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Market Update

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Crisis Intensifies

The crisis that began in the subprime mortgage area last year has intensified, culminating in a series of events that were once unthinkable: the de facto nationalization of Fannie Mae and Freddie Mac; the collapse of Lehman Brothers and spillover to Merrill Lynch, Morgan Stanley and Goldman Sachs that effectively ended the U.S. investment banking model; plus government-sponsored rescues of AIG, Washington Mutual and Wachovia. There is also growing realization that problems are global in nature, as several institutions in Europe and other parts of the world have required government assistance.

These developments have taken a heavy toll on financial markets. Credit markets have seized up in the United States, and spreads for investment-grade and high-yield bonds are at or near all-time wides. In addition, there is unprecedented illiquidity in short-term bank financing and the commercial paper market, and money market funds have come under scrutiny following the collapse of the Reserve Fund. In the wake of all this, global equity markets have fallen decisively into bear territory, with the major world indices down by 30% or more.

Until recently, policymakers in the United States and abroad reacted to problems on a case-by-case basis. However, the latest developments have convinced them that the financial problems are systemic in nature and require a comprehensive solution. In the United States, enactment of TARP (Troubled Asset Relief Program) is important to help restore liquidity to credit markets eventually. But the program will not address all of the problems plaguing the financial system such as worries about counterparty risk among financial institutions and need to recapitalize ones in trouble.

Meanwhile, economic conditions in the United States and abroad deteriorated markedly in August-September, and the global economy appears to be entering a synchronized recession for the first time since the early 1980s. While the consensus view among U.S. economic forecasters is that the recession will be short (2-3 quarters) and mild (a 1% decline in real GDP measured from peak to trough), the risk is that it could be deeper (a decline of 2%-3% or more) and longer, especially if businesses cutback on capital spending and unemployment mounts.

One positive is that oil and other commodity prices have fallen significantly from their peaks, and we anticipate significant declines in headline inflation readings in the United States and abroad before too long. With the U.S. dollar having rebounded off its lows, the Federal Reserve recently eased monetary policy in a coordinated move with other central banks.

Amid these developments, we have been pursuing a defensive posture in our investment portfolios. In equity portfolios, we have been maintaining larger-than-normal cash positions while shifting to more defensive sectors. In the fixed-income arena, we have been focusing on higher-quality names and have reduced exposure to mortgage-backed securities and financials. Overall, the current crisis has created long-term opportunities in both equities and fixed income, but we are waiting for evidence that the credit crunch is abating and home prices are stabilizing to capitalize on these opportunities.

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