

## Deciphering Recent Market Volatility

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"Financial markets remain under considerable stress, and credit has tightened further for some businesses and households. Moreover, recent information indicates a deepening of the housing contraction as well as some softening in labor markets."

*Federal Reserve January 30, 2008*

For most of the past four years, financial markets have been relatively calm, and compensation for assuming additional risk has been minimal. That has all changed since last summer. What happened? What might come next? While no one knows the precise answers to these questions, let's take a look at some possible explanations.

### **ANATOMY OF A BUBBLE**

To understand what is happening now we need to step back in time, back to the aftermath of the tech bubble and stock market meltdown of 2000-2002. The precipitous decline in the stock market, combined with the accompanying recession and the events of September 11, 2001 caused the Federal Reserve to lower the federal funds rate to an unprecedented 1%. The economy and stock market did recover, but the measured pace of the expansion prompted the Fed to leave rates at an unusually low level for an extended period of time.

The sustained period of low interest rates accomplished the goals of the Fed; economic growth rebounded and the stock market began to recover. Unfortunately, low interest rates also produced two unintended consequences; a huge boom in the housing market and an increasing willingness among some market participants to assume higher levels of risk for less compensation.

As house prices soared in many areas of the country, mortgage providers offered a variety of creative products designed to allow buyers to afford more expensive homes. At the same time, lenders also relaxed underwriting standards, allowing more marginal buyers to receive mortgages. The repricing of risk in the market place had a similar affect as financial instruments and deals that once may have struggled to find funding seemed to have money virtually thrown at them. These deals provided attractive returns for the providers of liquidity and the assumers of risk.

### **THE BUBBLE BURSTS**

As has often been the case in the past (1987, 2000) there was not a specific, easily identifiable catalyst for the recent bursting of the market bubbles. The trouble really began when the roaring housing market began to cool off.

Although real estate is an extremely difficult market to summarize in statistics, it now appears that the housing market began to slow sometime in 2006. This slowdown began to affect the financial markets in February 2007, when concerns about the subprime mortgage market led to a surge in market volatility.

Subprime mortgages are issued to households with below average credit or income histories and are generally considered more risky than traditional “prime” mortgages. Although they constitute a minority of the overall mortgage market, they have become increasingly important in recent years. Many people that took out subprime mortgages did so with the hope of “flipping” their house for a large gain, a tactic that worked well during the housing market rise. Other buyers were able to afford initially low payments, but when these “teaser” rates reset to current market rates the homeowners could not afford the new, much higher payments. As a result, subprime delinquencies and foreclosures increased.

This caused financial markets to gyrate wildly and economists to talk about possible spillover affects, but eventually most market participants concluded that subprime weakness would be relatively well contained and would not spread to the traditional, “prime” mortgage market. A sense of calm returned to the financial markets, causing treasury yields to rise, stock market indexes to hit record highs, and ever-larger buyouts to be announced. However this seemingly tranquil period proved to be the calm before the storm. By mid-summer 2007, concerns about subprime mortgage problems returned, and market participants began backing away from mortgage-related risks.



SOURCE: BLOOMBERG

The MOVE index measuring bond market volatility has spiked higher since last summer.

Again, it is difficult to point to any one event that prompted this crisis, but there were several notable occurrences. One of these was when several large leveraged buyouts (Chrysler, Alliance Boots) encountered difficulty in securing funding. Prices on exotic bond products composed of subprime mortgages also began to decline sharply. This led to the bankruptcy of two Bear Stearns hedge funds. Although Bear Stearns itself had little direct exposure to these losses, an already nervous marketplace began circulating rumors that Bear Stearns' would experience further difficulties. Stock market volatility increased, and the Dow Jones Industrial Average fell nearly 1000 points in less than four weeks.

### **LIQUIDITY DRIES UP**

Soon other financial institutions and hedge funds began reporting losses from their subprime mortgage and exotic bond holdings. Because these products are extremely difficult to value, concern grew over the exact magnitude of these potential losses. Almost every day a new rumor would circulate that a financial firm was experiencing difficulty from subprime losses. Concern spread that other risky and esoteric assets, in addition to subprime mortgages, would cause losses. In the face of this uncertainty, many market participants simply chose to avoid all risky assets, preferring instead to place their cash into ultra-safe treasury bills.

One of the results of this was that the commercial paper market nearly froze up, preventing corporations from accessing one of their most important sources of liquidity. Corporations depend upon access to short term funding in order to facilitate their daily activities. If they are cut off from this funding, they might have to severely restrict their operations; some of them can even be forced into bankruptcy, despite the fact that their underlying business fundamentals are relatively sound. Financial firms in particular are often very dependent upon commercial paper as a short term financing source.

As access to the commercial paper market essentially evaporated, bankruptcy rumors swirled around a variety of previously robust companies. Nevertheless, at its regularly scheduled meeting on August 7<sup>th</sup>, the Federal Reserve left short term interest rates unchanged, noting that while downside risks to the economy had increased, their primary concern was still inflation.

### **CENTRAL BANKS TO THE RESCUE**

Despite the Fed's relatively positive message, financial market conditions continued to deteriorate. On August 9<sup>th</sup> the European Central Bank stepped in to address the liquidity crisis by providing an unprecedented level of short term funding to banks and financial institutions in Europe. The US Federal Reserve and the Bank of Japan also implemented similar, though slightly smaller moves. This seemed to calm the markets, at least temporarily.

However, several days later, the problems deepened. In the United States, the additional compensation required for investing in risky assets increased dramatically, and demand soared for the safest securities. Amazingly, the yield on three month T-Bills dropped more than one percent (100 basis points) in only a week. With virtually no liquidity in the marketplace, and financial institutions clamoring for relief, the Federal Reserve held an emergency meeting. At this meeting, held on August 17<sup>th</sup>, the Fed essentially reversed its position from the August 9<sup>th</sup> meeting, stating that "financial market conditions have deteriorated, and tighter credit conditions and increased uncertainty have the potential to restrain economic growth going forward." As a result, the Fed judged that "downside risks to growth have increased dramatically."

Generally speaking, the Fed conducts monetary policy by changing the federal funds (fed funds) rate (the rate at which banks lend among themselves.) However, since they still saw this as primarily a liquidity crisis and not an economic event, the Fed decided that rather than lowering the fed funds rate, they would lower the discount rate (the rate at which banks can borrow directly from the Fed.) Therefore, the Fed left the fed funds rate unchanged, and instead lowered the discount rate by 50 basis points. The Fed also extended the time period over which it would offer these short term loans, and made several other technical changes designed to improve liquidity conditions in the financial markets.

The discount rate is usually an expensive source of capital, and carries a stigma of being something of a “last resort” capital source. However, at the Fed’s encouragement, some of the largest banks in the country, such as Citibank, Bank of America, JP Morgan, and Wachovia all borrowed from the Fed discount window, increasing confidence in the financial system and improving liquidity somewhat.

While the Fed’s surprise action did not solve all of the market’s problems, it did help to temporarily alleviate the liquidity crunch and restore a measure of calm to the marketplace.

### **NOT OUT OF THE WOODS YET**

At its regularly scheduled meeting on 9/18/07, the Federal Reserve cut both the fed funds rate and the discount rate by fifty basis points. They followed these moves with an additional twenty five basis point cut at the regularly scheduled 10/31/07 meeting. These moves, combined with some better than expected economic data, spurred hopes that perhaps the summer’s market volatility was merely an aberration. Many financial markets rallied and it appeared as if perhaps the worst of the market turmoil was behind us.

Since late October though, a number of financial firms have disclosed larger than expected losses due to their exposure to subprime mortgages and other risky assets. Several prominent CEOs have lost their jobs, and stock and corporate bond markets have declined. Additionally, several companies that insure municipal debt have begun to experience financial difficulty as a result of their exposure to subprime mortgage products. These difficulties have contributed to recent financial market volatility, and the insurers’ futures are still very much in doubt. Recent economic data has also pointed towards a slowing economy, as some measures of employment and manufacturing activity have been significantly weaker.

This combination of financial market volatility and weakening economic data prompted the Federal Reserve to hold an unscheduled meeting on 1/22/08 at which time they cut the fed funds and discount rates by seventy five basis points. They followed this surprise move with an additional fifty basis points cut at the regularly scheduled meeting on 1/30/08. While the Federal Reserve continues to respond to changing economic conditions, there is concern that they are too late to prevent further financial market volatility and an economic slowdown.

### **THE ROAD AHEAD**

There is little doubt that recent events have restrained economic growth and increased the downside risks that the economy faces. For some time now, market participants and economists have worried that housing weakness could lead to a general economic slowdown or even a recession. The financial market volatility and turmoil in the mortgage market have exacerbated these fears, and recent economic data has been weaker. Economists disagree over the future course of economic growth, but a growing percentage of them now foresee slower growth over the next six to twelve months, and some are even forecasting a recession.

Since it generally takes six months for the effects of an interest rate cut to filter through the broader economy, we do not yet know if the Federal Reserve's recent efforts will be successful in reinvigorating the economy. At this point, it appears that the economy will register little to no growth in the first quarter of 2008. The big question is whether this period will signal the low point in the economic cycle, or whether we are at the beginning of a prolonged economic downturn or recession.

As for individual corporations, market participants will continue to closely scrutinize financial firms in an effort to precisely determine their exposure to risky assets and potential losses. If financial firms are able to demonstrate that they have disclosed all of their potential losses and that their balance sheets remain sound, volatility will probably begin to diminish. As long as uncertainty remains though, the potential for unpleasant surprises exists.

### **IMPLICATIONS FOR YOUR PORTFOLIO**

At the end of the day, the direction of the economy, financial market volatility, and sensationalist headlines are all just background noise. What really matters is what happens in your portfolio, and what portfolio strategy you implement going forward.

Although the future course of market yields is impossible to predict, there are several emerging themes which can add value to your investment program.

The recent market volatility has caused a general repricing of risk, and this will likely be demonstrated through higher risk premiums than we have seen during the past several years. This means that the additional compensation for owning corporate bonds will be greater than it has been. Financing for leveraged buyouts will also be more difficult, decreasing the risk that corporate bond holders face from a leveraged buyout. The combination of these factors means that carefully researched, well diversified portfolios of corporate bonds may be attractive investments. Of course, if the economy slows and corporate profits drop, some corporate bonds could suffer. That is why we prefer strong, improving credits, issued by large well capitalized corporations.

Although they performed relatively well compared to some corporate issues, government agency bonds have not been immune to the recent market gyrations. Nevertheless, the government agencies appear likely to emerge from this period in excellent shape and have been viewed as a source of calm in these turbulent markets. Recent discussion among some government officials would broaden the scope and depth of Fannie Mae and Freddie Mac's activities. Regardless of whether or not this comes to fruition, agency bonds remain attractive, safe, liquid investments, and we consider them a cornerstone of high grade fixed income portfolios.

Most importantly, the recent market gyrations should not cause investors to deviate from their established strategies. Markets rise and fall, but a well constructed investment plan will stand the test of time. The investors that suffer during periods of market volatility are those that panic at market events or change their strategy in order to capture the newest or hottest fad. Investors that maintain discipline, implement subtle changes to their investment program as needed, and adhere to a long term strategy need not fear volatility. When all is said and done, these investors are likely to meet their investment goals, regardless of market gyrations.

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