

GRAnderson Wealth Management Group Presents

Quarterly Economic Update for 3Q 2008

Quote for the quarter. “There’s no present. There’s only the immediate future and the recent past.”
– George Carlin

The quarter in brief. In the third quarter of 2008, we saw the end of an investment banking era. We saw a level of government intervention in the financial markets unseen since the Great Depression. We saw a bold federal response to a potential freeze in the credit markets. We saw some things that perhaps we never thought we’d see. Days of exuberance gave way to a new bearish mood, as investment banks, mortgage lenders and thrifts paid dearly for assumptions that real estate would always go up, that any loan was permissible, and that owing 25 or 30 times your net worth was financially acceptable. On Main Street, the consumer tried to hold up as the markets and the broad economy rode through a tough three months.

Domestic economic health. In July, we got some surprisingly positive economic indicators, along with a dive in the price of oil. We learned that retail sales had increased by 4.3% in June, and wholesale inventories had increased 0.8% in May.^{1, 2} June durable goods orders increased by 0.8%, defying economists who had predicted a 0.4% decline.³ But producer prices and consumer prices had really jumped in June – PPI had shot up 1.8% (although core PPI only rose 0.2%) and CPI went up 1.1%.^{4, 5} Also, the service sector had contracted: the Institute for Supply Management’s June index was at 48.2.⁶

By August, the message was pretty clear: while oil prices and retail gas prices were down for the second straight month (oil fell more than 7% in August), the spring surge in energy prices was now taking its toll on producer and consumer prices.⁷ Wholesale prices had climbed 1.2% in July and 9.8% across the preceding 12 months; they hadn’t posted such a year-over-year gain since 1981.⁸ July consumer prices went up 0.8%, and the year-over-year gain was 5.6% – an inflation pace unseen since 1991.⁹ Still, consumer spending rose

0.2% for July.¹⁰ But unemployment hit a four-year peak of 5.7%.¹¹

In September, independent investment banks that had been Wall Street titans for the past 20 years faced a choice: change or die. By the end of the month, Lehman Brothers, Morgan Stanley, Goldman Sachs and Merrill Lynch had either folded, mutated, or were bought up. In a four-day period alone, Lehman Brothers went bankrupt, Merrill Lynch was gobbled up by Bank of America, and insurance giant AIG was nationalized by U.S. government regulators. Then Washington Mutual was bought out by JPMorgan Chase. Citigroup said it would acquire Wachovia (but in October, Wells Fargo moved to take it over instead over Citigroup’s protest).¹² In response to pleas from Federal Reserve Chairman Ben Bernanke and Treasury Secretary Henry Paulson, the Bush administration presented a plan to ward off a credit market freeze: a request for \$700 billion to buy troubled assets. It was rejected in the House of Representatives 228-205 on September 29, prompting a stunning plunge in world stock markets and inspiring a quick revision of the proposal.¹³ Elsewhere in August, unemployment kept climbing, to 6.1%.¹⁴ Other indicators dropped. PPI fell 0.9% in August, the biggest one-month dip in two years; consumer prices dropped 0.1%.^{15, 16} Industrial output dipped 1.1%.¹⁷

Major indexes. There’s no way to sugar it: this was a lousy quarter for stocks. The bright spot, of sorts: the Dow didn’t lose as much in the third quarter as it had lost in the second quarter.

% Change	3Q 2008	Y-T-D
DJIA	-4.40	-18.20
NASDAQ	-9.19	-21.49
S&P 500	-9.01	-20.68

Source: CNBC.com, 9/30/08¹⁸

Indices are unmanaged, do not incur fees or expenses, and cannot be invested into directly. These returns do not include dividends.

Global economic health. The slowdown was on around the globe, and in Europe, the end of the third quarter found the European Central Bank contemplating its first interest rate cut in five years.¹⁹ We learned that Eurozone GDP was -0.2% for the second quarter.²⁰ The European Commission predicted a flat third quarter and 0.1% growth in the fourth quarter for the 15-country Eurozone, which statistically would not amount to a recession. But it did see a recession for the economies of Germany, Great Britain and Spain. Inflation, meanwhile, came down from a high of 4% in July to 3.8% in August.²¹

In Japan, GDP shrank by 3% in the second quarter, the biggest such contraction since 2001.²² In China, growth slowed in 2Q 2008 to a 10.1% annual rate, with the inflation pace dropping from 8.7% in February to 6.3% in July.²³ In early September, Merrill Lynch had cut its Asia ex-Japan growth forecast to 7.7% for 2008 (revised down from 8%) and its 2009 forecast to 7.3% (revised down from 7.8%).²⁴ Elsewhere around the planet, Brazil's resource-heavy economy grew 6% in the second quarter.²⁵

World financial markets. Our stock market may have had a bad quarter, but we held up fairly well in comparison to most markets across the rest of the world. In Great Britain, the Dow Jones Stoxx 600 Index lost 12%, and the FTSE 100 sank 13%. Germany's DAX fell 9.2% for the quarter. The Shanghai Composite Index slipped 16%; in Japan, the Nikkei 225 lost 17%. Brazil's and Russia's main stock exchanges lost 24% and 47% - in fact, the stock market was so strained in Russia that government regulators actually halted trading at points during the quarter.²⁶

Commodities markets. It was a quarter of decline and correction on the NYMEX and COMEX. Gold lost 6.1%, silver 30.5%, copper 25.4% and platinum 50.4%. Crude oil and gasoline moved south: oil dropped nearly 29% in 3Q 2008, and gasoline futures fell 27.3%. Oats were down 33.2%, wheat 22.9% and corn 35.6%; soybeans were down 33.6%, but rice only lost .4%. For what it's worth, pork bellies gained almost 29% in the quarter.²⁷ It was a rough three months, yet given the current state of the stock market, it would not be unusual to see commodities surge again.

Housing & interest rates. The big news, of course, came September 7: the federal government seized control of Fannie Mae and Freddie Mac. In

July, the Treasury reassured the financial markets that it would stand behind both companies; in September, it put them under conservatorship, a move akin to a Chapter 11 bankruptcy. The Treasury announced plans to buy up to \$100 billion in senior-preferred shares in each company so that Fannie and Freddie could stay solvent.²⁸ Both companies were given permission to expand their portfolios into 2009, then shrink them beginning in 2010 to a total of \$500 billion – about a third of their present size.²⁹

Across the quarter, indicators were largely in the red. As of late September, adjusted Commerce Department figures had new home sales falling 2.9% in June, up 4.0% in July, and down a whopping 11.5% for August. A bright spot many people didn't notice: the inventory of unsold new homes was down to 408,000 by August, the lowest since 405,000 in August 2004.³⁰ Existing home sales mirrored this pattern. National Association of Realtors data had residential resales down 2.6% for June to a 10-year low; in July, sales rose 3.1%, but resale prices were down 7.1% from a year ago and a record number of homes were on the market. August saw a 2.2% decline, to a sales pace 10.7% below that of a year before.^{31, 32, 33}

Here's some good news: the national averages on mortgage rates went down during the third quarter, with a sharp September dip resulting from the government save of Fannie Mae and Freddie Mac. At the end of the quarter, 30-year FRMs were averaging 6.09%, where they had averaged 6.45% in the last week of 2Q 2008. Over the quarter, averages on 15-year FRMs came down from 6.04% to 5.77%. Averages on 1-year ARMs fell to 5.16% from 5.27%. Only 5-year ARMs saw averages rise during the quarter, from 5.99% to 6.02%.^{34, 35}

Fourth quarter outlook. Can the government fix the credit crisis by pouring cash into the financial markets? Maybe, but no one is assuming that the Wall Street rescue plan is a cure-all for the entire economy. We may be midway through a severe recession ... or technically, we may be just entering one. Recent unemployment, housing and manufacturing indicators suggest things may get a little worse before they get better. So what does that mean for you? It means that it's time to hang in there, plain and simple. Any history of the stock market will show you a long ascent punctuated by an occasional downturn. When the market rebounds, you don't want to miss the best days of the recovery, and the compounding that goes

hand in hand with a bull market. This is a time for perseverance, not a time to hide or blithely change course. You don't want to find yourself outside the market when the market changes for the better. Look for additional investment information in GRAnderson

Wealth Management Group's newsletter next quarter.
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Citations.

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