

Markets Skittish in '08 Debut

Market Summary

January 2008

The Roman god Janus, the guardian of thresholds and entrances for whom the first month of our calendar is named, is usually depicted as a bearded figure with a double face, looking both forward and backward. This year, at least as far as the financial markets are concerned, he might better be represented as a man looking both up and down. The Dow Jones Industrial Average dropped about 611 points in January, and averaged a swing of about 157 points from open to close for the month's 21 trading days. That's not a degree of volatility we would say makes for a white-knuckle ride. However, the Dow several times in January embarked on intraday excursions that spanned two to three times the difference between the actual opening and closing marks. For the month, the average daily high was 420 points above the low, and 200 points above the close. Ten times the DJIA seasawed more than 400 points in a single day, and once (January 23) exceeded 800 points—its largest intraday swing at least since mid-2002. Although raw point movements mean less and less as cumulative indices like the Dow climb ever-higher, it's clear the Dow took the long way around the block to arrive at a modest 4.3% monthly loss—less even than the much larger and usually more languid S&P 500 Index, which dropped 6.0% in January.



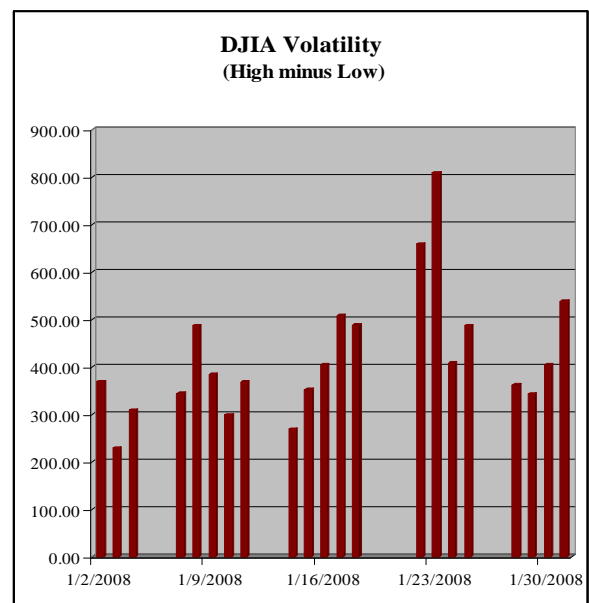
Roman bust of Janus, Vatican

The cause of this skittishness is not hard to discern: There were just too many straws in the wind. Should the market heed the myriad “red flags” it sees coming from all corners (rising unemployment claims, a disappearing dollar, \$1,000-an-ounce gold, sagging consumer

confidence, gargantuan corporate write-downs, tight credit, to-the-moon energy prices, a housing slump etc., etc.), or to the one great big green signal on the horizon: the Federal Reserve's declared readiness to throw itself bodily across the path of what it (a bit euphemistically) has called the “downside risks to growth?” How about both?

So it was, January 30, stocks surged on news of the Fed reducing the overnight lending rate by 50 basis points (to 3.0%), hard on the heels of a 75-point cut 8 days before. Taken together, this was the Fed's most aggressive action since 1982, when double-digit rates offered plenty of room for big cuts. But that wasn't enough for the stock market; the early rally foundered, and the Dow closed down 37 points. The next day's trading, needless to say, was the exact reverse: Stocks opened in a funk, then surged to a 200-point gain.

Mutatis mutandis, the market for now appears to be laying even money that the Fed will be able to get a lasso around an oncoming recession without triggering the inflationary threat that also abides in the econometric data. That seems like an uncharacteristically long leap of faith for the stock market, but then the Fed also has provided some very impressive rate cuts—225 basis points since September, with another 50 bps anticipated in March contracts for Fed Fund futures. For now, that's good enough to counter-weigh a barrage of bad news, and also provide just the right backdrop for continued schizoid behavior from the markets.



World Markets

In a month when all stock indices declined, large-cap and value benchmarks fared best (i.e., least bad). The Russell 1000 Value Index, with a 4.0% loss, was best among equity benchmarks (except the Irish country-specific index, with -1.2%). The Russell 1000 Growth Index slipped 7.8 percent. The broader S&P 500 and Russell 1000 indices each fell 6.0 percent.

As the results from the big-stock indices suggest, the tilt toward value was more pronounced than that toward large capitalization. The S&P MidCap Index dropped 6.2%, just slightly more than its large-cap parent. The Russell MidCap indices diverged similarly to their large-cap cousins, Value falling 4.6%; Growth 7.9 percent.

Small-caps fared worst among U.S. stocks, with growth issues taking the brunt of the punishment. The Russell 2000 Index fell 6.8%, pulled down by a 9.2% drop in its Russell 2000 Growth Index component. The NASDAQ, with large components of both growth and small-cap stocks, followed suit, losing 9.7 percent. The Russell 2000 Value Index, by contrast, turned in a relatively modest 4.1% loss, beating its MidCap Value sibling, and nearly matching the large-cap the Russell 1000 Value.

Pounded hardest in the world-wide smack down in equities were the emerging market issues. The MSCI Emerging Markets Free index dropped 12.5%, worst among all broad stock indices; the S&P/Citigroup EMI-EPAC and the Pacific Rim X-Japan fared little better, falling 10.0% and 10.1%, respectively. Even the larger-cap EAFE Index lost 9.2 percent.

As might be expected, bonds prospered in the general “flight-to-quality” motif in world markets in January. In fact, all bond indices advanced, except those tracking high yield issues, which followed their tendency to mimic equities. The order of precedence was according to Hoyle, with all high-quality bonds doing well, and government bonds doing better, and the longer government issues doing better still. The Lehman Aggregate Bond Index nudged up 1.7%; the Intermediate Government Bond Index 2.4% and the Long Government Bond Index 2.6 percent.

More interesting was the Citigroup World Government Bond Index, which gained 3.7% in its plain vanilla form, but climbed 4.0% unhedged. That suggests that those bond investors prospered most in January whose dollar exposure was least. Some were playing that card in the U.S. as well, with inflation-protected bonds. The Citigroup Inflation Linked Bond Index rose 4.0 percent.

High-yield bonds, as mentioned, were losers, with longer issues falling harder, in mirror image of the gains in higher-quality issues. The Citigroup High Yield Index fell 1.9%; the Citigroup Short Term High Yield dropped 0.8 percent.

Not surprisingly in a troubled real estate market, REITS had a bumpy January, though they rallied from a 10% dip to finish the month well ahead of all other equity indices. The Dow Jones Wilshire REIT Index lost only 0.5% for the month. It is down 24.7% for the 12-month period.

Alternatives

Hedge fund indices were down, generally according to their degree of kinship to the stock market. HFR’s Merger Arbitrage Index fared best, losing 0.3%; Equity Hedge Funds slid 4.1%. Distressed Securities and Event Driven indices were closely matched, dropping 2.0% and 1.8% respectively. The HFR Fund of Funds Index fell 2.6%. The Goldman Sachs Commodity Index was flat (0.0%); the DJ-AIG Commodity Index gained 4.0%, matching inflation-linked bonds.

Perhaps the Romans chose well with their double-visaged patron for January. Certainly the world’s stock markets seem to have begun the year looking both forward and back. So far, the face looking backward has had the better view.



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