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Third-Quarter 2008 Market Review ~ Bubbles, Crashes & Recoveries!

October 2008 - Buyouts, bailouts, and bankruptcies! The second half of 2008 will certainly be enshrined in the annals of financial history, with the U.S. Treasury, Federal Reserve, Securities and Exchange Commission, and Congress taking unprecedented actions to address the disarray in financial markets, and beginning to ultimately address an obsolete regulatory framework which is insufficient to address modern-day financial instruments and markets.

The bears continued growling on Wall Street at the outset of the third quarter, quieted down by mid July, hibernated in August, and left the cave with a vengeance in September. The July recovery came when the federal government signaled it would provide a backstop to mortgage-behemoths Fannie Mae and Freddie Mac. By September, the implicit guarantee became explicit when both companies were placed into government conservatorship.

The capital markets turmoil forever changed the financial industry landscape. The upheaval yielded the buyout of Merrill Lynch by Bank of America in a 100% stock deal, the bankruptcy of investment banking firm Lehman Brothers Holdings Inc., the failure of Washington Mutual Bank (and the sale of its assets to JP Morgan Chase & Co.), the bailout by the Feds of insurance-giant American International Group (AIG) (wherein the government took a 79.9% stake in AIG in exchange for a loan from the Federal Reserve for as much as $85 billion, with another $38 billion advanced in October), and the merger of financial services firm Wachovia Corp. into Wells Fargo. The collapse of Lehman Brothers and Washington Mutual were the largest bankruptcy and bank failure, respectively, in U.S. history.

In the meantime, although the Federal Reserve left its discount rate unchanged at 2.0% at both of its meetings during the quarter, it provided additional liquidity by increasing its lending facilities and expanding the type of collateral it would accept from borrowers. Investor fear and anxiety drove investors to the relative safety of Treasury securities. At one point, the rally pushed the yield on the 10-year Treasury Note below 3.40%. However, as stocks made fitful attempts to recover, at quarter end, the yield on the 10-year Treasury Note was just 16 basis points lower to close at 3.82% (the yield as of October 15th was 3.95%).

On the penultimate day of the quarter, stocks were bludgeoned as Congress failed to pass legislation designed to unclog credit markets (the $700 billion act was subsequently signed into law on October 3rd). Major-market barometers suffered their worst one-day percentage losses since September 2001 and point-declines in history. Stocks recovered a bit on the final day of the period, but the quarter's story was already written, as the instability left both stocks and bonds severely pummeled.

There was almost no place to hide during the quarter, with the only bright spot being Domestic Small Cap Value stocks, rising 5.0%. All other equity indices were in negative territory. With the dollar strengthening during the period, international stocks felt the brunt of the carnage, tumbling by double-digits. Year-to-date, all equity indices are off by double-digits, again with the exception of Domestic Small Cap Value, shrinking only 5.4%. Typically a safe haven during periods of market disorder, key bond indices also posted across-the-board declines.

Subsequent to quarter end, as the credit market mayhem spread to international markets, stocks around the world plummeted (see Bubbles, Crashes & Recoveries below). On October 8th, in a coordinated global effort, the U.S. Federal Reserve and six other central banks lowered interest rates. In the U.S., the Fed dropped the Fed Funds and Discount Rate by 50 basis points to 1.50% and 1.75%, respectively.

Below are rates of return for selected market indices for the third quarter of 2008, year-to-date 2008, and the three, five, and 10-year compound annual returns as of December 31, 2007.

	3Q:2008	YTD-2008	3-Year	5-Year	10-Year
Equity (Stock) Indices					
Domestic Large Cap					
Russell 1000 - Growth	-12.33%	-20.27%	8.68%	12.10%	3.83%
Russell 1000 - Value	-6.11%	-18.85%	9.32%	14.63%	7.68%
Russell 1000 - Blend	-9.35%	-19.50%	9.08%	13.43%	6.20%
Domestic Small Cap					
Russell 2000 - Growth	-6.99%	-15.29%	8.11%	16.50%	4.32%
Russell 2000 - Value	4.96%	-5.37%	5.27%	15.80%	9.06%
Russell 2000 - Blend	-1.11%	-10.38%	6.80%	16.25%	7.08%
Real Estate (FTSE EPRA/NAREIT Global)	-10.41%	-22.69%	15.17%	24.28%	12.75%
International					
MSCI EAFE Developed Large Cap	-20.50%	-28.91%	17.32%	22.08%	9.04%
MSCI EAFE Developed Small Cap	-23.92%	-31.68%	15.55%	26.84%	NA
MSCI Emerging Markets	-26.86%	-35.37%	35.60%	37.46%	14.53%
Fixed-Income (Bond) Indices					
Lehman Brothers					
Global Aggregate	-3.83%	-0.44%	3.70%	6.51%	6.08%
U.S. Aggregate	-0.49%	0.63%	4.56%	4.42%	5.97%
U.S. Treasury TIPs	-3.54%	1.17%	4.85%	6.27%	7.46%
U.S. Corporate High Yield	-8.89%	-10.08%	5.39%	10.90%	5.51%
Municipal	-3.21%	-3.19%	3.90%	4.30%	5.18%
International Emerging Markets	-5.80%	-6.00%	9.11%	13.03%	10.02%

Source: www.russell.com, www.nareit.com, www.mscibarra.com, www.lehman.com

Note from www.lehman.com: On September 22, 2008, Barclays Capital completed its acquisition of Lehman Brothers' North American Investment Banking and Capital Markets businesses. As part of the transaction, Lehman Brothers indices have become part of Barclays Capital. Recognizing the industry significance of these indices, Barclays is committed to maintaining the family of Lehman Brothers indices and the associated index calculation, publication, and analytical infrastructure and tools.

Bubbles, Crashes & Recoveries!

Savings and investment banks failing, commercial paper markets freezing, money market funds "breaking the buck," and credit default swaps imploding. The genesis of the crisis in financial markets was the bursting of the housing bubble. Soaring home prices were driven by baseless demand created by unlimited lending to unqualified borrowers. The affect of homeowner delinquencies and defaults on the value of mortgage backed securities and derivatives resulted in systemic liquidity failures.

With the severity of calamities and the resulting re-pricing of assets, all market participants are in un-chartered territory. The federal government continues to use every monetary solution at its disposal to address the market disruptions. (Is the kitchen sink next? Unsubstantiated rumors around Washington say they are collecting kitchen sinks at the U.S. Treasury as a substitute container for Hoover's "chicken in every pot"!) Not since the Great Depression of the 1930s have market conditions prevailed which would require the government to intervene at such a level to address capital-market liquidity issues.

Meanwhile, whether you realize it, you have lived through a global stock market crash. Unlike 1987, when U.S. stocks collapsed more than 20% in one day, this crash was in slow motion over a couple of weeks. At the close of trading on October 10th, U.S. stocks had retreated more than 20% over eight consecutive trading sessions. Coincidentally, October 9th marked the one-year anniversary of market bellwethers hitting their all-time highs: the Dow Jones Industrial Average and the Standard & Poor's 500-Stock Index had closed at 14,164.53 and 1,565.15, respectively. A year and a day later, the Dow Jones shrank more than 41% to 8,451.19 and the S&P 500 plunged 43% to 899.22.

Although an economic recession is probably unavoidable at this juncture, many are asking whether 2008 will be the beginning of another Great Depression. Hopefully not; the Great Depression generated 25% unemployment and bank depositors lost their life savings. Probably not; the 1930's chaos shaped today's federal insurance for bank deposits, Social Security and Medicare for the elderly, unemployment insurance, and other safety nets.

Today's national unemployment rate is 6.1%. The U.S. has endured 10 post-World War II recessions with average peak unemployment of 7.6%. The worst slumps occurred in 1973-75 and 1981-82, with peak unemployment of 9.0% and 10.8%, respectively. Further, the Depression's economic malaise was escalated by contrary government actions which led to the banking collapse and a devastating drop in the money supply. To the Federal Reserve's benefit, the concept of monetary policy had not yet been fully developed.

Now that it appears the dust is settling, perhaps it is the time to review past crashes and recoveries. The whopper, of course, was the 1929 crash and subsequent depression. As measured by the Dow Jones Industrial Average, it took stocks 25 years until 1954 to recover from the 1929 crash (the lowest point was actually reached in 1932). Again, perhaps not the most relevant based on the government policies and actions of that era.

There have been 10 previous post-war bear markets, which are defined as declines of at least 20% in the S&P 500. The average slump was 31.5%. More recently, the S&P 500 spent about five years retracing the 50% slide from the 2000-2002 aftermath of the tech-bubble. During the October 1987 retrenchment, the Dow Jones was able to completely recover within two years. In addition, the S&P 500 retreated 30% in the three-month period ending November 1987, and rebounded 23% over the next 12 months.

What's a long-term investor to do? First, don't panic; although past performance does not guarantee future results, historically all bear markets have come to an end and have been followed by a recovery. Also, markets tend to over-extend on the upside and downside. Second, stick to your plan or strategy. If you've created a sound plan to achieve your financial goals, you should maintain your long-term strategy. Furthermore, don't stop contributing to your retirement or other accounts. Remember, its buy low and sell high, not sell low and buy high! In addition, maintain a well-diversified portfolio and periodically rebalance to make sure the asset allocation is consistent with your risk tolerance.

If you are not sure whether your portfolio is adequately structured to benefit from a future recovery, Kalorama Wealth Strategies can help you create an investment plan to achieve your financial goals. For more information, please see our web site at www.kaloramawealth.com.

Thank you for your business, trust, and referrals. Please feel free to provide a copy of this newsletter to friends and colleagues who can benefit from information about investing and financial planning. If I can be of any assistance to you or anyone you know, please do not hesitate to contact me.

Fee-Only Investment Advisory And Financial Planning

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