

March Roars, First to Last

Market Summary

March 2008

Never mind the cliché about March coming in like a lion and going out like a lamb, or vice versa. March '08 was a lion from beginning to end, true not to hackneyed adages about the weather, but to its fearsome namesake, Mars, the Roman god of war. This was a month for big events, including, said the Wall Street Journal, "Ten Days That Changed Capitalism."

The ten days in question were March 18 to 28, which began with an historic entry by the Federal Reserve into the buyout of a private investment bank, and ended with a proposal from Treasury Secretary Henry Paulson to institute the most sweeping reform in financial regulation since the passage of the Securities Exchange Act in 1934.

The big move by the Fed was a \$29 billion loan underwriting the purchase of Bear Stearns by J.P. Morgan Chase, Inc. The Fed had bailed out banks before, but always depository institutions, where small-time (relatively speaking) and presumably innocent investors were set up to be gored. There were no small-time beneficiaries in the Bear Stearns deal, speaking relatively or otherwise. And if there was a genuinely innocent party involved, he or she is yet to be identified.

J.P. Morgan used the \$29 billion to finance an offer of \$2 a share for the ailing Bear Stearns. Later, the deal was sweetened to \$10 a share, by means of a second massive loan from the Fed. Bear Stearns paid a \$25 billion visit to the Federal Reserve's "discount window" facility, under a newly liberalized policy permitting loans to non-depository institutions (J.P. Morgan guaranteed the loan). The revised offer created an instant windfall for investors who had braved the near-total collapse in Bear Stearns' stock to buy at the bottom, which was established on St. Patrick's Day, at the intraday low of \$2.84. Less happy were those who bought the stock just one week before, when the price touched \$70.59. In January 2007, Bear Stearns' shares had traded above \$172.

The financial world was shocked to see the Federal Reserve not only back a private takeover deal, but also to accept security for its funding in

the form of assets from Bear Stearns' balance sheet, the shakiness of which was the reason the company had to be rescued in the first place. Some economists worried aloud that this meant some specimens of the notorious "subprime" mortgage notes that had been fatal to Bear Stearns and highly damaging to many other investment houses now would be brought onto the Fed's own balance sheet—effectively exchanging good money for bad, and setting the central bank up for what Wall Street calls a "haircut." However, Federal Reserve Chairman Ben Bernanke assured Congress the securities taken as collateral are "current and performing," entirely of investment-grade, and likely even to return a profit to the Fed (eventually). Furthermore, J.P. Morgan has pledged to absorb losses up to \$1 billion.

The takeover of Bear Stearns was supplanted in the headlines by further announcements of hemorrhaging from other investment banks. Leadership in the "write-down" derby went over, perhaps permanently (touch wood), to UBS AG, which announced a new round of losses that brought its total to \$38 billion. As has become customary, the chief executive officer was sacked after this news was released, and some large investors began a clamor to break up the company. The losses, again following form, were attributed to large holdings of subprime mortgage securities. Meanwhile, Merrill Lynch and Citigroup, Inc., two other highly prominent owners of subprime mortgage debt obligations, soon will announce first quarter earnings. The two firms, taken together, so far have reported losses of about \$40 billion, exceeding only slightly those UBS piled up on its own. Conclusion: More bad news could be coming. Wall Street waits with breath bated.

The R Word Cometh

What no one need wait for, it seems, is a recession. It's here. Fed Chairman Bernanke surprisingly broached the word in an address to Congress, though only as a "possibility." Nevertheless, for a presidential appointee to invoke the "R" word in a presidential election year can only mean two things: 1) The president that appointed him is not running for re-election; 2) the nation quite probably already has logged at least

one of the two consecutive quarters of negative change in Gross Domestic Product required to meet the definition of a recession.

The evidence of that has become unambiguous, according to an equally clear consensus of economic commentators. If doubters remain, they were nowhere to be found after the Labor Department released its March employment data.

Non-farm payrolls, the most-cited indicator of jobs growth, were down by 80,000 in March, the third straight decline this year and the biggest in five years. The prior losses were 76,000 non-farm jobs in both January and February. The unemployment rate jumped 0.3%, to 5.1%, the highest since September 2005. There were 400,000 new jobless claims, also a number associated with recession.

Consumers apparently have gone glum in this barrage of less than good news, according to the Conference Board's survey data. The Consumer Confidence index fell 11.9 points in March to 64.5, its lowest level since 2003 (the 1985 level equals 100). The Board's Expectations Index fell 10.1 points to 47.9, its lowest level since 1973, a year memorable for the introduction of the term *stagflation* to our econometric vocabulary.

In an attempt to excise the "stag(nation)" component from the threatened stagflation, the Federal Reserve slashed the Fed Funds rate by $\frac{3}{4}$ of a percentage point—to 2.25%. Only one other cut of such size has been imposed since 1990, that coming in January of this year.

Markets Cautious

The markets reacted to these developments with well-justified circumspection. Stocks generally were down, bonds flat or slightly up. The big winner among all investment securities was REITS, which might have collected some restitution after being wrongly tarred with the subprime mortgage brush earlier in the year. The biggest losers were among the emerging market stock categories, mainly the Far Eastern issues.

The Dow Jones Industrial Average was unique among the large-cap equity indices, in that it eked out a modest gain (0.2%). All others fell: The S&P 500 by 0.4%, the Dow Jones Wilshire 5000 by 0.7% and the Russell 1000 by 0.8 percent. Large-

cap growth stocks muddled through March in slightly better form than value issues: The Russell 1000 Growth Index fell 0.6%; the Russell 1000 Value Index fell 0.8 percent.

The opposite was the case in mid-cap stock indices, as the Russell MidCap Value benchmark lost 1.0% and the MidCap Growth Index lost 1.8 percent. The S&P MidCap 400 fell 1.0 percent.

U.S. small-cap stock indices did relatively well, and again value was favored over growth. The NASDAQ was up 0.8%; the Russell 2000 Index gained 0.4 percent. In the subcategories of the Russell indices, Russell 2000 Value gained 1.5%; the 2000 Growth Index lost 0.6 percent.

The international stock indices fell across the board, with the worst loss (-5.3%) being that of the MSCI Emerging Markets Free Index. The Pacific Rim Ex-Japan Index fell 4.9%; the EAFE index lost 1.1 percent.

Among bonds, the Lehman Broad Muni Bond Index gained 2.9%, most of any category. This was a partial recovery from drubbing they took in February. Betting against the dollar again paid off, as the Citigroup World Government Bond Index rose 3.8% (unhedged).

The Dow Jones Wilshire REIT Index rose 6.6% for the month. The DJ-AIG Commodity Index lost about that amount (6.3%), and the Goldman Sachs Commodity Index lost 1.2 percent. Both commodity indices are well up on the year, however: 9.6% and 9.9%, respectively.

All hedge fund indices fell in March, the furthest drop coming from the HFR Convertible Arbitrage Index (-3.8%). The HFR Equity Hedge Index fell 3.0%; the HFR Fund of Funds Index fell 2.3%; all other HFR indices fell slightly less than 1 percent.



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