



THE ADVOCATE GROUP

A Bridge to Financial Clarity

Weekly Commentary October 6, 2008

The Markets

There's only one word to describe what took place in the financial markets last week – ugly.

You probably don't need to glance at the box score below to know that stocks dropped significantly last week. Monday's dizzying drop of 777 points in the Dow Jones Industrial Average, attributed to the House of Representative's failure to pass the bailout bill, set the tone. That was the largest point drop in Dow history, but in percentage terms, the 7.0% drop was not even in the top 15, according to MarketWatch. Interestingly, since the Dow was created in 1896, it has averaged a 7% or greater decline every 7 years. Coincidentally, the last time the Dow dropped more than 7% was on September 17, 2001 – just a fraction more than 7 years ago. While that offers little comfort, it does indicate that Monday's decline was well within historical norms.

By the end of last week, lawmakers had approved a revised version of the bailout bill that included enough sweeteners to garner a few more “yes” votes. What started as a three-page treatment from Treasury Secretary Hank Paulson turned into a 451-page behemoth by the time President Bush signed the bill last Friday. Unfortunately, the added girth only weighed it down and investors sent the Dow to a 157-point loss on the day it was signed.

Where do we go from here? As much as we like to be optimists and say everything will be rosy starting this week, we know that would be disingenuous. Frankly, we cannot predict the future, but we are doing everything in our power to anticipate it and respond appropriately on your behalf.

Perhaps the best way to summarize our thoughts is to quote Admiral Jim Stockdale, the highest ranking U.S. prisoner during the height of the Vietnam War. In describing how he survived eight years of torture and imprisonment, he said, “You must never confuse faith that you will prevail in the end – which you can never afford to lose – with the discipline to confront the most brutal facts of your current reality, whatever they might be.” Simply put, having faith in the future and realism about your present situation is a good way to live and to manage money.

Returns through 10/3/08	1-Week	Y-T-D	1-Year	3-Year	5-Year	10-Year
Dow Jones Industrial Average	-7.3	-22.2	-26.6	-0.7	1.5	2.9
NASDAQ Composite	-10.8	-26.6	-30.0	-3.3	0.7	2.4
Standard & Poor's 500	-9.4	-25.1	-29.4	-2.8	1.2	1.1

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

THIRD QUARTER REVIEW

STOCKS TOOK IT ON THE CHIN

There were few places to profitably park money in the stock market in the third quarter. The Dow Jones Industrial Average closed the quarter with a 4.4% loss while the S&P 500 ended with a 9.0% loss. In the strange way that Wall Street works, the three biggest gainers in the Dow for the quarter were bank stocks. Bank of America, J.P. Morgan Chase, and Citigroup rose 46%, 36%, and 22%, respectively, for the quarter, according to *The Wall Street Journal*. Moving overseas, the picture was no better as shown in the chart below.

Country Returns Ranked by U.S. Dollar Performance

Winners (there were none)

Losers

Russia	-47.8%
Bulgaria	-43.8
Romania	-43.4
Latvia	-41.9
Iceland	-43.8
Other notable losers	
Hong Kong	-26.6
Canada	-23.1
China	-22.8
U.K.	-22.0
Germany	-21.0
Mexico	-18.7
Japan	-18.5

Source: Dow Jones Indexes

Overall, the Dow Jones World Stock Index, excluding the U.S., dropped a stunning 22% in dollar terms during the quarter, according to the *Journal*.

CREDIT MARKETS WERE ROILED

Credits markets tried to withstand the government seizure of Fannie and Freddie, Lehman Brother's bankruptcy, AIG's \$85 billion lifeline, Merrill Lynch's shotgun marriage to Bank of America, and the conversion of Morgan Stanley and Goldman Sachs into bank holding companies. Were they up to the challenge? Not quite.

Here's how the October 1, *Wall Street Journal* summed up the quarter: "Credit markets came nearly to a standstill. Investors fled anything that seemed the slightest bit risky and rushed into super-safe Treasurys. Borrowing costs for companies soared, if they could borrow at all. Overnight and other short-term credit markets seized up as banks stopped lending, even to one another."

Investors were so scared at one point during the quarter that yields on the 13-week Treasury bill essentially dropped to zero, according to data from Yahoo! Finance. Apparently, the return *of* principal was more important than the return *on* principal.

What's really frustrating about the credit situation is that there's no shortage of money. Banks and other financial institutions have money, but, the problem is, they're hoarding it. They are so scared of lending money and not getting paid that they've decided to simply sit on some of their cash and beef up their balance sheet. Now, we're not arguing that beefing up the balance sheet is a bad idea. The trick is to balance the need to shore up their capital base with the economy's need for credit to grease the wheels of commerce.

An analogy might help here. The economy is like the human body with the heart representing consumers, the brain representing businesses, and the lungs representing the government (notice how the brain does not represent the government). What helps keep our human organs functioning is the circulatory system. Credit is effectively the circulatory system of our economy. With too little credit, the economy shuts down. With too much of it, the economy blows up. Finding the right balance so we can keep the economy functioning smoothly is our current struggle. Right now, banks are being too stingy and the economy is shutting down. The aim of the bailout bill is to get the bad loans off the books of the banks so they will stop hoarding cash and begin lending again.

COMMODITY MARKETS FELL BACK TO EARTH

After a tremendous run in the first half of the year, many commodity markets lost steam in the third quarter. *The Wall Street Journal* said it was the worst three-month stretch for the commodity sector since at least 1970 as prices dropped 29.0%. Blame it on the financial crisis and a deteriorating outlook for global growth. Here's a list of how some prominent commodities fared during the quarter:

Wheat	-60.9%
Corn	-32.7
Crude Oil	-28.0
Gold	-5.6

Source: The Wall Street Journal

It's astonishing how quickly sentiment changes in this market environment. For example, it seems like one day we're talking about running out of oil with demand far outstripping supply, then the next day global growth cools, demand declines, and oil prices plunge. What ever happened to the so-called "rational investor?"

THE DOLLAR FOUND ITS GROOVE

An explosive rally in the dollar saw it gain about 5% for the quarter when measured against a broad range of currencies in a Federal Reserve index, according to *The Wall Street Journal*. The rally was even more impressive when compared to the euro, where it gained 11.8%, and the British pound, where it gained 12.0%. According to Richard Clarida, global strategic adviser at Pacific Investment Management Co. and an economics professor at Columbia University, as quoted in *The Wall Street Journal*, the dollar strengthened "not because the U.S. looked better, but because the rest of the world looked worse."

The outlook for the dollar is uncertain because we have several crosscurrents coming into play. For example, the currency's historical view as a safe haven in times of crisis may help support it, but the government's need for hundreds of billions of dollars to support the bailout may put pressure on it. Of course, if the government starts printing money to jumpstart the "circulatory" system, then all bets for a strengthening dollar are off.

SUMMARY

We're probably not out of the woods yet even though the bailout bill is now law. As Warren Buffett said on CNBC last Friday in reference to the bill, "This does not solve all our problems." Hopefully, it will be a catalyst to get the financial system back on its feet. If not, the Federal Reserve, Treasury, and Congress may have to swing back into action with more goodies. No matter what happens, we remain focused on serving you. If you have any questions or concerns, please let us know. Thank you.

Weekly Focus – Think About It

"Some of the secret joys of living are not found by rushing from point A to point B, but by inventing some imaginary letters along the way."

-- Douglas Pagels

Best regards,

The Advocate Group

P.S. Please feel free to forward this commentary to family, friends, or colleagues. If you would like us to add them to the list, please reply to this e-mail with their e-mail address and we will ask for their permission to be added.

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* The Standard & Poor's 500 (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general.

* The Dow Jones Industrial Average is a price-weighted index of 30 actively traded blue-chip stocks.

* The NASDAQ Composite Index is an unmanaged, market-weighted index of all over-the-counter common stocks traded on the National Association of Securities Dealers Automated Quotation System.

* Yahoo! Finance is the source for any reference to the performance of an index between two specific periods.

* Opinions expressed are subject to change without notice and are not intended as investment advice or to predict future performance.

* Consult your financial professional before making any investment decision.

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