

Weekly Commentary January 28, 2008

The Markets

It could have been much worse.

When the markets opened last Tuesday morning after the Martin Luther King, Jr. Day break, all signs pointed to a potential market meltdown. Overseas markets had dropped precipitously and futures prices were signaling a very large decline for the U.S. markets. But then the Federal Reserve Board swung into action and made a rare emergency interest rate cut prior to the opening of the U.S. markets (see below) and that helped calm the jitters. The Dow did open with a several hundred-point drop but by the end of the day, cooler heads prevailed and the Dow closed with “just” a 128-point loss.

The volatility continued the next day with the Dow dropping more than 325 points before staging a dramatic comeback to end the day up nearly 300 points, according to MarketWatch. For the week, the Dow even ended with a gain.

While this type of volatility can be nerve-racking, it may also create opportunities. Mark Boyar, who heads Mark Boyar & Co., a New York investment firm, was quoted in Barron’s as saying, “These are some of the best opportunities that I’ve seen in the past seven years.”

Will it be smooth sailing ahead? Probably not. We still have multiple cross-currents buffeting the markets including credit market issues, a slowing economy, and problems in the banking sector. As always, we try to keep an appropriate perspective and stay focused on the goals and objectives of our clients.

Returns through 1/25/08	1-Week	Y-T-D	1-Year	3-Year	5-Year	10-Year
Dow Jones Industrials	0.9	-8.0	-2.2	5.3	8.8	4.7
Nasdaq Composite	-0.6	-12.3	-4.5	4.8	11.9	4.1
Standard & Poor's 500	0.4	-9.4	-6.4	4.4	9.4	3.4

Sources: Yahoo! Finance, Barron’s. Past performance is no guarantee of future results. Indices are unmanaged and cannot be invested into directly. Three-, 5-, and 10-year returns are annualized. Assumes dividends are not reinvested.

ALTHOUGH JUST A WHISPER A FEW MONTHS AGO, in the last week prominent economists from former Federal Reserve Chairman Alan Greenspan to former Treasury Secretary Lawrence Summers have spoken the word out loud: Recession.

These cautionary voices undoubtedly were bolstered when, during a telephone conference on January 22, 2008, the Federal Reserve slashed the federal funds rate by three-quarters of a percentage point, from 4.25 to 3.5 percent. The move came a week in advance of the Fed’s regularly scheduled meeting and was the biggest one-day cut since the central bank cut its discount rate by a full percentage point in December 1991, a period when the U.S. was, you guessed it, struggling to climb out of a recession.

So, are we staring a recession in the face? There's been no word yet from the National Bureau of Economic Research, a non-profit group based in Cambridge, Mass., the generally accepted arbiter of when U.S. recessions begin and end. The NBER defines a recession as a "significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales." Notably absent from that definition is the commonly-held public opinion that a recession is marked by two consecutive quarters of decline in real GDP.

Of course, silence from the NBER cannot be read as proof that the U.S. is not treading in recessionary waters. For example, it wasn't until November 2001 that the NBER declared that a recession had begun earlier that year in March.

Let's look at some key economic factors: Although the GDP has yet to shrink, stock market volatility, long-term interest rates below short-term rates, higher unemployment, and a persistent decline in housing all signal a recession. What's more, the Commerce Department reported a 0.4 percent drop in retail sales in December that wrapped up the weakest sales year since 2002 -- and continued purse-tightening could be problematic.

However, even in a bleak economic picture, there are some positive signs that point away from a recession. Employers have not trimmed employee work weeks, indicating that product demand hasn't swooned. More importantly, because inventories are not unusually high, it's doubtful manufacturers will scale back production. Of course, the wildcard in the economic fortune deck may well be the extent to which fallout from last year's subprime collapse continues to spread.

The recession debate seems destined to see-saw back and forth. Some experts peg the odds of a recession this year at 50 percent, others target the end of the second quarter. Some economists insist recession could be averted by rate cuts and an economic stimulus package, others say we're in a recession already.

Interestingly, while there's little agreement on the topic of recession, most experts do agree on one thing: that the Fed will continue to cut rates. Accordingly, it's important to evaluate how aggressive rate cuts impact stocks. According to analysis from Standard & Poor's, the S&P 500 index gained 12 percent, on average, in the first six months of the past 11 Fed rate-cutting cycles, although those cycles don't match-up 100% with recessions. Measured from recession lows, rebounds are more compelling. According to Ned Davis Research, during the last 10 recessions, stocks rose an average of 24 percent in the six months following their recession lows.

Another point of agreement comes on the question of whether a recession, current or hypothetical, will be mild or protracted. In fact, many expect the downturn to be modest with growth resuming by yearend. Historical data supports that assumption. According to the NBER, there have been 32 recessions since 1854, lasting an average of 17 months. However, since 1945, recessions have averaged just 10 months, while the duration of the two last relatively mild recessions, 1990-1991 and 2001, was just eight months. You can review the data in detail at www.nber.org/cycles.html.

Weekly Focus – Turning to the Internet

A recent Pew Research report, “*Information Searches That Solve Problems*,” found that for help with a variety of common problems, from illness to finances, more people turn to the internet than consult experts or family members to provide information and resources. Specifically, 58 percent said they used the internet to get help; 53 percent said they turned to professionals such as doctors, lawyers, or financial experts; and 45 percent said they sought out friends and family members for advice.

The study also surprisingly revealed that members of Gen Y are the leading users of libraries for help solving problems and in more general patronage.