January 2008—Special Market Commentary

# Fed Responds Aggressively to Market Volatility

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While Americans were enjoying the final day of a long weekend, financial markets around the world were plummeting amid concerns that the global reach of the U.S. economic slowdown was far greater than previously expected. Early Tuesday morning indications pointed towards a rout in U.S. equities with Standard & Poor's 500 (the "S&P 500" Index) futures trading down significantly before the cash market opened.

Enter the Federal Reserve Board with the single biggest rate reduction since 1984 (there was a 75 basis point rate hike in November 1994) and the first inter-meeting rate move since the September 11, 2001 terrorist attack. Domestic equity markets, upon learning of the Fed action, subsequently "stabilized" and broad equity market losses were minimized to levels at which we have grown accustomed recently. The Fed's action, an extension of their easing cycle that commenced in mid-August, was not conceived with a desire to stem equity market losses on this single day but rather to alleviate current pressures in the credit markets and increase the access to capital for our nation's consumers and businesses. You will recall from my 2008 outlook that the Fed's policy flexibility given the relatively benign inflation backdrop is one of my primary considerations in expecting a shallower downturn than the naysayers, the market pundits, and the equity markets are currently forecasting.

Remember, however, that although the Fed action "calmed" markets today, the effects of today's rate cut will not be felt by the real economy for at least 9 to 12 months. In the interim the probability of a recession is growing, if we are not already mired in one. Tighter bank lending standards continue to push the U.S. housing sector into a deeper recession and are limiting the expansionary plans of our nation's businesses. Capital expenditures remain sluggish as a result and hiring trends are trending downward putting further pressure on the U.S. consumer.

There are some optimistic signs however. Recent Fed action coupled with capital injections into the global banks by the sovereign wealth funds have helped to kick loose some of the financial logjam. Interbank overnight rates have narrowed indicating that banks are no longer hoarding capital. The yield curve has steepened providing banks once again with their reliable profit model of borrowing short and lending long. Importantly jobless claims have trended lower for the past two weeks and remain at the low end of historical averages. We'll be watching future employment data closely, looking for a clearer picture of how much the U.S. job market will contribute to a possible consumer retrenchment.

What does this all mean for investors? We all like to quip that the stock market has predicted nine of the last five recessions. While Paul Samuelson's quote is comical (at least for an economist), it reminds us that the financial markets are forward looking—markets forecast the economy; today's economic data don't determine tomorrow's markets. Equity markets do decline as a recession approaches (the S&P 500 Index is currently down 13% over the past three months), but they tend to stabilize as the recession or sharp economic downturn takes hold. Most importantly for investors, markets usually rebound significantly from the economic trough. The S&P 500 rose 24% on average in the six months following ten of the last eleven recessions. The one outlier year was 2001 where stocks were excessively overvalued heading into the downturn. Today, stocks are cheap compared to Treasuries and cheap compared to their own historical valuations.

Investors should remain defensive by maintaining exposure to the highest quality bonds (higher quality mortgages and corporates are trading at attractive valuations as investors have recently fled anything deemed more risky than a U.S. Treasury note) as well as larger-cap, growth stocks both in the U.S. and around the globe. Internationally, this is not shaping up to be an ETF year. Diversification comes from maintaining exposure to the highest quality companies around the globe even as certain regions, in the aggregate, fall from their recent highs. Municipal bonds continue to remain attractive as some of the highest quality municipal debt trades at 50-100 basis points above Treasuries—and that's before the tax advantage.

The old adage remains true. It's time in the market, not timing the market that builds wealth. Expect further volatility over the coming weeks, but investors should be positioning for the rebound.

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