

MARKET VOLATILITY

March 31, 2008

In 2007, the world's stock markets experienced the fifth bull market year in a row. However, we also saw signs of struggling markets during 2007, with significant declines in February, August, and November. Since 2008, the world's stock markets have generally declined in value, with the S&P 500 Index declining 9.5%. The S&P's five month decline from November 2007 through March 2008 marks the index's longest losing streak since October 1990. This index has fallen 16% from its mid-October 2007 all-time high.

As 2008 began, many on Wall Street and Main Street thought the U.S. economy would avoid a recession. Now most experts suggest we may already be in a recession. The current debate is over how long and how deep the downturn will be. At the start of 2008, corporate profit growth (which drives stock prices) was expected to slow, but remain positive. Now, first and second quarter 2008 earnings are expected to decline, as current discussions focus on when the rebound will start and how big it will be. Generally, industry experts are predicting corporate earnings growth will start again in the second half of 2008.

Why is the Market Down?

In January and February, we've seen many companies report disappointing earnings (mostly from financial companies), which has caused stock prices to drop. In addition, investor concerns have been sparked by a financial crisis, resulting from the combination of defaults on subprime mortgage loans and declining values in the housing market. This immediately impacted banks and other lending institutions, as they saw the value of their assets dramatically decline. They were either unable or unwilling to continue to make loans to both individuals and corporations. This shortage of accessible money means less spending and, therefore, a slowdown in the economy.

It really doesn't matter if we are already in a recession, still entering a recession, or may even squeak by without a recession. As far as the mood of the stock market is concerned, a U.S. recession is a reality and *the market has already reacted to this*. If companies and consumers continue to curtail their spending, it could lead to further declines in corporate earnings and a continued gloomy outlook for stocks. However, all is not bad news, when compared to previous recessions and market downturns:

- Short-term interest rates are declining, allowing consumers to repay debt easier, and in select cases refinance homes at more reasonable rates
- Unemployment is relatively low by long-term historic measures
- Stock valuations are attractive compared to other investment alternatives (e.g., bonds)
- Companies are making adjustments to improve future earnings and have ample capital
- Both the Federal Reserve and Congress are acting to ease economic strains through monetary and legislative policy

Note that in ten out of the last eleven Federal Reserve rate reductions, regardless of whether there was an economic recession, the stock market (using the S&P 500 Index as a proxy) returned an average of 17% in the 12 months after the first rate cut. This current round of short-term interest rate reductions began September 18, 2007, just over five months ago.

What Should Investors Do Now?

Although it is only a small-comfort for investors who are totaling up their losses for the first quarter, neither the Dow Jones Industrials Average nor the S&P 500 Index have reached the 20% peak-to-trough decline that defines a Bear Market. Both indices hit their lows for the quarter in the days before the collapse of Bear Stearns amid concerns that their financial systems were in danger of seizing up. On March 10, 2008, the Dow closed down 17% from its October peak, and the S&P 500 Index was down 19% from its high. Since then, the Dow has rebounded 5%, and the S&P 500 has bounced up 4%.

The bounce that has thus far kept the S&P 500 Index from bear market territory is largely the result of aggressive Federal Reserve tactics to improve liquidity in the credit markets, such as giving brokerage firms access to short-term loans from its lending window. In addition, since the start of the year the Federal Reserve has slashed the key federal funds target rate from 4.25% to 2.25%, the largest short-term interest rate reduction in Fed history. There's growing confidence that the credit markets are stabilizing, resulting from the Fed's actions and announcements like J.P. Morgan's deal to acquire Bear Stearns.

During these volatile times, we must remember that the stock market will always fluctuate and that as investors we will be emotionally challenged. But as a general statement, stock markets have always recovered, and over the long-term, investing in the stock market is a critical factor in meeting your retirement goals. History repeatedly demonstrates the best course of action is to stay with the investment strategy that you've put in place.

If you feel you do not currently have a long term investment strategy, please call our Client Services team for help at 248-620-8100.

Donald I. Gregg
Vice President, Investment Advisory Services

Norman C. León
Investment Analyst

