Market Analysis, Research & Education
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The Top 10 Surprises of 2008 in the Financial Markets

By Dirk Hofschire

It was truly an extraordinary year, and one to which most investors are happy to bid good riddance. The following is the MARE group's list (in no particular order of priority) of the most surprising developments in the financial markets in 2008.

1 ***Historic sell-off - almost nowhere to hide***

In an environment that was not just risk-averse but avoided risk like the plague, it came down to this: If the asset was backed in some form by the U.S. government in 2008, it produced positive returns. Everything else—literally—lost money. In many cases, these losses were of historic proportions. Treasury bonds were up 14%, their best year since 1991, while U.S. stocks suffered their worst returns since the 1930s (U.S. large-caps were down 37%, and small-caps 34%). Foreign stocks fared even worse, with developed-country equities falling 43% and emerging-market stocks plummeting 53%—in both cases their worst annual performance on record. The more shocking thing about 2008, however, was not that global stock markets fell at the same time. It was that high-quality, fixed-income categories failed to follow the rally in government paper, thus depriving investors of gains that in typical bear markets may have offset their stock losses. Ravaged by the credit crisis, investment-grade corporate bonds fell 3% and high-quality municipal bonds dropped nearly 3%, in both cases their worst performances since 1994. Even money markets suffered a brief scare in the wake of the Lehman Brothers bankruptcy in early October. Never has so much wealth disappeared so quickly across such a wide variety of asset categories.[i]

KEY TAKEAWAYS

- **For investors, 2008 was a year to forget, with most surprises of the "not pleasant" variety.**
- **Amid gut-wrenching volatility and broad-based declines across nearly all asset categories, the speed of devastation stunned investors of all experience levels.**
- **Surprisingly low asset valuation levels and an unprecedented U.S. government response provided hope for 2009.**

2 ***Gut-wrenching volatility***

In 2008, by a variety of measurements, the financial markets were at their most volatile since the Great Depression. Nearly 17% of all trading days for U.S. stocks—almost one a week—ended in a move that was 3% or more (either up or down) compared to the beginning of the day. Prior to 2008, the highest percentage of three-percent-move days during the past 70 years was 7% in 2003, meaning this year was more than twice as volatile than anything since the late 1930s. And while many of those days were negative, 2008 was the first time since the 1930s the U.S. stock market went up 10% or more in a single day—and it did so twice.[ii] The Chicago Board Options Exchange Volatility Index (VIX)—an option index that indicates the implied volatility of stock returns—doubled its previous record high.[iii] And stocks had no monopoly on volatility in 2008, as credit markets and economic indicators fluctuated with a violence higher than anything in recent memory.

3 ***Valuations reached multi-year lows***

The flip side of the violent sell-off was that it pushed down the valuations of many asset categories to levels not seen in years, decades or in some cases ever. U.S. stocks reached a price-to-earnings (P/E) ratio of about 13, nearly half the

average of the past two decades. Foreign P/E ratios, for both developed countries and emerging markets, reached their lowest levels in more than two decades (9 and 8, respectively).[iv] The prices of most bonds, outside of government issued or guaranteed debt, declined as well, resulting in extraordinarily high yields compared to assets such as Treasuries. Investment-grade corporate bond spreads hit their highest levels in at least three decades, while the yields on non-investment-grade corporates topped 22%.[v] Municipal bonds yielded more than Treasuries, without even factoring in their tax-exempt status. One hope for 2009 is that fear may give way to bargain-hunting, with plenty of asset categories at sales prices not witnessed in years.

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4 ***Financial landscape changed forever***

While there is still physically a Wall Street in downtown Manhattan, the U.S. financial system this moniker represented for decades ceased to exist in 2008. Within a span of months, Wall Street institutions Bear Stearns, Lehman Brothers and Merrill Lynch either went bankrupt or were merged away. Survivors Goldman Sachs and Morgan Stanley morphed into deposit-taking banks. Insurance juggernaut AIG and financial services titan Citigroup both received rescue financing from Washington, D.C. Dozens of other U.S. financial institutions received capital injections from Uncle Sam as part of the Troubled Asset Relief Program (TARP). Regulatory changes will be a hot-button issue in 2009, and U.S. lenders will have to figure out not only how to thrive with taxpayers as shareholders but also how to grow profits with less leverage.

5 ***From inflationary to deflationary threat***

At mid-year in 2008, oil prices reached record highs near $150 per barrel and U.S. motorists grappled with $4 a gallon gasoline. The Fed stopped lowering interest rates due to concerns about inflation. Food and other commodity prices also surged, causing the U.S. government's consumer price index (CPI) to rise 5.5% in August (on a year-over-year basis), the highest inflation rate in 17 years. Then the financial crisis reared up, the global economy went into a tailspin, and oil prices slumped nearly 70% to $44 per barrel, while gasoline fell to $1.70 per gallon. Four months after posting a two-decade high, the CPI declined nearly 2% in November (from the month before), the biggest monthly price drop of the post-war era.[vi] The good news is consumers just received a massive stimulus injection in the form of cheaper energy prices, and the Fed resumed rate cuts with abandon. The bad news is deflationary forces have reared their ugly head, and government efforts to battle them will be a major theme of 2009.

6 ***Government deficit exploded, dollar strengthened***

Entering 2008, the U.S. was confronted with a sizeable government budget deficit, a medium-term threat to financial stability from entitlement spending on retiring baby boomers, and concerns its massive trade deficit would continue to weigh on the dollar. Then the government approved nearly $1 trillion of emergency funding in 2008, including the $700 billion TARP program, with the incoming Obama Administration promising to spend hundreds of billions more in 2009 and beyond. Deficit projections soared, with most experts believing the deficit over the next year will reach a record high relative to the size of the economy. So how did investors react to concerns the U.S. may be putting its fiscal stability at risk amid a mounting pile of debt? Investors were so scared of risk everywhere else, they couldn't buy Treasury bonds fast enough and the dollar rebounded sharply against most currencies in the second half of the year. It is not likely investors will want to buy short-term Treasuries that yield nearly 0% forever, and the dollar may face pressures down the road. But in 2008, investors treated the greenback and the U.S. Treasury like blue-chip entities amid the global financial carnage.

7 *U.S. consumer finally succumbed*

This was not a surprise in the sense that for years, many economists had predicted U.S. consumers would falter amid a mix of heavy debt, meager inflation-adjusted income growth, and budgets increasingly consumed by health care and other rising costs. But time and again, consumers proved resilient, even treading water in 2007 and the first half of 2008 as housing prices plummeted and gasoline prices spiked. However, in the fall of 2008, U.S. consumers cried "uncle." With troubled debt markets choking off credit, big-ticket purchases of everything from homes to autos sank to multi-year lows. Consumer spending dropped 3.8% in the third quarter (on an annualized basis), the biggest decline since 1980, and the fourth quarter was likely much worse.[vii] Rising unemployment poses a challenge for the 2009 outlook for spending, and consumers will have to rebuild their balance sheets by saving more. After two decades of acting as the engine for global economic growth, the world may need to look somewhere else for awhile.

8 *Global economy whipsawed*

Though the U.S. suffered through its housing bust and credit crunch in the first half of 2008, most of the rest of the global economy appeared to be holding up fairly well. Many emerging-market countries hummed along, with China continuing its double-digit growth and commodity exporters from Russia to Brazil enjoying the boom in raw materials prices. But when the U.S. credit crunch became an all-out financial crisis and U.S. consumer demand dropped off a cliff in the fall, the contagion reverberated quickly around the globe. Credit dried up as global investors fled risk, and exports plummeted amid flagging demand. The once-trendy notion that foreign economies would "de-couple" from U.S. weakness was laid to rest, as the world economy potentially faces its deepest synchronized recession of the post-war period.

9 *Lightning speed*

Perhaps even more surprising than some of the remarkable 2008 events themselves was how quickly they unfolded. The U.S. stock market lost 40% of its value in just nine weeks from September through November. Venerable, century-old financial institutions disappeared overnight. A commodity boom became a commodity bust within four months. Billionaire tycoons went from accumulating mansions to defaulting on their debts. Momentous changes at breakneck speed left investors not only with lighter pockets but with a bad case of motion sickness as well.

10 *Unprecedented government response*

Maybe just as surprising as the speed with which things unraveled in the fall of 2008 was how promptly the Federal Reserve and the U.S. government moved to unveil what is potentially the largest and most broad-based economic stimulus effort in history. The Fed moved its target interest rate to an unprecedented low near 0%. It flooded the financial system with liquidity, doubling the amount of credit it provides to more than $2 trillion. The Fed promised to do even more, committing to purchase $800 billion of mortgage-backed securities, agency bonds and consumer loans. As mentioned, the federal government committed $700 billion to the TARP plan, which included a massive recapitalization of the banking system, with promises to do much more in 2009. Going forward, these policy responses will present massive challenges on a number of fronts, including to the government budget. For now, however, they are perhaps the best chance for economic stabilization in 2009 and may be the major reason why the current outlook does not resemble the 1930s.

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[i] – All references to asset class performance and statistics by the following indices unless otherwise noted: Treasury bonds – BarCap Treasury Index; "Large-cap U.S. Stocks" or "U.S. Stocks" – S&P 500 Index; Small-cap U.S. stocks – Russell 2000 Index; Foreign developed-country stocks – MSCI EAFE Index; Emerging-market stocks – MSCI EM Index; Investment-grade corporate bonds – BarCap Credit Index; Municipal bonds – BarCap Municipal Index. Source: FMRCo (MARE) as of 12/31/08.
[ii] – Source: Bloomberg, FMRCo (MARE) as of 12/31/08.
[iii] – Source: Wall Street Journal, Haver Analytics, FMRCo (MARE) as of 12/31/08.
[iv] – U.S. stocks P/E ratio is normalized 5-year trailing P/E ratio of the S&P 500 Index. Foreign-developed country stocks and emerging market stocks P/E ratios are 1-year trailing P/E ratios for the MSCI EAFE Index and MSCI EM Index, respectively. Source: Standard and Poor's, FactSet, FMRCo (MARE) as of 12/31/08.
[v] – Non-investment grade corporate bonds represented by Merrill Lynch High Yield Master II Index. Source: Merrill Lynch, Barclays Capital, FMRCo (MARE) as of 12/31/08.
[vi] – Oil prices represented by 1st expiring futures contract settlement price. Inflation represented by Consumer Price Index. Source: Bureau of Labor Statistics, Wall Street Journal, Haver Analytics, FMRCo (MARE) as of 12/31/08.
[vii] – Source: Bureau of Economic Analysis, Haver Analytics, FMRCo (MARE) as of 9/30/08.

Although bonds generally present less short-term risk and volatility than stocks, bonds do contain interest rate risk (as interest rate rise, bond prices usually fall and vice versa) and the risk of default, or the risk that an issuer will be unable to make income or principal payments.

Additionally, bonds and short-term investments entail greater inflation risk, or the risk that the return of an investment will not keep up with increases in the prices of goods and services, than stocks.

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The Merrill Lynch High-Yield Bond Master II Index is an unmanaged index that tracks the performance of below investment grade U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market.

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