Market Insight Series

Market Bulletin

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Two Months After Lehman: Where Are We Now?

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Three months ago, the American economy was in a mild recession induced by a steep decline in home-building. Oil prices spiraled to $147 a barrel in mid-July as a commodity bubble reached fever pitch, and these higher energy costs, along with their negative impact on consumer sentiment, offset government attempts to reinvigorate the economy. However, with unemployment still moderate relative to prior recessions, and with exports booming and home-building approaching what appeared to be a trough, the economy seemed set to embark upon a languid recovery either late in 2008 or early in 2009. Then, a financial hurricane hit the global economy.

The storm which has engulfed financial markets for the last few months arrived in bands of increasing intensity. The woes of the mono-line insurers, the freezing of the auction-rate securities market, and the forced takeover of Bear Stearns dominated financial markets early in the year. Then, there was a lull followed by the government takeover of Fannie and Freddie, the weekend of the Lehman Brothers bankruptcy, the emergency takeover of AIG, the request by the biggest remaining investment banks to obtain commercial bank charters, turmoil in the money markets, the dramatic attempts to get Congress to agree to TARP, direct equity infusions into financial institutions and, most recently, the growing troubles of the automakers.

If there was one point in this long continuum when turmoil turned to crisis, it was probably the weekend of the Lehman bankruptcy. Before then, the stock market was down 15% for the year with an average daily movement of 1.1% in the S&P 500 index. Since then, the market has fallen 36% further, with an average daily movement of 3.7%. Since that weekend in mid-September, life has been chaotic for everyone in the financial industry, and it has been difficult for financial advisors, never mind their clients, to keep up. But the need for investors to get sound counsel has never been greater. This being the case, it's worth doing a check-up of where things stand, two months after the Lehman bankruptcy.

On the credit crunch

Government efforts to ease the credit crunch have met with some success. As one measure of this, the spread between the three-month LIBOR rate and the three-month Treasury Bill rate, an indicator of the risk which banks see in lending to each other, has fallen sharply, as governments and central banks around the world have stepped in with various guarantees on interbank lending and direct equity infusions into financial institutions. In early October, this spread peaked at 4.5% and it has since retreated to roughly 2.0%. There has also been some small growth in commercial paper issuance, and outflows from institutional money market funds have been reversed.

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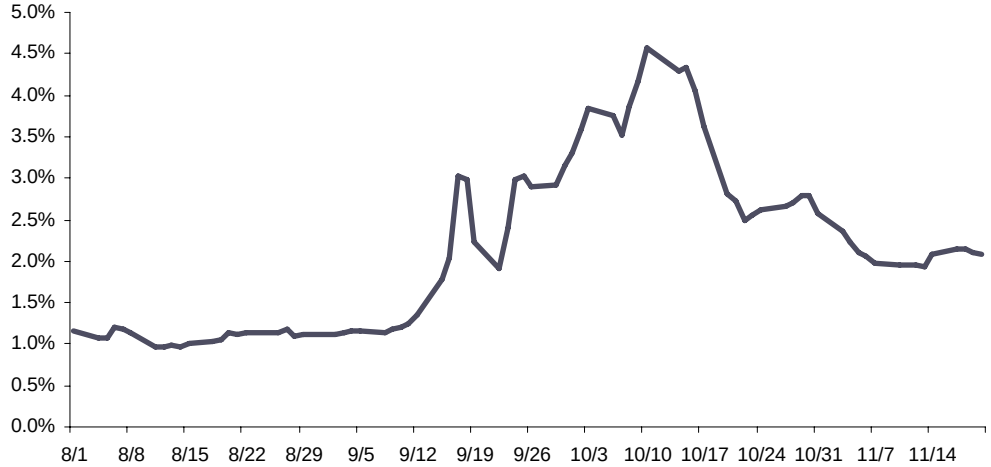
Signs of thawing in interbank lending market
(3 month LIBOR rate - 3 month T-bill rate)



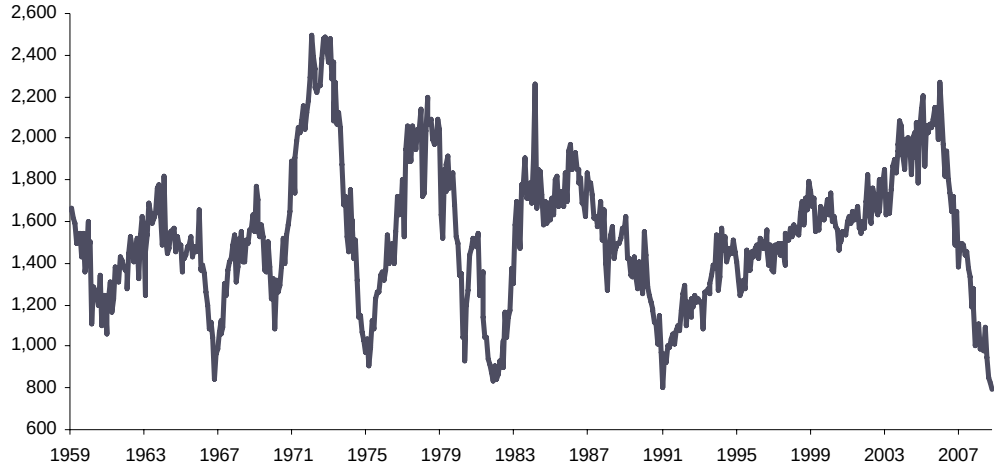
Source: British Bankers Association, Federal Reserve, JPMorgan Asset Management.
Data are as of 11/20/08.

However, even so, lenders remain extremely cautious and credit markets are far from normal. Moreover, as the global economy sinks into a recession of unknown depth and duration, consumers and businesses may be as unwilling to borrow going forward, as banks have been reluctant to lend in the past few months.

On the U.S. economy

Numbers on the U.S. economy grew markedly worse over the past two months. More than half a million jobs were lost during the months of September and October combined. October saw the weakest housing starts in almost 50 years, while light vehicle sales fell to their lowest levels in more than 25 years. As recession psychology takes hold, real GDP is likely to fall by more than 3% in the fourth quarter with the unemployment rate vaulting above 7% early in 2009. Beyond that, the outlook for 2009 is very uncertain.

Housing Starts fall to record low
Thousands of units, annual rate



Source: Census Bureau, JPMorgan Asset Management. Data are as of 11/20/08.

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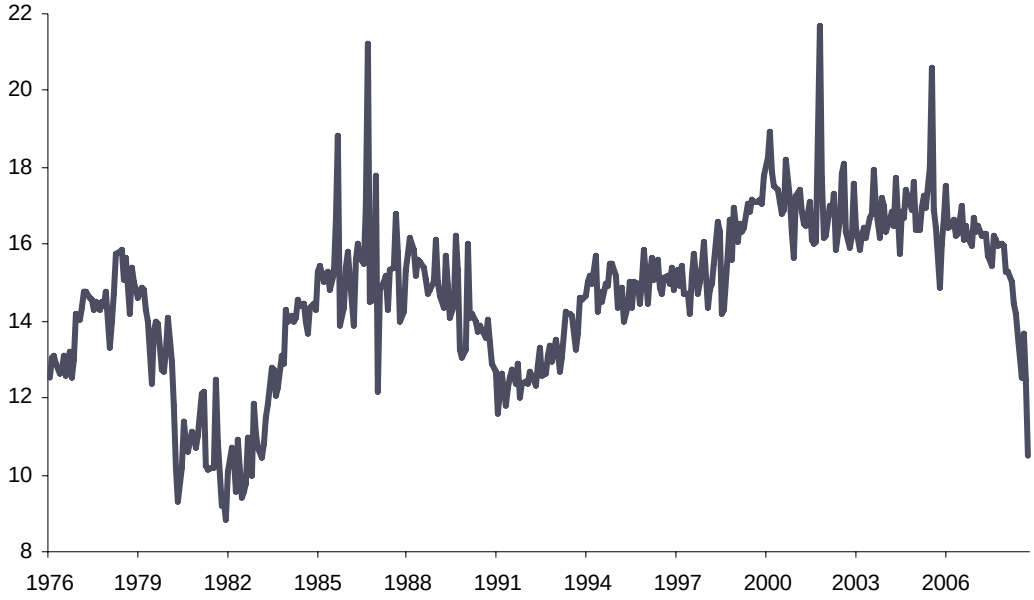
Vehicle sales at lowest levels in 25 years
Millions of units, annual rate



Source: Bureau of Economic Analysis, JPMorgan Asset Management. Data are as of 11/20/08.

Those looking for a shorter, milder recession can point to the fact that the most cyclical areas of the economy (that is to say, home-building, car-buying and inventory accumulation), are all at very low levels normally associated with the trough of a recession. They can also take some solace in the plunge in gasoline prices, now down 50% from their peak, which acts as a tax cut on the U.S. economy as well as the determination of the new administration to jump start the economy through a stimulus package.

Those who fear a worse outcome can note that the financial system remains under significant strain. Moreover, consumers with very low savings rates, diminished confidence and balance sheets battered by the drop in both real estate and stock prices, might reduce their spending for a number of successive quarters. Finally, although a booming global economy has supported a quiet surge in U.S. exports in recent years, this aid will go away in 2009, as the world economy slows sharply.

In a more optimistic scenario, the economy may begin to pull itself off the ground in early 2009 with the unemployment rate peaking at 7%. In a more pessimistic scenario, the recession could linger throughout 2009 with unemployment rising to 8.5% or higher. However, it is important to recognize that in the long run, that is, looking forward a few years rather than a few months, unemployment should retreat back to its full employment level of about 5%, and economic growth will have to accelerate to get us there. Moreover, as the economy begins to move solidly towards recovery, financial markets should also move back to levels more aligned with a balanced economy.

On U.S. stocks

Stock market volatility remains at unprecedented levels, with the average daily move up or down on the S&P 500 index equaling an astonishing 3.7% since the Lehman weekend, five times its long-term average. Much of this volatility appears to be due to heavy trading activity by hedge funds in a market where many long-term investors have fled to the sidelines. Eventually, this volatility will subside as the hedge fund industry meets redemption demands and Congress imposes new regulations on both Wall Street players and strategies. When this occurs, and provided the economy shows signs of embarking on a path of recovery, the market should begin to move up as it currently looks very cheap whether price is measured against earnings, asset values or dividends.

On U.S. fixed income

Long-term Treasury yields remain very low relative to current inflation. Over the past 40 years, the 10-year Treasury yield has averaged 2.8% above the year-over-year core inflation rate. With core inflation now running at 2.2% year-over-year, this would imply a 10-year yield of closer to 5% than its current 3.4%, and when the economy embarks upon a sustained recovery, Treasury yields will likely rise. However, there are other, more attractive areas of fixed income, with municipal bonds generally paying higher yields than Treasuries despite their tax advantage, BAA corporate bonds yielding in the high single digits and high yield bonds carrying yields of close to 20%. Clearly, fixed income markets are pricing in some risk of a very negative economic outcome, but they are also being affected by a very general flight to quality. Any improvement in the underlying economy should result in very attractive returns in corporate and municipal bonds over the next few years.

On international investing

After the strongest sustained boom since the early 1970s, the global economy is now slowing sharply. The Euro area and Japan have now both experienced two back-to-back quarters of negative GDP growth, while economic activity is slowing rapidly among commodity producers in Latin America, Canada and Australia. Even the powerhouse Chinese economy is seeing signs of a significant slowdown. Some countries, most notably Spain, Britain and Ireland, still have to deal with the full ramifications of a real estate bubble. The last few months have seen enormous declines in international stock prices and a rally in the U.S. dollar, leaving the MSCI EAFE index on international stocks trailing behind the S&P 500 on a year-to-date basis. Because of this, it is hard to argue that international stocks have yet to catch up with economic reality. Bleak as it is, they may have overshot it. But from an investor perspective, it's clear that the outlook for international investments is more complicated than for most of this decade when the prospect of a declining dollar and stronger overseas economic growth made an international overweight an easy call.

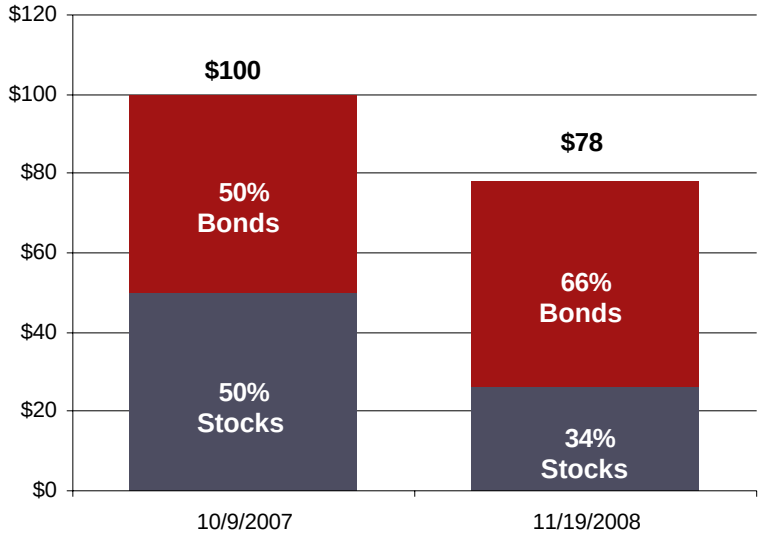
On what's important – investing with discipline in the teeth of a storm

So what is an investor to do?

First, recognize that the economy will eventually recover. While the short-term economic outlook is highly uncertain, over the long-run, the economy has the potential to grow by roughly 3% per year, comprised of 2% productivity growth and 1% labor force growth. Some years, such as in 2008 and 2009, we may not live up to that potential. But like cell-phone rollover minutes, this growth potential doesn't vanish, and the deeper the recession, the stronger the eventual rebound.

Second, it is important to be balanced. Very few investors have been spared the wrath of the financial storm this year. However, generally those who have been most diversified, with broad portfolios of stocks, bonds and alternative assets, have fared best.

An un-rebalanced portfolio has become much more conservative



Stocks are represented by the S&P 500 Index and bonds are represented by the Barclays Capital U.S. Aggregate. Source: Standard & Poors, Barclays Capital, JPMorgan Asset Management. For illustrative purposes only. Not representative of an actual portfolio.

Third, it is important to recognize that the markets themselves have actually made portfolios more conservative. For example, a portfolio which was 50% U.S. stocks and 50% bonds at the peak of the market on October 9th, 2007 is now roughly 35% stocks and 65% bonds if it hasn't been rebalanced. Emotionally, the instinct is to sell stocks. The disciplined approach, in many cases, would be to buy them. In some cases, of course, particularly when an investor is already in retirement, tough choices may need to be made. But those choices should be dictated by logic rather than emotion. The markets of 2008 have tested investors and financial advisors like no other period in modern history. In time, the markets will recover and as they do, those investors who maintained the greatest discipline at the bottom will likely fare best in the rebound.

The S&P 500 Index is widely regarded as the best single gauge of the U.S. equities market. This world-renowned index includes a representative sample of 500 leading companies in leading industries of the U.S. economy. Although the S&P 500 Index focuses on the large-cap segment of the market, with approximately 75% coverage of U.S. equities, it is also an ideal proxy for the total market. An investor cannot invest directly in an index.

The MSCI® EAFE (Europe, Australia, Far East) Net Index is recognized as the pre-eminent benchmark in the United States to measure international equity performance. It comprises 21 MSCI country indexes, representing the developed markets outside of North America.

Indexes are unmanaged. One cannot invest directly in an index.

Diversification does not guarantee investment returns and does not eliminate the risk of loss. International investing involves a greater degree of risk and increased volatility. Changes in currency exchange rates and differences in accounting and taxation policies outside the U.S. can raise or lower returns. Also, some overseas markets may not be as politically and economically stable as the United States and other nations.

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