



# MARKET REPORT

THIRD QUARTER 2008

## THE ECONOMY

*Banks in many countries are unwilling to lend, and corporations and individuals are having difficulty obtaining the loans they need to fund inventory and buy homes.*

As the third quarter ends, economies around the world are trying to avoid a global recession. Banks in many countries are unwilling to lend, and corporations and individuals are having difficulty obtaining the loans they need to fund inventory and buy homes. The primary cause of the current crisis was the lax lending standards over the past six or seven years. In order to spur economic activity the Federal Reserve kept interest rates low. Supported by this cheap money, banks were willing to lend money to increasingly unqualified borrowers in order to satisfy Wall Street's desire for higher yielding mortgage-backed securities. House prices soared. But recently unqualified borrowers began to default, flooding the market in certain parts of the country with unsold homes. Housing prices plunged and the securities backed by these mortgages and held by most financial institutions lost their value. Banks stopped lending money to other financial firms because they could not be sure how much exposure the borrower had to the bad loans. Without the ability to borrow, Lehman Brothers went bankrupt, which escalated the crisis of confidence in the international banking system. As global liquidity dried up, the potential for global economic growth to grind to a halt increased.

The fallout has been dramatic. The financial landscape in the United States and around the world is changing dramatically. Some of the most well-known and respected institutions in the world have either collapsed or have been forced to merge. Fannie Mae and Freddie Mac have effectively been taken over by the government. The government also has assumed all of the liabilities of AIG in return for an \$85 billion loan. The Federal Reserve and the Treasury Department together orchestrated takeovers of Washington Mutual and Merrill Lynch at a fraction of their values a few months ago. Investment Banks Goldman Sachs and Morgan Stanley also are in trouble and are converting themselves into regulated commercial bank holding companies in order to have access to the funding they need to survive.

The United States Treasury Department in conjunction with the Federal Reserve took several actions designed to restore confidence in the financial system and encouraged banks to resume lending. Initially they eliminated the short selling of approximately 1,000 financial stocks, and also provided insurance for money market fund depositors. They also negotiated the passage of a \$700 billion bailout package to purchase mortgage-backed securities that held the bad loans. In order to boost confidence in the commercial banking system, the FDIC raised the amount of deposits covered under FDIC deposit insurance from \$100,000 to \$250,000. Through these actions the United States government sent the message that they will do everything in their power to prevent the crisis from worsening. Already, though, real damage was done to the economy during the last few weeks of September when economic activity practically came to a standstill.

## THE STOCK MARKET

In the third quarter, stock markets around the world took a turn for the worse as sentiment soured significantly. The S&P 500 Index was actually up for the quarter as late as the end of August. Economists were optimistic that the Federal Reserve's stimulative policies would enable the economy to avoid a recession. However, as the credit crisis worsened and the failures in the financial industry mounted, a selloff in the global stock markets accelerated through the end of the quarter. For the quarter, the S&P 500 Index was down 8.37% and the Dow Jones Industrial Average was down 3.90%. International markets were down as well, with the MSCI EAFE Index, a measure of foreign developed countries, down 18.01%. Small Capitalization stocks did comparatively better, as the Russell 2000 Index was down only 1.11%.

With lending activity grinding to a halt, companies are having difficulty obtaining the necessary capital to invest in their inventory. This will undoubtedly hinder corporate earnings growth over the next several quarters. Companies will continue to lower their profit expectations, keeping a lid on the stock market in the near term. However, we do believe that the market declines have been overdone. Investor psychology

*Companies will continue to lower their profit expectations, keeping a lid on the stock market in the near term. However, we do believe that the market declines have been overdone.*

is very bleak at the moment, and most investors expect the current crisis of confidence in the banking system to last a long time. It is important to remember that what is happening today will not last indefinitely. Governments in all of the developed nations have stated a willingness to do whatever they need to do in order to solve the problem. Eventually investors will begin focusing once again on market fundamentals, and the fundamentals suggest the equity markets could rebound if world leaders can effectively neutralize the financial crisis.

Interest rates are low. Lower interest rates will eventually lead to stabilization in the housing market and make it easier to qualify for loans, which will help businesses expand and hire. The price of oil has fallen below \$90 per barrel, which will help consumers' bank accounts. The Federal Reserve continues to stimulate the economy by lowering the Fed Funds rate. We believe that although the global economy may contract over the next three to six months, the actions taken by governments and central banks around the world will produce an economic recovery sometime next year. Additionally, growth from emerging market economies, especially China, India and Russia, will continue to provide a source of demand for products as they continue to build out their infrastructure.

Historical trends also favor at least a short term rally in stocks. The months of September and October have often produced significant drops in the market but provided a point where meaningful advances have occurred. Also, studies have shown that the stock market has historically performed reasonably well once recessions are underway with an average annualized return of around 7%. Market rallies also usually begin when everything looks hopeless as many believe it does now. Global stock markets are almost certainly not at their lows currently, but the present sentiment of panic is typically one that presents useful opportunities for gradual scaling into stocks, as difficult as that might be.

## THE BOND MARKET

*The flight to Treasuries intensified as investors wanted nothing to do with anything that contained even the slightest risk.*

It was a difficult quarter in the fixed income markets as well. The tenuous situation in the economy was already weighing on all fixed income securities with the exception of ultra-safe U.S. Treasuries. Then in September the U.S. government took control of Fannie Mae and Freddie Mac, the government-sponsored entities that own or guarantee most of the outstanding U.S. mortgage debt. As one financial firm after another either filed for bankruptcy or were forced into being acquired, the credit markets became completely frozen as firms became distrustful of each other's ability to remain solvent. Many companies found it difficult to borrow, and short-term overnight borrowing came to a halt as banks stopped lending, even to each other. The flight to Treasuries intensified as investors wanted nothing to do with anything that contained even the slightest risk.

The result was a drop in the price of all bonds except for Treasuries. Bond spreads, or the yield that bonds offer over comparable Treasuries, grew dramatically during the quarter, even on investment grade corporate bonds that are usually considered very safe. As we move into the fourth quarter the outlook for the credit markets remain uncertain. The \$700 billion rescue plan passed by Congress is likely to require the issuance of a large amount of Treasuries, which would cause Treasury prices to drop and push yields higher. This has the potential to put upward pressure on interest rates, although it is being offset by the weak U.S. economy.

The Federal Reserve is widely expected to cut rates again in order to spur growth in the economy. If the government's rescue plan succeeds in easing the credit crunch, the extra stimulus being provided by the Federal Reserve will help to heal the economy. Then, investors may sell their safe Treasury securities and start buying more risky bonds such as investment grade corporate bonds and even high yield bonds. When that occurs, however, is very difficult to determine. Meanwhile, it makes sense to keep a conservative portfolio of mostly Treasury bonds while looking for opportunities in the corporate bond area.

McKinley Carter Wealth Services, Inc. ("McKinley Carter") is an SEC registered investment adviser with its principal place of business in the State of West Virginia. This market summary is limited to the dissemination of general market information not personalized or specific investment advice. The information presented herein is subject to change without notice and should not be considered as a solicitation to buy or sell any security. Past performance of the various indices described above is no indication of future results and nothing in this market summary is guaranteed to come to a pass. McKinley Carter and its representatives are in compliance with the current registration requirements imposed upon registered investment advisers by those states in which McKinley Carter maintains clients. McKinley Carter may only transact business in those states in which it is registered, or qualifies for an exemption or exclusion from notice filing requirements. Any subsequent, direct communication by McKinley Carter with a prospective client shall be conducted by a representative that is either registered or qualifies for an exemption or exclusion from registration in the state where the prospective client resides. For information pertaining to the registration status of McKinley Carter, please contact McKinley Carter or refer to the Investment Adviser Public Disclosure web site ([www.adviserinfo.sec.gov](http://www.adviserinfo.sec.gov)). For additional information about McKinley Carter, including fees and services, send for our disclosure statement as set forth on Form ADV. Please read the disclosure statement carefully before you invest or send money.

For more information on McKinley Carter, visit our website, [www.mc-ws.com](http://www.mc-ws.com), or contact us at 866.306.2400.