

# March 31, 2008 Market Commentary and Outlook

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*History doesn't repeat itself, but it does rhyme.*

Mark Twain

During the 4<sup>th</sup> Quarter of 2007, there were discussions about the odds a recession would ensue. Then after the start of 2008, many began wondering if we were already in a recession. Some argued we were only in a “mild slowdown of economic activity” and we should not even speak of a recession until the economy had two successive quarters of negative growth (a widely accepted definition<sup>1</sup> of a recession). *Isn't that like saying, “Don't worry about skating on thin ice until you break through”?*

If we are only in a slowdown, explain the interest rate decisions of the Federal Open Market Committee (aka, the Fed). The Federal Funds Rate has been lowered a total of 3 percentage points since September 2007. Only once before has such a steep drop occurred in a seven month period (August 1984 through March 1985). By contrast when the Fed began to raise rates in 2004, it took them 2 years to raise rates by 4.25 percentage points from 1% to 5.25%!

This 3 percentage point cut in the Federal Funds Rate<sup>2</sup> is the largest percentage drop (a 57.1% drop) since September 1982. Coming in a close second to the recent drop was a 55.1% decline over the 7 months ending November 2001—the last time we were in a recession.

The U.S. lost jobs in each month of the 1<sup>st</sup> Quarter 2008 and manufacturing contracted at the fastest pace in five years. Consumer confidence continues to decline and the housing market extends its slump. Revisions to 4<sup>th</sup> Quarter growth in the Gross Domestic Product (GDP) for the U.S. economy came in at an annual rate of 0.6%—a sharp decline from the 2<sup>nd</sup> Quarter's rate of 3.9% and the 3<sup>rd</sup> Quarter's rate of 4.7%.

*Do you hear the sounds of ice popping and cracking?* Fed Chairman Ben Bernanke in testimony to Congress this past week almost used the R- word!

Some economists liken a recession to a forest fire. They will argue periodic burns can contribute to overall forest health by clearing dead wood from the forest floor and lowering tree branches, providing ideal growing conditions for many desirable species. Similarly, economists see the benefits of a recession, such as a reduction of inflationary

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<sup>1</sup> The National Bureau of Economic Research (NBER), the official arbiter of recessions, defines a recession as “a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real Gross Domestic Product (GDP), real income, employment, industrial production, and wholesale retail sales.”

<sup>2</sup> The interest rate on very short-term loans from one commercial bank to another. This is used as a target for monetary policy by the FOMC.

pressures, a working-off of supply-demand imbalances, and a reallocation of production resources to more efficient uses. Small consolation if your house burns down, you lose your job, or the value of your stock portfolio gets hammered!

*Oh, did we mention that Bear Markets can accompany recessions?* Since the end of World War II, 7 of 10 U.S. recessions suffered Bear Markets (the other three had “Corrections”). The majority of the Corrections and/or Bear Markets began in advance of, or early in, each recession.

Let's get our definitions right so we can determine how thick or thin the ice is. A Bear Market is often defined as one in which a financial market declines at least 20% in value. “Corrections” are declines in value ranging from 10% to 20%. Since its closing high of 1565.15 on October 9, 2007 to its subsequent closing low of 1273.37 on March 10, 2008, the S&P 500—one of the most widely-watched, stock market indices—declined 18.64%. We have not *yet* met the technical definition of a Bear Market for the S&P 500, but taking comfort from this might be “whistling past the graveyard” if one realizes that other types of stock markets, e.g., U.S. Small Capitalization stocks and most foreign markets, are experiencing Bear Markets.

*But haven't the actions of the Fed made it less likely that we will have a recession, or at least, that it will be mild?* Largely due to investor's enthusiastic response to some very unprecedented actions of the Fed in late March, the S&P 500 thankfully has recovered from its low of March 10, closing on April 4 (the day this commentary was written) at 1,370.40. From its peak, the S&P 500 is now down *only* 12.44%.

Financial markets never go straight up or straight down. There are always “Bear Market rallies” within declining markets, giving investors false hope that the market has “bottomed.” Conversely, there are regular periods of declining prices in Bull Markets to make investors nervous. Fear and greed are significant driving forces which affect the movement of the financial markets: peak levels of optimism are often followed by corrections, and vice versa. Similarly, the economy is impacted by the optimism and euphoria (or alternatively, pessimism and despair) of the consumer since consumer spending accounts for nearly 70% of GDP.

Let's assume (and hope!) that the recent recovery in the S&P 500 will not prove to be merely a Bear Market Rally. If indeed March 10 was the low and you classify the recent performance of the S&P 500 as a “Bear Market” because of the performance of other stock markets, the index's close on March 10 will represent the highest level of relative valuation that has ever prevailed at the bottom of an S&P 500 Bear Market. In other words, it was a Correction!

The table below has some interesting statistics about recessions and the accompanying performance of the S&P 500—including performance once the market’s lows were set.

Recession	Bear Market/ Correction	Bear Market/ Correction	Return of S&P 500	
			6-Months Later	1-Year Later
11/48-10/49	- 21%	6/48-6/49	19%	34%
7/53-5/54	- 15%	1/53-9/53	18%	39%
8/57-4/58	- 22%	8/56-10/57	10%	32%
4/60-2/61	- 14%	8/59-10/60	25%	31%
12/69-11/70	- 36%	11/68-5/70	21%	45%
11/73-3/75	- 48%	1/73-10/74	30%	35%
1/80-7/80	- 17%	2/80-3/80	31%	37%
7/81-11/82	- 27%	11/80-8/82	42%	58%
7/90-3/91	- 20%	7/90-10/90	29%	29%
3/01-11/01	- 49%	3/00-10/02	17%	- 14%

*Does history repeat itself? Or in this instance, will there be any “rhyming”?*

When the Fed began to aggressively raise interest rates in 2004 and 2005, many raised concerns that rising interest rates could burst the housing “bubble” (its subsequent, negative impact on the economy now known all too well.) Few expected that the negative impact on stock prices attributable to the housing market’s decline would be as long in coming as it was (although it was certain its impact would be negative). Nor did many anticipate that the U.S. credit markets would be in such desperate shape that financial firms would write off tens of billions of losses from mortgage-related securities. Nor that the nation’s 5th largest brokerage firm (Bear Stearns) would collapse overnight.

The risk remains that there are still some “surprises” about the poor condition of the balance sheets of corporations, particularly financial institutions. Faced with a significant credit crunch and liquidity problems, the Fed has initiated three creative endeavors: Term Auction Facility, Term-Securities Lending Facility, and Primary Dealer Credit Facility programs. Many commentators bemoan the fact the Fed’s action—particularly involving the bail out of Bear Stearns—has made it likely the U.S. taxpayer will bear the burden of billions of dollars of potential losses properly those of the greedy. *“Heads,” Wall Street financiers win; “tails,” the taxpayer loses.* But those same commentators will not disagree that some action was necessary to avoid a catastrophic meltdown of the financial markets were Bear Stearns to declare bankruptcy (which it would have done but for the Fed’s action).

Let’s ignore for the moment that the Fed was certainly asleep for many years as today’s problems in the credit markets developed, *Will the Fed’s newly-initiated and various lending programs turn the tide? Or will they merely plug the dike?*

We think the stock markets cannot recover meaningfully until the credit crisis is resolved; that here is an active “structured financing market”; and, financial firms are adequately recapitalized. The Fed is hoping that its aggressive actions are enough “lipstick on the pig” to cause credit markets to settle down and unwind some of its excesses in a more orderly fashion. Only the aggressive investor, or one heavily in cash, should begin to accept greater amounts of risk in his or her portfolio without further evidence the tide has turned.

The disaster that struck Bear Stearns was because of the significant borrowings they undertook to gain leverage through the purchase of mortgage securities that ultimately proved to be illiquid. Some hedge funds have suffered the same fate as Bear Stearns (one of which was reported to have leveraged its underlying capital 32 times!) The lesson to be learned here is that individual investors should look closely at their personal household balance sheets and work hard to minimize the debt they carry.

When analyzing your investment portfolio, keep in mind the following:

- Declines in market valuations are inevitable; the timing of declines is what is uncertain.
- Investment returns must be measured over complete market cycles, and not just in the Bull and Bear portion of the cycle.
- Diversification by asset class and management style within your portfolio is an absolute necessity.
- Market timing (selling high and buying low) only works if you can make two successive, prescient decisions in a row—a very difficult challenge. It’s not enough to sell high if you then fail to buy back at a lower market level.
- Financial markets do react to current economic events, but they also price in expectations of future events. Markets can forecast an improvement in the economy and can recover much earlier than an economy in recession might recover.
- When the market turns bullish, there will not have been any pre-announcement (complicating efforts to market time). Movement will be quick and significant gains are earned in the early stages of a market recovery.

Perhaps most important of all, remember Bear Markets do end, and historically, Bull Markets are stronger and last longer than Bear Markets. In the long run, returns in Bull Markets have offset the declines of their preceding Bear Markets.

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