MCG Journal

Boston 617-298-0967 | Chicago 312-575-9000

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MARKET UPDATE

No wonder you are exhausted. The markets took investors for quite a ride this past year. Encouraging market rallies were followed by frustrating and unnerving market sell-offs, and the cycle kept repeating itself. It is hard to know what Prudent Man would do in a market like this.

As Figure 1 shows, as of the end of the second quarter, the S&P 500 was trading at the same level as mid-March, after the Bear Stearns collapse. It was also trading close to the levels from mid-January, after international markets collapsed on Martin Luther King Day. Each rally has run out of steam.

Figure 1: S&P 500 Index

SAME OLD STORY

There was a familiar refrain to the song. The same woes kept hitting the market, month after month, with no clear sign of resolution.

Banks and other financials showed up for their quarterly confessions with a steady stream of write-downs and capital raising. Losses from financial firms have hit $400 billion since the credit crisis began. In early 2007, the financial sector represented 22% of the market cap of the S&P 500 index and that fell to 14% by June 30 of this year.

Housing continued to deteriorate with prices falling and foreclosure rates rising. And, because banks pulled back on lending, many potential home buyers couldn't get financing. Fewer buyers meant home prices couldn't stabilize.

Commodities continued their upward march, led by oil. The media made a big splash when oil hit $100 a barrel the first week in January, and this quarter brought more new highs—$119 a barrel at the end of April, $129 a barrel at the end of May, and $140 a barrel at the end of June.

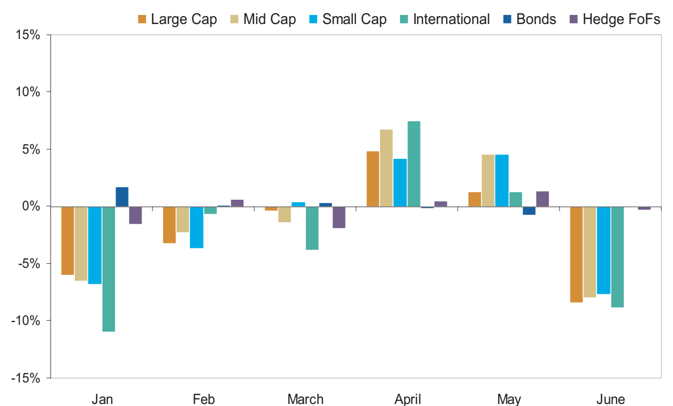
Michael Bullion, Analyst, Fiduciary Services Group

We'd also like to welcome Michael Bullion, an analyst in our Fiduciary Services group. Michael joins us from the Tranel Financial Group, where he was Financial Services Manager and part of the Investment Committee. During his five years at Tranel Financial Group, Michael also held the positions of Financial Services Representative and Client Services Registered Representative. Michael earned his BS in applied mathematics and business administration from Spring Hill College, Mobile, Alabama. Michael is pursuing his CFA designation.

U.S. consumers were worried about energy prices, food prices, unemployment—all the way down to the well-being of the bank that has their checking account. Needless to say, consumer confidence plummeted and consumer spending tightened.

Developed global markets faced many of the same problems as the US, including slow growth and inflation, while inflation was a bigger concern for emerging markets.

Figure 2: Monthly Returns



ASSET CLASSES

Unfortunately, the combination of slow growth and inflation is problematic for most asset classes. Figure 2 shows month-by-month similarities between some of the major asset classes.

The second quarter started with a nice rally in April and May after the Federal Reserve Bank calmed the market with its efforts to help rescue Bear Stearns. But, sentiment changed in June with increased risk aversion and inflation fears. Stocks, bonds, and funds of hedge funds were all down in June, reinforcing the notion that correlations increase during times of market stress.

The losses from June wiped out gains from April and May for stocks and bonds, with the S&P 500 index losing 2.73% and the Lehman Brothers Aggregate Bond index losing 1.02% for Q2.

Funds of hedge funds followed a similar directional pattern of monthly performance as equities, but losses were modest and these investments did offer protection on the downside, as intended. The HFRI Fund of Funds Conservative Index gained 1.53% for the second quarter.

As a good inflation hedge and as an alternative to stocks and bonds, one would expect real estate to hold up during periods of slow growth and inflation. But, given the multi-year bull market for real estate, this sector is showing signs of weakness. Slower economic growth led to increased vacancies and delinquencies, and higher energy prices drove up costs. Negative indicators like these will weigh on both commercial mortgage-backed bonds and real estate partnerships going forward. The NCREIF Property Index returned 0.56% for Q2, with positive income but negative capital appreciation.

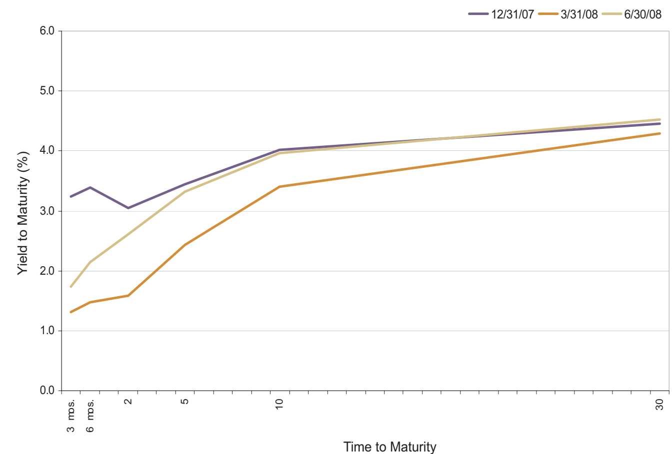
THE FED'S DILEMMA

The Federal Reserve played a large role in stabilizing the market over the past year, but their task is now more difficult. The Fed lowered the federal funds rate from 4.25% at the beginning of the year to 2.0% at the end of Q2. Low interest rates should help spur growth eventually, but low interest rates also contribute to inflationary pressures in the meantime. (Low interest rates mean there is more money available for spending and that creates more demand for goods, bidding prices upward.)

Investors expect that the Fed will need to raise rates soon to combat inflation, and that is one of the reasons that Treasury yields rose during the second quarter (Figure 3), even as the Fed was easing rates. (Remember that rising yields lead to lower prices for bonds.)

Another complicating factor is the weakness of the US dollar. A weak US dollar makes US exports more competitive (this is one of the reasons that some industrial stocks have done well lately), but it makes imported goods more costly. A weak dollar

Figure 3: Treasury Yield Curve



Source:Bloomberg

can also encourage inflation in commodities like oil that are priced in US dollars. When oil buyers convert strong foreign currencies into weak dollars, they get a lot more dollars and can bid up the price.

The Fed has expressed concern about the weakness of the US dollar. But, the best way to strengthen the dollar is to raise interest rates in the US (thereby encouraging more investment), and the Fed doesn't want to raise rates yet because the economy is still weak. The Fed also can't lower rates to encourage growth, because that could encourage more inflation and weakness in the dollar. This means that one of the key tools in their toolbox is off limits for now.

The European Central Bank recently raised rates for the first time in 13 months in order to fight inflation. This can contribute to further weakness in the US dollar if investors prefer higher yielding euros than dollars.

WEATHER REPORT

Money managers always use weather analogies—the perfect storms in the market, the proverbial headwinds. Without a doubt, there are major challenges facing the economy right now. But, it is somewhat comforting that these challenges are familiar and not new storms on the horizon.

In many ways, the first quarter felt like a hurricane—global markets in a tailspin, a major financial institution (Bear Stearns) on the brink, drastic cuts to the federal funds rate and unprecedented action by central bankers to calm the markets.

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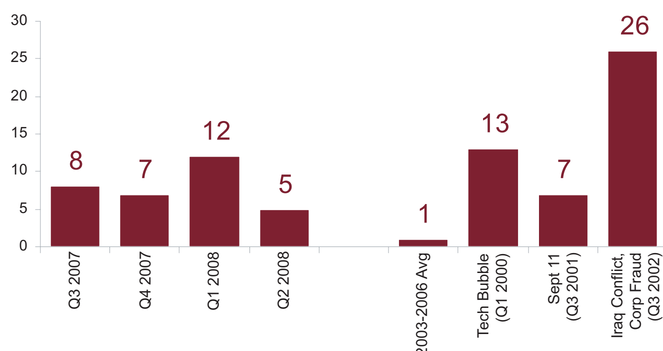
Figure 4: Days When S&P 500 Moved >2%



In contrast, the second quarter had fewer startling headlines. The Fed only did one minor cut of 25 basis points to the federal funds rate. No major financial institutions collapsed; those who wanted to raise capital could (eventually). Corporate earnings were a mixed bag of surprises and warnings, as they always are. Unemployment was still relatively low at 5.5%. At the end of the day, slow growth and inflation are familiar aches and pains. But yet, it is somewhat surprising that the stock market is at the same level as March, even though it has been calmer.

Figure 4 shows the number of trading days per quarter when the S&P 500 index moved by more than 2%, up or down. The second quarter only had five such days, compared to 12 in the first quarter. The steady period from 2003-2006 makes the last year seem exceptionally volatile. But, it is fairly similar to past crises, from the collapse of the tech stock bubble (2% moves on 13 days) to September 11, 2001 (seven days). The most volatile period in recent years was Q3 of 2002 (26 days) when there were corporate accounting scandals and the build-up to the Iraq war.

Part of the reason the markets are so volatile now is the lack of transparency in the most troubled spots. It is difficult to see what banks are hiding on their balance sheets. It is difficult to predict how long the real estate downturn will last. It is difficult to price a security that is illiquid, and it is difficult to anticipate when pricing will become more "rational."

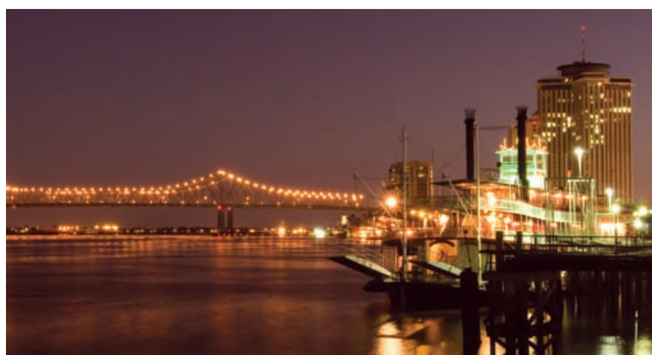
WHAT NEXT?

So, what should investors do when markets are so choppy and the future is so uncertain?

Don't Panic: Many short-term investors fled to the safety of Treasury bonds when the markets began to unravel, and Treasury prices rose accordingly. Now, the Treasury yield curve is shifting upward (figure 3), and those prices are falling. There is no single strategy that is perfectly immune to losses, and a diversified portfolio is still the best way to meet your plan's long-term goals.

Don't Freeze: The relentless headlines can overwhelm investors to the point of indecision or to the point where they just want to walk away. Neither is a good strategy. Portfolios require regular oversight and maintenance, for example, rebalancing the plan's exposures back to target weights after significant market movements.

Don't Be Greedy: In an environment where many asset classes and managers produced disappointing returns, investors can be eager for anything that is different. Be cautious before making dramatic changes to your portfolio or before attempting to call the market bottom. One clear lesson from the last year is that history does not tell the whole story. For example, historical returns did not anticipate how mortgage-backed securities would react to years of unusually aggressive lending practices.



Save the Date

IFEBP Breakfast
Sunday, Nov. 16, 2008 from 8am to 11am

2009 Client Conference
Friday, January 30 to Tuesday, February 3, 2009
Loews New Orleans Hotel