



Market Perspective

If you've been reading the financial headlines lately, you've certainly witnessed increased volatility in the stock market. Over the last month, we've seen the Dow Jones Industrial Average down 200 points in a day, up 200 the next, and then back down another 200. This level of volatility can be unsettling for some, so it's helpful to understand what's driving it, and to place it in historical perspective.

First, the driving factor. Most market commentators agree that the recent volatility can largely be attributed to investor fears of a credit crisis, sparked by problems in the subprime mortgage market, and inflamed by and the subsequent spillover to the broader credit markets.

As you may recall from a previous communication, subprime mortgages are home loans made to poorly qualified buyers. Many of these loans are adjustable rate mortgages, and were made to people who could barely qualify to make their payments even when interest rates were low. As adjustable rates moved higher over the last several years, the rising payments squeezed these borrowers' cash flow tighter and tighter until eventually, many subprime borrowers were unable to make their house payments, and defaulted on their loans. Unfortunately, this scenario has repeated itself over and over, affecting hundreds of thousands of people this year.

These subprime loans were securitized - meaning they were pooled and packaged into debt that could be traded on the bond market. These risky securities were purchased by hedge funds, banks, and other financial institutions.

When the subprime problem first hit the news earlier this year, Treasury Secretary Henry Paulson tried to calm the markets, and was quoted in the Wall Street Journal stating "the distress of the subprime mortgage market is something that should have been anticipated, given the housing correction. From the standpoint of the overall economy, it's largely contained". Investors seemed to agree, and over the following months, stock prices surged to new highs, with the Dow Jones Industrial Average trading above 14,000 for the first time in its history in early July.

Then in mid-July, investor fears of a spreading slump in home prices (fueled by increased foreclosure rates and a tightening in the credit markets) and a potential slow down in mergers-and-acquisitions activity introduced a new wave of volatility in the stock market. Since then, the market has reacted negatively to a spate of bad news: Bear Stearns and Goldman Sachs announced massive losses in some of their hedge funds due to subprime holdings, a French bank froze three large investments funds because of losses relating to US housing loans, a German bank required a massive bailout for the same reason, and Countrywide, the largest home lender in the US, announced that "unprecedented disruptions" in credit markets could affect its financial condition.

At the same time, the fundamentals of the US stock market appear to remain strong. Valuations of companies, as measured by their price-to-earnings ratios, are reasonable, US corporations are reporting strong profits, and inflation remains contained. These fundamental strengths are in a daily war with bad news like the above for investor's hearts and minds.

Over the last several years we've been lulled into a false sense of stock market stability. If we look at volatility data from 1928 to the present, we'd expect to see a 2% or more daily decline an average of eight times a year. A surge in volatility does not necessarily imply that we are entering a bear market -- volatility and corrections are a normal and healthy part of the market cycle. While past performance can never be an indicator of future results, there have been many periods where the market has done very well following a period of an increased level of volatility.

In the near term, the bull market may continue, or we may be facing a bear market -- no one can say for certain which direction the market is headed. You'll experience many rising and falling markets as a long term investor, and we want to remind you that the key to success in that endeavor is avoidance of emotional behavior at market extremes via a disciplined adherence to an asset mix consistent with your risk tolerance, goals, and required rate of return. If you feel that discipline wavering, please give us a call!

-- Joe Hebert. Posted 08/15/07.