

Schadenfreude Goes Global

Market Summary September 2008

Ironically, it is in the country of unfettered capitalism that the government now plans to intervene in the economy on a scale not seen since the Great Depression.

From *The End of Arrogance*, in *Der Spiegel*, September 30.

To receive chastisements for national arrogance from Germany—where such sentiments were much in vogue prior to May 1945—should give pause. Is America really so black a pot that the kettle feels impelled to raise a cry? Where do we draw the line between chutzpah and hypocrisy?

Or was it mere schadenfreude—the joy one takes in the misfortune of others? *Der Spiegel* (unconvincingly) disavows it (“this is no time to gloat”), but its British rival, *The Economist*, says flatly that dark exultation has been pandemic in Europe, where it says leftist leaders “have lined up to hail the triumph of welfare over Wall Street.”

If Europe gloated, it does so no more, for the Yankee credit distress officially has gone global. Bank rescues have broken out like a rash all over the map, including Germany, where a €50-billion salvage operation was mounted for the ironically named Hypo Real Estate of Munich, a week after *Der Spiegel* published its cover piece.

The Bank of England has announced a gargantuan rescue plan for its entire banking sector, including loans, guarantees and outright infusions of cash summing to £500-billion (\$880 billion). The European Central Bank, which has no access to any national treasury, assembled its 27 finance ministers to form a set of rules for bank bail-outs.

The ECB and Bank of England also raised their guarantees on deposits, as the Federal Reserve earlier had done (to \$250,000), and all three, along with the banks of Switzerland, Canada and

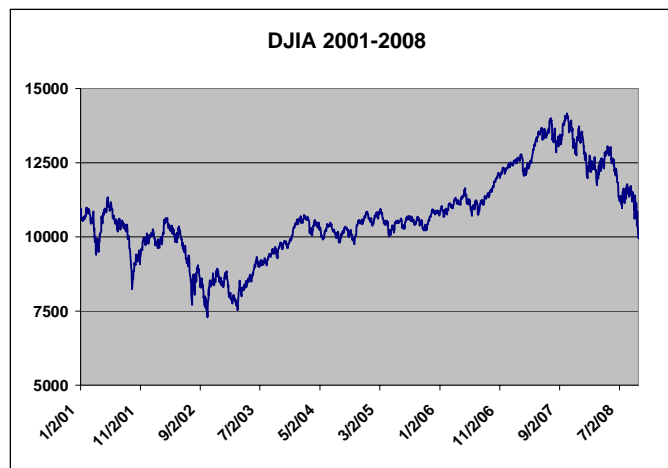
Sweden issued a dramatic (for banks) synchronized announcement cutting their basic interest rates by one half percent. Even China joined the chorus with a 27-basis-point rate reduction—the second in three weeks—and a reduction in its reserve requirement. So much for gloating by leftist leaders.

The Fed’s benchmark interest rate is now 1.5%, down from 5.25% in August, 2007.

Fed Chairman Ben Bernanke announced the bank also will seek to generate liquidity in the financial system by directly purchasing commercial paper from issuing corporations, something not done in 70 years. Corporations have had difficulty selling their paper, resorting to higher yields and shorter durations, since a money market mutual fund, holding debt from the bankrupt Lehman Brothers, “broke the buck,” meaning the net asset value fell below the critical \$1 per share that assures short-term purchasers of breaking even. Money funds promptly flocked to government bonds, and the

market for commercial paper shrunk by \$150 billion through the latter half of September.

The Fed also said it will begin immediately paying interest on bank reserves, rather than wait until 2011 as originally planned. The idea is to coax money out of bank vaults and into circulation.



Treasury Plan Still the Big Enchilada

The most momentous federal intervention—not only since the Great Depression, but in all of American history—remains that launched by the U.S. Treasury, which has authorization to spend \$700 billion buying tainted securities from beleaguered banks. The money was approved by Congress after two rounds of highly publicized and even more highly politicized haggling, which was watched so closely on Wall Street that, when the process faltered, the DJIA plunged 777.68 points—the most ever in one day.

Not that passage of the bail-out did much to quell the market. Elation on news of the final vote lifted the DJIA by 313 points October 3. But lunches settled poorly on queasy stomachs that day, and a severe afternoon sell-off drove wiped out the morning gains and drove the average down to a closing loss of 157 points.

From the big fire sale September 29 to the announcement of the international bank rescue plan October 8, the Dow Industrials shed nearly 1700 points—about 15%—including a 485-point “dead cat” bounce September 30. The plan was announced on the 365th day after the DJIA had hit its all-time peak of 14164.53. In that year, the Dow dropped 33%; the S&P 500 Index 36%.

That approximately matches the losses in a horrific two-week period in October 1987 when the Dow Industrials fell more than 34%, and the S&P 500 more than 33%. But there was nothing in the 1987 crash, or even in the more protracted Y2K bear market, to match the disappearance of such Wall Street bastions as Merrill Lynch, Lehman Brothers and Bear Stearns. Presumably, when the present pestilence subsides, those still standing will be in a position to prosper. At this writing, Citigroup, Bank of America and Goldman Sachs are intact, though not untouched.

Real World Economic News: Grim

Meanwhile, away from Wall Street, on the real-world side of the looking glass, things also were rough in September. Non-farm payrolls shrank by 159,000—the most since March 2003, and about half again as much as expected by economists who track these data. The unemployment rate remained at 6.1%, after rising for several months. Unsurprisingly, manufacturing activity also contracted last month, after clinging to break-even levels most of the year, according to the Institute for Supply Management. The ISM’s September index was 43.5, down 6.4 points from August and decidedly below the neutral 50.0 level. Non-manufacturing activity was gauged at 50.2, which still represents expansion, though down 4/10’s of a point from August.

Capital Markets: Grim

The story in the markets in September was that of a hemorrhage of capital. With the exception of

fixed-rate government bonds, every category of asset, every strategy and every country fund fell. Such a headlong flight to quality might be expected to buoy the price of Treasury Bills, and it did, by 40 bps. The Lehman Government Bond and Intermediate Government Bond indices also gained, rising a half percent each; the Lehman Long Government Bond Index rose 0.3%, and the Citigroup World Government bond Index squeaked through with a gain 0.2%. However, the Lehman Aggregate Bond Index fell 1.3%, and the Lehman 1-10-year TIPS benchmark dropped 2.9%, suggesting markets are skeptical of commercial credit ratings and also are discounting a heightened prospect of disinflation or deflation.

Leading the losers in all categories were securities involving longer term structure and higher volatility. Hardest hit among bond indices were the Citigroup High Yield Index (-8.7%) and the JPM Emerging Market Bond Index (-6.7%).

Among stocks, MSCI Emerging Market Index fared worst, dropping a very chunky 17.5%. The best performer was the Russell 2000 Value Index, which surrendered 4.7% of its value. The Dow Jones Industrial Average dropped 5.8%, and the S&P 500 Index fell by 8.9%.

Real Estate, the putative culprit in all these troubles, survived September nearly unscathed. The Dow Jones Wilshire REIT Index dropped 0.4%. Commodities, which prospered through the first half of the year, fell hard as the third quarter closed. The Goldman Sachs Commodities Index fell 12.4%, cutting its year-to-date gain to 1.0%

Absolute Return indices retained value somewhat better than commodities benchmarks. The HFR Fund of Funds Index lost 5.0%, which was better than three of the five standalone indices. The Merger Arbitrage Index led the group with a 3.4% loss; the Convertible Arbitrage Index was last in the HFR group last month, dropping 12.0%.



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