



Overview

Financial market historians may recall the third quarter of 2008—in particular, the month of September—as one of the most challenging periods investors have ever endured. A stunning turn of events transformed Wall Street in a matter of weeks, laying waste to corporate giants and spurring the rapid enactment of a \$700 billion, taxpayer-funded rescue plan.

In our core presentation, we will review:

- The dramatic events of September;
- The third-quarter slide in equity prices; and
- The bond market's bifurcated third-quarter performance.

The first of our two special features compares recent economic and financial market conditions with those of the Great Depression, a period that's been recalled with increasing frequency in recent weeks. Our second feature summarizes the efforts that U.S. government officials have undertaken to avert an economic and financial market meltdown.



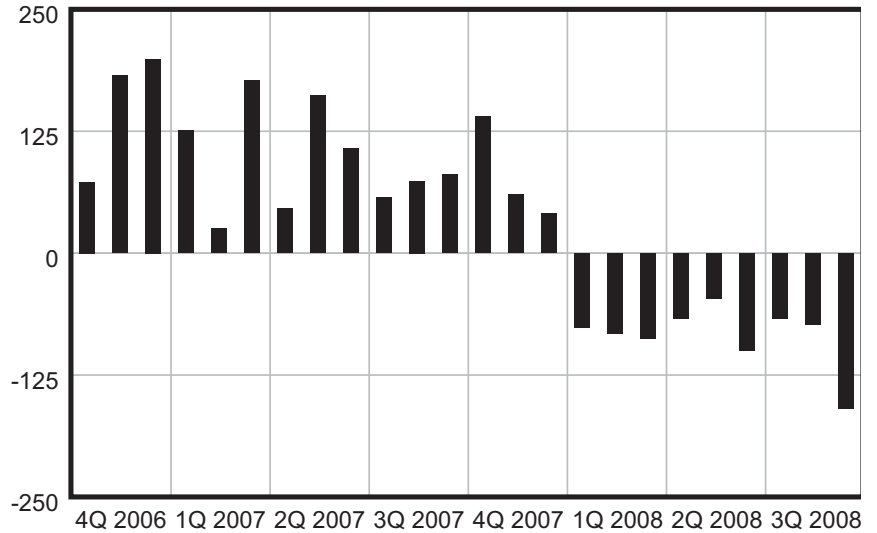
The Economy

On Wall Street lately, time and events have appeared to move faster than anyone can fathom: On Sunday, September 7, the government seized control of Fannie Mae and Freddie Mac, the congressionally chartered mortgage financing companies. On September 14, Merrill Lynch agreed to sell itself to Bank of America. The next day Lehman Brothers filed for bankruptcy protection. The day after that, the government extended an \$85 billion line of credit to American International Group, effectively nationalizing one of the world's largest insurance companies. On September 25 came news of the biggest bank failure in U.S. history—the collapse of Washington Mutual, which was immediately sold to J.P. Morgan Chase. Eight days later, President Bush signed into law the Emergency Economic Stabilization Act of 2008.

In the wake of Wall Street's sickly September, a key question is: To what extent will the economy suffer? By one important measure of the nation's potential output—employment—conditions have been weakening. The number of nonfarm jobs declined in each of the first nine months of the year, and September saw the largest monthly job loss in more than five years. It should come as no surprise that consumer confidence is low, as are expectations for upcoming holiday sales.

A Steadily Weakening Job Market

Total Nonfarm Payrolls: All Employees, Monthly Change (in 000's)
Source: U.S. Department of Labor: Bureau of Labor Statistics





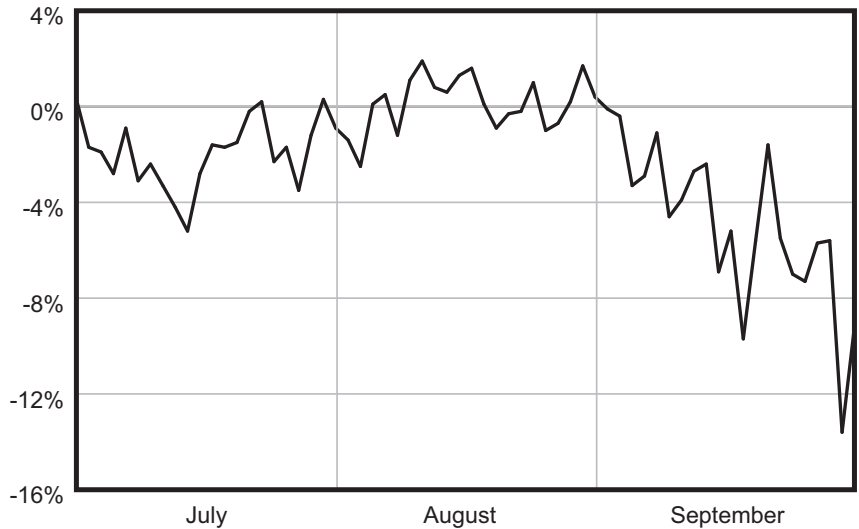
U.S. Equity Markets

At the risk of understating the case, what U.S. stocks offered investors during the third quarter of 2008 was a sharp reminder that equity investing sometimes demands a lot of fortitude. Paced by a decline of more than 25% in energy stocks, the broad market Russell 3000® Index fell nearly 9%. A swoon that began in early June continued into mid-July before a modest and volatile rally generally lifted prices through the end of August. Then came the historic month of September and a 9.4% drop in the broad market index, which left the overall market with a 12-month loss of 21.5%.

Considering six broad categories of stocks—value-oriented and pricier growth stocks of the large-, mid-, and small-capitalization varieties—the best performers in the last three- and twelve-month periods were small-cap value stocks, including shares in financial services, health care, and consumer staples companies. They managed to gain 5.0% in the third quarter, and their 12.3% decline during the past year was half as bad as the drop in the hardest hit market segments. The largest stocks fell roughly 5–10% during the last three months and 20–25% during the 12 months ending September 30.

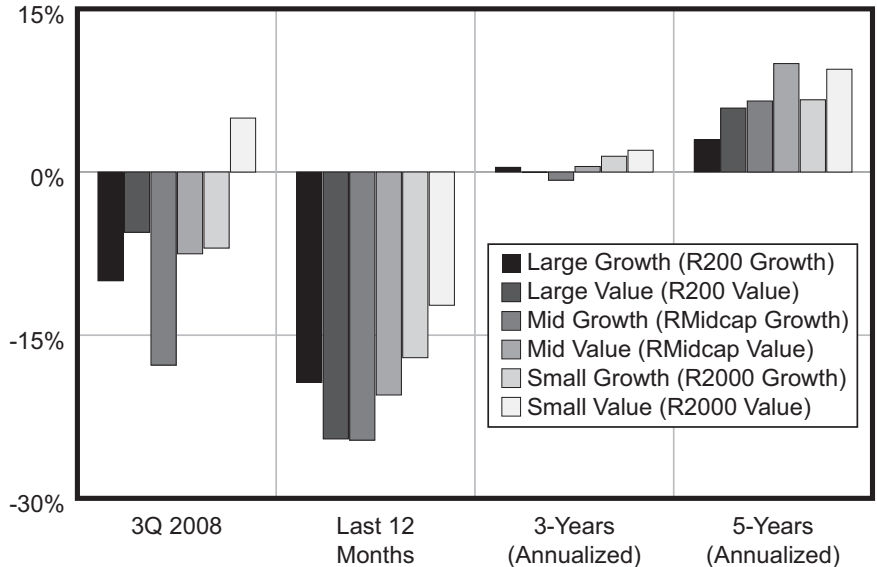
Equity Investing Sometimes Demands a Lot of Fortitude

Russell 3000 Index Returns - 3rd Quarter 2008
Source: Russell Investment Group. Used with permission.



The Bad And The Ugly

U.S. Stock Market Returns Through September 30, 2008
Source: Russell Investment Group. Used with permission.





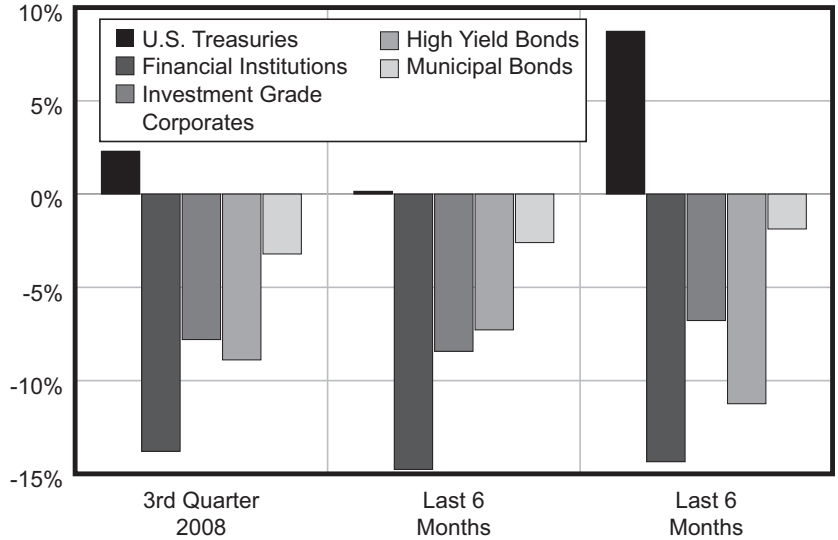
Fixed Income Markets

There have been several periods during the credit crisis in which bond investors behaved as if there were two classes of fixed income securities—U.S. Treasuries and everything else. The third quarter of 2008 provided another case in point. Amid a huge surge in demand for safe assets, Treasuries recorded a strong three-month total return of 2.3%. Virtually every other major segment of the bond market posted losses. Bonds issued by financial institutions plunged 14% in value, leaving the overall investment-grade corporate bond market with a loss of nearly 8%. High yield corporate or junk bonds shed nearly 9% of their value. Even the municipal bond market suffered, falling more than 3%.

The latest flight to quality was evident in the divergent yields of U.S. Treasury bills and commercial paper, which many companies have long used to finance short-term operations. Relatively stable for much of the quarter, the yield of 3-month Treasury bills plunged from 1.7% to nearly zero in mid-September, and commercial paper rates leapt from 2.3% to 3.4%. Treasury bill yields rose somewhat to end the quarter, but even so investors were accepting very little in the way of income—and probably losses in inflation-adjusted terms—for the full faith and credit of the government.

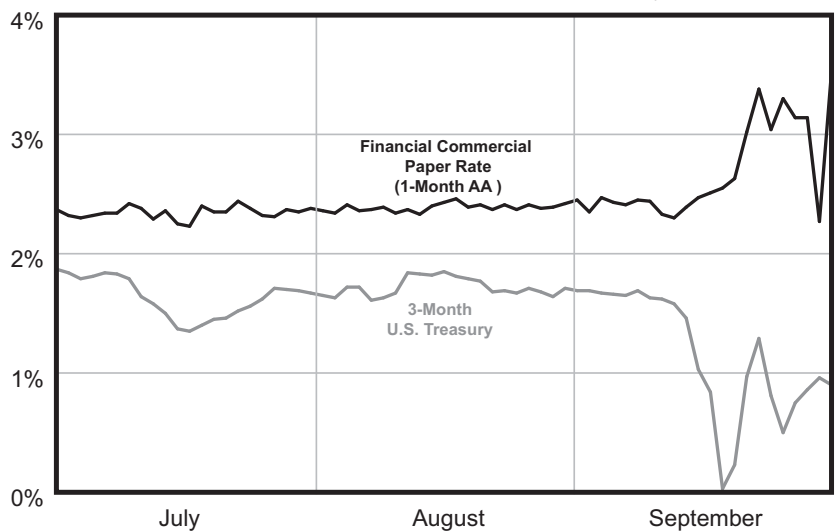
Safety Sought in U.S. Treasuries

Total Returns for Various Fixed Income Indexes
Source: Lehman Brothers (Lehman.com)



Flight to Quality

Yields for 3-Month Treasuries and Commercial Paper
Source: Board of Governors of the Federal Reserve System





International Equity Markets

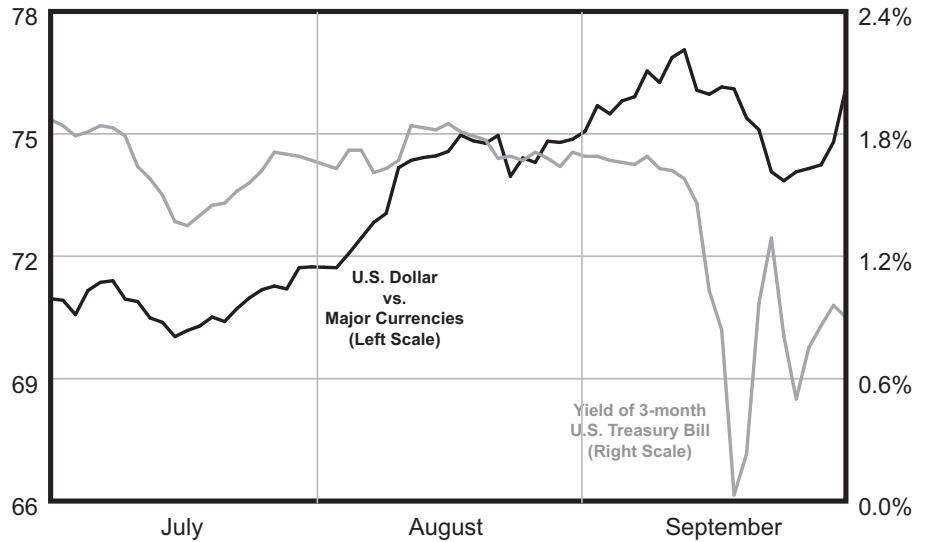
International stock investors could find no refuge from the storm that assailed Wall Street in September. From Oslo to Vienna, a number of stock markets plummeted 25% or more in dollar terms—roughly three times as much as the U.S. market. The best performing developed international market in September was in Lisbon, where shares fell 9.1%. The returns on non-U.S. stocks for the full third quarter were even worse: the MSCI EAFE (net) Index of developed markets dropped 20.6%, while the MSCI Emerging Markets (net) Index ceded 27.0% of its value.

By any measure, the third-quarter performance of international stock markets was poor. But in a break from a years-long trend that has not often been interrupted, non-U.S. shares fared worse in dollar terms than in local currency terms. At play was a rise in the value of the dollar; it gained an average of 7% versus other major currencies, as investors from around the globe piled into U.S. Treasury securities. As its price rose, the yield of the benchmark 3-month Treasury bill fell from 1.9% at the end of June to just 0.9% at the end of September. These forces helped to turn a 13.0% decline of the EAFE Index in local currencies into the near 21% decline experienced by dollar-based investors.

Demand for U.S. Treasuries Boosts the Dollar

3-month U.S. T-Bill Yield and U.S. Dollar vs. Major Currencies

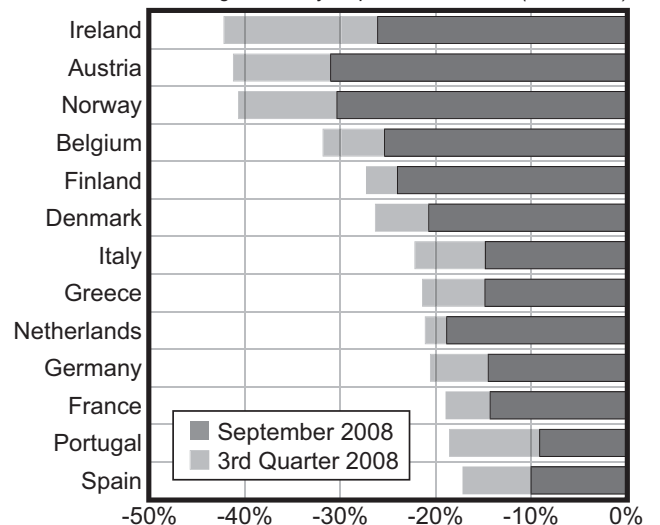
Source: Federal Reserve Bank of St. Louis



No Refuge

MSCI EAFE Index Country Returns - 3rd Quarter 2008

Source: Morgan Stanley Capital International (MSCI.com)





Feature Article: The Credit Crisis: A Long Way from a Great Depression

“So, first of all, let me assert my firm belief that the only thing we have to fear is fear itself” Franklin Roosevelt spoke those famous words as part of his first inaugural address in March 1933, amid the Great Depression. The worst era in American financial history has been recalled with increasing frequency of late, as the credit crisis has intensified. But a comparison of some major signposts of the times suggests that the comparisons are not especially apt.

At the height of the depression in 1933, one out of every four workers was unemployed; in September 2008, one out of 16 was out of work. Those lucky enough to keep their jobs between 1929 and 1933 saw their wage income plummet 42.5%. In last four years, wages have grown fairly steadily, at a year-over-rate of roughly 3% and 13% on a cumulative basis. Finally, stock prices were decimated in the Great Depression, falling by 90% from October 1929 to July 1932. In early October 2008, stocks were about 40% off their latest peak.

To be sure, recent financial and economic times have been tough, with weak conditions standing in great contrast to the great prosperity the nation generally has enjoyed in the post-World War era. We remain, however, a long way from another depression.

Feature Article: The Government’s Dramatic Interventions

As the credit crisis that revealed itself in 2007 has intensified in 2008, the nation’s economic and political leaders have been actively trying to prevent a prolonged and deep recession. Following is a summary of the major initiatives the government had undertaken as of early October:

- The Federal Reserve Board has lowered its target for short-term interest rates from 5.25% to 1.50%.
- In May and June, tax rebates—most ranging from \$300 to \$1,200—were delivered to 130 million American households.
- The Federal Reserve has granted commercial banks nearly \$900 billion in loans lasting up to 12 weeks.
- The central bank has also made sizable loans to investment banks and other financial institutions, including American International Group, which has tapped a line of credit worth more than \$120 billion.
- Regulators temporarily nationalized Fannie Mae and Freddie Mac, which finance a large portion of the nation’s home loans. They also closed Washington Mutual, the biggest failed bank in U.S. history, and helped to engineer a sale of the firm’s banking operations.
- The Treasury Department offered to temporarily insure money market mutual funds, protecting assets held in participating funds as of mid-September.
- On October 3rd, President Bush signed into law the Emergency Economic Stabilization Act of 2008, which authorizes the Treasury to purchase up to \$700 billion in distressed assets from financial institutions. The law also temporarily increased the insured level of bank deposits from \$100,000 to \$250,000.

Historians will surely debate the wisdom of the government’s various actions, but policymakers probably cannot be fairly accused of doing nothing.

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