February Uglies-Up

Market Summary

February 2008

*Not very much is expected of February, a possible explanation of its rather skimpy allotment of days in the calendar. The month's most celebrated events (not involving chocolate) are Mardi Gras and the beginning of baseball's spring training, both of which speak less of February than of the coming of April.

The hint would seem clear—from February less is more. Unfortunately, it was not taken, as our second month in 2008 chose to step out to make its mark, reiterating, even amplifying, some rather irksome developments from the first weeks of the new year. A development twice cited acquires the status of trend, and these are such trends as to ugly-up the usual basket of goodies that come to capital markets in a presidential election year.

The ugliest of the uglies—the *"R"* word—is not a threat, but a fact, according to a chorus of economists polled by the Wall Street Journal after the Department of Labor reported the loss of 63,000 non-farm jobs last month. That's the worst monthly decline in five years, and bad enough, say the dismal scientists, to portend a negative marginal GDP through the first two quarters of the year, thus fulfilling the technical definition of a recession, and also fitting neatly with the sudden 4.3% descent in the annualized growth rate (to an anemic 0.6%) in the fourth quarter of 2007.

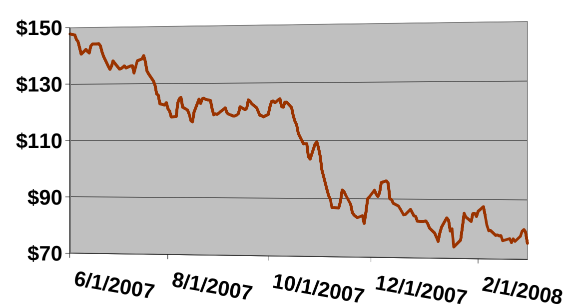
The culprit, by consensus, is a nasty deflation in the housing industry. This alone chipped 1.25% from the already weak December growth rate, said the Commerce Department. Investment in the sector fell at a 25.2% annualized rate in the fourth quarter, the worst drop since 1981. As this investment drought has taken hold, employment in the construction trades has shriveled, falling for eight consecutive months, including a loss of 39,000 jobs in February.

Investment dollars have fled residential construction as prices have been caught in a pincers of increased supply and decreased demand. Both stem from a horrific spike in defaults on "subprime" jumbo adjustable-rate home loans. The Federal Reserve reported last month that about 10% of the subprime loans originated in 2006 defaulted in the first year, which is twice the usual rate. Home prices enjoyed a big run-up through the first years of this decade, but began decelerating in 2006. They topped-out in April and have been falling hard ever since, having dropped 8.9% year-over-year by the fourth quarter, according to the S&P/Chase-Shiller National Home Price Index of 100 major real estate markets. It was the biggest year-over-year drop in the 20 years the index has been compiled.

The full dimension of this mess recently was estimated at $400 billion in a well-publicized study conducted by economists from Morgan Stanley, Goldman Sachs, and the business school faculties of the University of Chicago and Princeton, bearing the bewitching title of *Leveraged Losses: Lessons from the Mortgage Meltdown.* Half of this very sizable kettle of trouble, says the study, belongs to financial institutions that now must shore up their balance sheets against these losses by a factor of ten to one to meet reserve requirements. That's a $2 trillion shift, much of which will be accomplished by shedding mortgage-based assets into an already glutted market. That will spoil more than one day for traders from Sydney to San Francisco. Sensing trouble, investors have been selling off financial stocks for many months, notably those of Citigroup and Merrill Lynch, which together lost 47% of their share value (see chart) from mid-2007 through the end of February.

Merrill Lynch + Citicorp

Combined Closing Stock Price



Attempting to staunch the hemorrhage, Merrill and Citigroup announced massive asset write-downs. That failing, they sacked their CEO's. Next, emissaries were dispatched to foreign capitals (Merrill's to Singapore; Citigroup's to Abu Dhabi) seeking large infusions of cash. In this last endeavor, they were joined by several of their fellow financial titans, including Morgan Stanley and Bear Stearns, which sent appeals to China, and UBS, which made solicitations to Singapore.

Fed is Firm

In the face of all of this ominous news, the Federal Reserve has made it clear that its priority will be to fend off recession rather than suppress inflation or support the plummeting dollar. Fed Funds futures prices are believed to incorporate a further cut of 75 basis points (to 2.25%) from the Open Markets Committee meeting March 18. That is taken to mean the Fed is prepared to see inflation exceed 2% this year. Accordingly, some key rates, notably Jumbo mortgages (above $417,000) and adjustable-rate loans, have balked at taking the Fed's lead on further cuts, and actually have backed up. Jumbos finished February more than 100 basis points above the year prior, and only 22 basis points off their 52-week high.

Stocks are Queasy

Equity markets could not be expected to greet these events enthusiastically, and they didn't. But neither did they tuck tail and run, and they had in January. Every U.S. stock category was down in February, though all but one improved on its January performance. The Russell 1000 Value Index was the exception, losing 4.2% for the month, vs. a drop of 4.0% in January. Generally, growth issues were preferred across all size categories.

The S&P 500 Index fell 3.2% in February (vs. a 6.0% drop in January) and the Dow Jones Industrial Average fell 2.8% (vs. 4.3%).

Mid-caps fared best among U.S. stock indices last month in each stylistic category. The S&P MidCap 400 dropped 1.9%, best among the U.S. indices organized by size. The Russell MidCap Growth Index fell 1.5%, which was best among all U.S. stock benchmarks. The Russell MidCap Value Index dropped 3.3 percent.

Small-caps brought up the rear, with the NASDAQ dropping 4.9%, and the Russell 2000 Index down 3.7 percent.

International stocks had the more convincing bounce in February, most posting actual gains. The MSCI Emerging Markets Free Index led the pack, rising 7.4 percent. The broader EAFE Index gained 1.4% (1.6% ex. Japan).

With the uproar in the home mortgage market threatening to spread to commercial real estate, REITS were not destined for a banner month. The Dow Jones Wilshire REIT Index and the NAREIT (All REITs) Index fell 3.8% each.

Bonds are Steady

Bonds last month were not so vigorous as in January, but posted healthy gains nonetheless. The big winners predominantly were the international issues, where the Citigroup World Government Bond Index, Non U.S. (unhedged) set the pace with a 2.8% gain. Divorcement from the dollar helped the index by 40 basis points, as the hedged version returned 2.4% in February. Inflation-protected issues led the domestic bonds, with Lehman 1-10 Year TIPS Index posting the top mark, a 2.0% gain. Turmoil among municipal bond insurers contributed to a sell-off in that sector. The Lehman Broad Muni Bond Index fell 4.6% last month, worst among all bond indices.

Commodities Roar

Hedge funds recovered in February, the HFR Equity Hedge Index rising 1.8%. But commodities were the hedge to have, as the Goldman Sachs Commodities Index gained 11.3% and the DJ-AIG Commodity Index leapt 12.3 percent.

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