WEEKLY MARKET REVIEW

Week ended October 24th

Volatility Reaches All-Time High As Equities Test New Lows

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Stocks continued to plummet throughout the week ended October 24, as markets tested new lows amid growing expectations of a protracted global recession. Friday saw massive declines in Asian and European stock markets, followed by an intense sell off in the U.S.

The growing interconnectedness of world markets and economies has left few areas of the globe unscathed. Economic data out of the European Union this week was particularly meager following an array of disconcerting U.S. economic reports a week earlier. Japanese policymakers are also now sounding recession concerns as well, especially as a sizeable rally in the yen threatens to crimp exports, which were already at risk as consumers in the U.S. and Europe tighten their belts.

The pain is no longer confined to the developed world as foreign investors have been fleeing the more liquid assets across the emerging world for the safe haven of U.S. Treasuries. Countries dependent on petroleum or raw materials exports have suffered as expectations of slower worldwide growth—and therefore demand for materials—have hurt commodity prices. Even some of the healthier developing countries, such as Brazil and Mexico, have taken a substantial hit due to their closer integration with global markets and broad-brush risk aversion.

The economic and financial market downturns following banking crises tend to be far more severe and protracted than anything we have experienced over the past 20+ years. Evidence from past bank recapitalization efforts suggests that the healing is slow and that economies do not rebound overnight as leverage evaporates from the system. The sheer extent of the de-leveraging process, particularly of U.S. household balance sheets, suggests that the economy is likely to be in a malaise well into 2009.

This deleveraging process is driving asset values even lower across the globe. In particular, prices are dropping due to the massive forced selling of assets by hedge funds and other financial institutions that suddenly must unwind large, leveraged positions to cover losses. Unfortunately, this process generates additional losses, perpetuating the cycle. I would advise against getting caught up in this herd mentality as many quality assets are now changing hands at unjustifiably low prices, particularly but not limited to high-quality corporate debt and municipal debt, whose implied default probabilities appear well overstated.

Dr. Jerry Webman is Senior Investment Officer and Chief Economist for OppenheimerFunds, Inc. In this capacity, Dr. Webman provides strategic viewpoints on the overall financial and economic markets to investment management and the financial advisor and investor communities. In addition, he serves as Director of Fixed Income, where he oversees portfolio managers, analysts and traders managing over $80 billion (as of 9/30/08) in fixed income assets.

For over 20 years, Dr. Webman has been involved in the investment and economic markets—as a researcher, a financial advisor and a portfolio manager.

Dr. Webman holds a B.A. in political science, with honors, from the University of Chicago, where he graduated Phi Beta Kappa, and a Ph.D. in political science from Yale University. He is also a Chartered Financial Analyst.

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Evidence suggests that credit spreads narrow as recapitalization takes place. This is likely to occur prior to the beginning of a renewed rally in equities, which continue to be bogged down by over-optimistic earnings expectations and limited prospects for margin expansion. Of course, it is impossible to predict the timing of any eventual market recovery. Stocks may behave somewhat like Treasuries did in the 1980s, in continuing to price in high levels of risk (in the 80s, due to rampant inflation) for years after the threat had passed. Though the markets are generally forward looking, given the severity of the recent crisis, skeptical investors may remain in a "show-me" mindset for some time to come. The winners are likely to be companies whose clean balance sheets and proprietary market strategies enable them to generate organic growth.

Despite all the negativity permeating the financial markets during a week in which equity market volatility hit all-time highs there were in fact some real positive signals. I would be remiss to not at least mention them.

- The U.S. financial system is no longer facing an imminent collapse as the TARP goes a long way in helping to recapitalize the 9 largest U.S. banks. Market mechanisms are beginning to work again as inter-bank lending spreads moderate and insurance against default for many U.S. financial institutions cheapens significantly. The banks are unlikely to re-lever their balance sheets at a strong clip, but I expect a portion of the money to be used to consolidate the banking industry and limit a further wave of banking failures. Inflation is moderating and allowing central banks around the globe to consider further steps to recapitalize the system.

- As governments around the world work to backstop the global financial system, private investors are once again entering the marketplace. Note Mitsubishi's investment in Morgan Stanley, Banco Santander's purchase of Sovereign Bankcorp, and Qatar Investment Authority's investment in Credit Suisse.

- Muni bond yields plunged on Wednesday and Thursday as the municipal market roared back to life with a rally that saw huge demand for bonds in both retail and institutional sectors. The state of California, which only a week ago indicated that it would need $7 billion from the federal government, was able to issue $5 billion in debt to private investors—albeit at a high interest rate and a short time horizon.

- Existing home sales jumped 5.5% in September marked by a sharp increase in single-family home sales. The stock of unsold homes is starting to decline, a necessary condition to stabilize home prices, but it will take time to bring inventories back to acceptable levels.

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