financials (due to banks' subprime exposure) and

Figure 2: S&P 500 Sector Returns



YTD through 1/24/2008.

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consumer discretionary (on fears that consumers would tighten spending). Many other sectors posted double-digit returns, with rising commodity prices helping the energy, materials, and utilities sectors and strong earnings in the technology sector. In contrast, in 2008 so far, all sectors of the S&P 500 index have posted negative returns, as investors worry about the broad-based impact of a possible recession.

The same pattern appears when evaluating U.S. stock markets through a style-based lens (figure 3). There were periods of strength in 2007, specifically in large-cap and growth styles, but there has been weakness across the board so far in 2008.

Figure 3: U.S. Equity Returns by Style

2007 Returns

	Value	Core	Growth
Large	-0.2%	5.5%	11.8%
Mid	-1.4%	5.6%	11.4%
Small	-9.8%	-1.6%	7.0%

YTD 2008 Returns

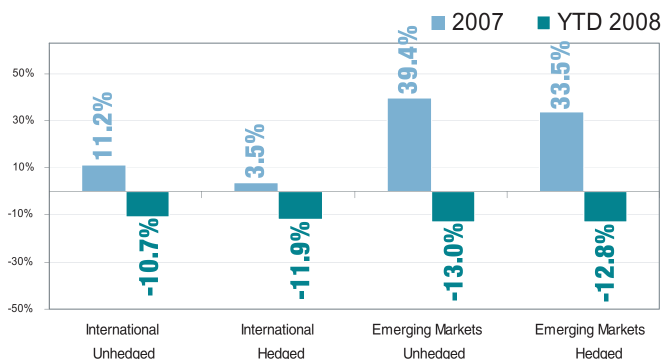
	Value	Core	Growth
Large	-7.0%	-7.8%	-8.9%
Mid	-8.0%	-9.2%	-10.1%
Small	-8.0%	-9.5%	-10.8%

Source: Russell indexes for all styles except large core, which is represented by the S&P 500 index. YTD through 1/24/2008.

INTERNATIONAL EQUITIES

A similar picture emerges in foreign markets, as shown in figure 4. In 2007, many investors were proponents of the idea of "decoupling," the theory that global markets weren't as dependent on the United States as before. The argument was that these countries could continue to grow even if the U.S. faced a recession. Both developed and emerging markets posted gains in 2007, with unhedged positions boosted by foreign currency gains (US dollar weakness). The tide turned in 2008, when investors began to appreciate that other countries are indeed highly dependent on Americans' ability to continue to spend.

Figure 4: International Stock Returns

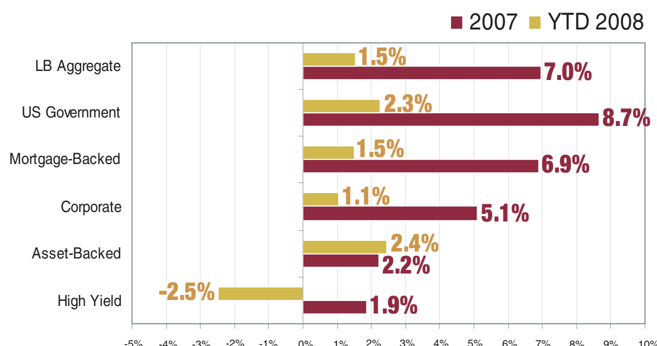


Source: International unhedged is represented by the MSCI EAFE NR USD index, and international hedged is represented by the MSCI EAFE NR LCL index. Emerging markets unhedged is represented by the MSCI EM NR USD index, and emerging markets hedged is represented by the MSCI EM NR LCL index. YTD through 1/24/2008.

BONDS

In 2007 and 2008, high-quality bonds became the investment of choice for risk-averse investors. As demand for these bonds increased and as the Fed lowered interest rates, prices rose and yields fell on government bonds and mortgage-backed bonds (based on mortgages from prime borrowers). In fact, the yield on the 10-year Treasury note fell to an intraday low of 3.28% on January 23, 2008. Apart from a few periods of low interest rates in 2002-2004, the 10-year Treasury note yield hasn't been that low since 1962. The Lehman Brothers Aggregate Index has a large weight in government and mortgage-backed bonds, so the returns held up for both 2007 and year-to-date 2008. Losses from subprime mortgages hurt asset-backed securities, and high-yield corporate bonds declined as investors braced for higher corporate default rates.

Figure 5: Bond Returns



Source: Lehman Brothers indexes. YTD through 1/24/2008.

GOING FORWARD

All the events that transpired in the last six months have added a great deal of volatility to the markets. In the first half of 2007, there were 16 days when the S&P 500 index moved by more than 1% (up or down). In the second half of 2007, that number jumped to 49. So far in 2008, 11 of the 16 trading days have been moves greater than 1%. This volatility can be unsettling, with day after day of stock-market headlines, but it is not necessarily a bad thing. Smart money managers can find good investment opportunities in times of distress. And, the U.S. economy has proven to be quite resilient in recovering from past recessions.

CLIENT CONFERENCE 2009

2009 Marco Consulting Group Client Conference
Friday, January 30 to Tuesday, February 3, 2009
Loews New Orleans Hotel, Louisiana

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