

GRAnderson Wealth Management Group Presents

Quarterly Economic Update for 1Q 2008

Quote for the quarter. “It still holds true that man is most uniquely human when he turns obstacles into opportunities.” – Eric Hoffer

The quarter in brief. Economists and analysts warned us that the opening quarter of 2008 would be rough. They were right. Perseverance was the word for the American investor.

Our stock market performed poorly, but investors in Europe and Asia took the biggest hits. Had the real estate sector hit bottom yet? No one could tell, and nobody was making that kind of pronouncement. Despite a weak dollar and signs of rising inflation, the Federal Reserve cut the key interest rate three times within the first quarter of 2008, trying to cheer investors contending with a wave of declining indicators, the collapse of Bear Stearns Cos., and a steep Wall Street correction in January. The White House rolled out a rebate plan for the American taxpayer, ostensibly to stimulate consumer spending. If America was not in a recession, it was apparently in something very close to one. A (relatively) flat March for the Dow, NASDAQ and S&P 500 amounted to just a hint of hope for a better quarter ahead.

Domestic economic health. What do you do when indicator after indicator, headline after headline, is negative? If you're the federal government, you get to work on the economy – fast. The response was not fast enough or strong enough in the eyes of some investors, but the White House, the Treasury Department and the Federal Reserve all took some dramatic action in the first quarter.

The Fed cut and cut, bringing the federal funds rate to its lowest level since 2004 (2.25%) with its sixth interest rate cut since September. We saw two radically large 75 basis point cuts during the first quarter, the largest cuts since the mid-1980s: one on Jan. 22, another on March 18, with another half-point drop between them on Jan. 30.¹ The Fed reacted quickly to a January plunge on Wall Street, and also

helped JP Morgan Chase buy out Bear Stearns in March while it worked to patch a crisis of confidence, announcing an auction program to loan banks and brokerages as much as \$200 billion in Treasuries, in exchange for mortgage-backed securities and bundled mortgage debt.²

President Bush signed the Economic Stimulus Act of 2008, which took less than four weeks to go from discussion to bipartisan approval.³ Treasury Secretary Henry Paulson, the driver behind the fourth quarter plan to help subprime borrowers freeze the interest rates on their mortgages, grabbed headlines again on March 31 when he proposed a sweeping, multi-year reform of the federal regulation of the financial industry on behalf of the Bush administration. The 218-page reform blueprint proposes increasing the Fed's power, creating one regulatory body to oversee the banking industry, merging the Securities and Exchange Commission and the Commodity Futures Trading Commission, and starting a Mortgage Origination Commission to oversee state mortgage regulations.⁴

In January, the markets shook when the Philadelphia Fed's January factory index fell to -20.9, far below the -1.3 economists had forecast.⁵ The economy began to shed jobs: 22,000 in January (adjusted from an earlier estimate of 17,000), and 63,000 in February.⁶ The Institute for Supply Management's January service sector index sank to its first reading below 50 in nearly five years, a signal of service sector contraction.⁷

The Fed scaled back its 2008 prospectus for the economy in February, projecting an annual unemployment rate of 5.2-5.3%, 2008 inflation of 2.1-2.4%, and 2008 GDP of 1.3%-2%.⁸ Noted economists polled by Bloomberg News arrived at median estimates of 50% odds of a recession, interest rates at 2.5% by June, 0.5% 1Q GDP, 1.0% 2Q GDP and 1.7% total growth for 2008.⁹ U.S. consumer spending rose only 0.1% in February, a flashing red indicator that depressed investors worldwide.¹⁰

Major indexes. It was a miserable first quarter for stocks, a Wall Street swoon that featured the foundering of Bear Stearns. The FOMC's frantic rate cuts and the Fed's decision to loan up to \$200 billion in Treasuries to struggling banks and brokerages through a new auction program gave investors some hope.¹¹ While the S&P 500 certainly suffered this quarter, the damage did not match the fourth quarter of 1987 (-23.2%) or the third quarter of 1990 (-14.5%).¹²

% Change	1Q 2008	2007
DJIA	-7.55	+6.43
NASDAQ	-14.07	+9.81
S&P 500	-9.92	+3.53

Source: Reuters.com, APGoogle.com^{13, 14}

Global economic health. If America's economy tanked, Asian economies would ride through the crisis reasonably unaffected – or so a popular theory goes. But in the first quarter, the UN Economic and Social Commission issued a report presenting its view of what would happen to Asia's economies with a sustained American recession and a weak dollar. In the Commission's view, India would emerge with the least damage because of its strong manufacturing and service sector, while the economies of Taiwan, Singapore and South Korea would fare the worst because they depend so much on high-technology exports.¹⁵ As for China, its inflation rate reached 8.7% in February (the highest inflation in 12 years), as opposed to a government target of 4.6%.¹⁶ In Japan, the yen hit its highest level against the dollar since 1995, climbing over 20% against the buck since June 2007 – very troubling for an export-reliant economy. But Japan's consumer spending rose 3.6% in January, a gain not seen since May 2004.¹⁷

How about Europe? Europe's No. 1 economy, Germany, celebrated a very positive indicator: unemployment fell to a 15½-year low in March, down to 7.8%; consumer confidence and business confidence also rose, suggesting resilience.¹⁸ Meanwhile, the dollar had its worst quarter against the Euro. ¹⁸ Eurozone inflation rose to 3.5% in March, compared to 3.3% for February (the inflation target of the European Central Bank has long been 2% or less). A 3.5% inflation

reading represents the highest inflation rate for the Eurozone since mid-1992. ¹⁹

World financial markets. If you think it was bad here, consider the headaches of investors in Asia and Europe. The major Asian indexes took a nosedive in the first quarter: The Hang Seng lost close to 18%, the Nikkei 225 fell more than 18%, and Australia's S&P/ASX 200 went down almost 16%.²⁰ The Shanghai Composite Index dropped 34%; 86% of the stocks in the broad SCI were losers in the first quarter.²¹

And how about the major European indexes in the first quarter? Well, the numbers were similar. The Dax in Germany: -20% for the quarter. The FTSE 100 in London: -13%. The DJ Euro Stoxx 50: - 18%. The CAC 40 in France: -17%.²⁰

Commodities markets. The bull run continued into mid-March as we saw \$1,000 gold prices and \$110 oil prices ... and then the bulls ran off a small cliff in the wake of the Bear Stearns snafu. On the day the Bear mauled the Street, it also severely wounded the commodities markets: gold fell \$58.50 on March 19 to \$944.79 and crude fell \$4.94 to \$104.48.²² The dollar rallied in late March as well, and there was a movement toward equities. While April might prove to be a challenging month for the commodities markets, the first quarter saw some very pleasant gains: gold up 9.7% and platinum up 33% on the New York Mercantile Exchange, wheat futures up 5% on the Chicago Board of Trade, oil futures up 5.8% on the NYMEX.²²

Housing & interest rates. Hmm. Existing home sales were up 2.9% in February.²³ Was it a sign of a rebound? Or warmer weather? Or just a statistical aberration? Whatever it was, it was practically the only positive news item from the housing sector. But existing home sale prices were down 8.2% in February from levels a year ago, and foreclosures were up 60% from a year ago.^{23, 24} New home sales fell to their lowest level since 1995 in February, from 601,000 in January to 590,000. The median new home price in February was \$244,100, up from \$225,600 in January but still down 2% from February 2007.²⁵ Unnervingly, the Census Bureau reported in late January that the national vacancy rate (houses for sale sitting empty) had increased to 2.8% in the fourth quarter, a high unseen in recordkeeping dating back to 1956.²⁶

At least mortgage rates were a bit lower ... though given the current liquidity-challenged financial climate, the banking industry has not exactly lowered them as much as borrowers would like. Take the 30-year fixed rate mortgage: it closed out the quarter averaging 5.85%, as opposed to 6.17% for the week ending December 27. The average rate on the 15-year fixed rate mortgage descended to 5.34% at the end of the first quarter, from 5.79% in the last survey of 2007.^{27,28}

Second quarter outlook. Hopefully, the worst of 2008 is behind us financially. Will we look back on

this quarter a year or two from now and see it as the midpoint of a recession? April has started with a rally. Earnings season is just ahead. Investors want a new quarter with a new outlook, a clean slate. April Fool's Day brought some relatively good news: the Institute for Supply Management's March index of national manufacturing activity registered 48.6 — still below 50, indicating a contraction, but above analysts' expectations. The numbers on construction spending for February also surpassed forecasts.²⁹ Are we subtly turning a corner? Is there reason for optimism? Look for additional investment information in GRAnderson Wealth Management Group's newsletter next quarter.

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Citations.

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