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## CRISIS OF CONFIDENCE SWEEPS ACROSS MARKETS

The U.S. financial system was rocked in September by what some have called the greatest crisis since the Great Depression. Some frantic economic experts claimed the entire global economy was only days away from financial Armageddon. How close we came to this hypothetical brink is still unknowable. Some calmer voices claim the situation isn't nearly as dire as it is being portrayed. One thing is for sure - markets have no tolerance for uncertainty, and these are very uncertain times. The dominos began falling at a furious rate with the collapse or merger of Fannie Mae, Freddie Mac, Lehman Brothers, AIG, Merrill Lynch, WaMu, and Wachovia. In an effort to stop the crisis, Washington stepped in with a massive government intervention plan not seen since the New Deal. The fed's basic proposal is to end the credit freeze by purchasing toxic mortgage assets and offering new federal insurance for money funds. The infusion of capital should have a positive effect on credit markets and help the economy recover quicker. How much the pending bailout will eventually cost and how much impact it will have on improving matters is unknown. Depending on who you listen to, the cost of the plan ranges from an optimistic view of taxpayers making money on the deal to a dour scenario costing between 1 to 1.5 trillion dollars. It is important to keep in mind some perspective when speaking about hundreds of billions or a trillion dollars. Even at the worst case cost of 1.5 trillion dollars, and with Americans holding over 40 trillion dollars in financial assets - the bailout represents about 3% of total financial assets. Regardless of cost, the best and the brightest financial minds have reached a consensus that while no one can be certain how well the proposed plan will work - the credit situation is so dire something must be done or we face a severe credit freeze.

**Americans hold over 40 trillion dollars in financial assets - the cost of the bailout should be kept in perspective.**

The housing meltdown and its resulting credit crunch are at the heart of the crisis. The genesis of the catastrophe can be traced to a combination of the federal government promoting home ownership and a climate of loose credit. For years, people were permitted to purchase homes they couldn't afford at fabulously overblown prices with little or no down payment. The unraveling of the housing bubble and ensuing credit freeze has created a crisis of confidence. Currently, everyone is finger pointing to identify the kingpin villain, but the truth is, from unqualified buyers, speculators, greedy mortgage brokers, apathetic regulators, Wall Street innovators, and vote-seeking politicians influencing markets - no one is innocent.

Financial institutions and personal households must now face what is referred to in economic terminology as "deleveraging" - an effort to reduce their reliance on debt. Deleveraging is a painful process in the best of conditions, but in times of tight credit, a slowing global economy, job cuts, falling home prices, and a contraction in consumer spending - the process of deleveraging can be torturous. There is not going to be any easy or painless fix to the current situation. The aftershocks from the recent calamity will be impacting both Wall Street and Main Street for the immediate future regardless of government action.

### U.S. Stock Market

While the stock market has tumbled downward recently, it is important for investors to remember a good portion of these bleak future prognostications have already been discounted in the current stock prices.

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No one can be sure if the market has found a bottom, but some investors are betting we must be near a bottom. Warren Buffet wouldn't be investing billions of dollars this past week in the market if he felt the sky was falling. Investors, except those at or near retirement, should take the long view and keep in mind that when the market does rebound, investors need to be in the market to reap the greatest rewards. It is nearly impossible to time a move out of a market in a downturn and miraculously move back into the market when it positions itself for a steep increase. Timing markets is a fool's game.

## **Employment**

The job report for August and the weekly September numbers have been dismal. The unemployment rate jumped from 5.7% in July to 6.1% in August, the highest in nearly 5 years. Net job losses for 2008 stand at more than 600,000. Spiking summer energy prices and continuing problems in housing and financial sectors have radiated outward impacting overall economic activity. Some analysts cite the recent extension in federal jobless benefits coupled with the increase in the minimum wage for the sudden increase in unemployment.

### **The Most Recent Employment Figures Have Been Dismal**

Either way, the employment outlook remains weak for the remainder of 2008 and will probably deepen in 2009 due to lethargic economic growth. Employment is a trailing indicator of economic growth, so jobless claims will climb even after the end of a recession. Employer's staffing decisions are typically based on current profitability and not forecasts for future growth, hence employment opportunities will remain weak until the economy is well past its current situation.

## **International Markets**

The euro has been sliding against the dollar amid concerns about the health of the euro-zone economy. The European Central Bank has kept interest rate cuts on hold as inflation concerns continue to trump the increased risk of recession. The ECB continues to view inflation as problematic. Not only are prices rising, but wages are also increasing rapidly in many foreign nations and that makes for a more intractable inflation scenario. Aggressive lending practices and their own housing bubble have created a crisis of confidence that is spreading across European markets.

Russia's domestic stock market (RTS) has fallen to a two year low despite government efforts to prop up the ruble. Falling oil revenues have led to a sizeable exodus of foreign investors who doubt any government action can offset the impact of falling global crude prices. In addition, Russia's recent foray into Georgia has many international investors questioning the ethics of investing any amount in Russia.

Asia has proven not to be immune from the global economic slowdown. Japan's Prime Minister Fukuda announced abruptly he is resigning as the world's second-largest economy is flirting with recession. Structural problems (an aging population, declining workforce, government regulations, inflation concerns, and an enormous debt level) plus falling exports have hampered all efforts to spur growth. Many economists expect Japan's economy to expand by less than 1% through 2008 and 2009.

A combination of factors has sent the South Korean currency (won) tumbling downward. The won hit a four-year low against the dollar recently despite government efforts to prop it up. The dollar has gained more than 20% against the won this year. South Korea currently spends more on imports than it receives from exports and the gap must be financed in a tight worldwide credit environment. The nation's stock market is down 25% this year and many foreign investors are making a beeline for the exit. Foreigners have pulled out a net total of more than \$30 billion from Korean stocks so far in 2008.

Hong Kong's Hang Seng Index hit its lowest close since early 2007. The Shanghai composite index, among the worst performing markets in the world this year, has retreated to a level not seen since autumn of 2006.

Emerging stock markets and their currencies have been taking a beating. Falling commodity prices and a stronger U.S. dollar hit many emerging economies hard, and the global credit crunch has only exacerbated an already severe downturn.

## **Housing**

The most recent housing numbers are bleak. New home sales fell to the lowest level since 1971 and the excess inventory remains very high.

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The housing bubble is at the heart of the current financial mess dragging down the economy. Until we find a bottom in housing prices the foreclosure crisis won't end. Rates of foreclosures and overdue mortgages continue to climb. Falling real estate prices are leaving more and more people owing more on their mortgage than the current value of the home. In certain overbuilt markets in CA, NV, AZ, and FL there has been a 40% yr/yr decline in home prices. When you factor in many of these homeowners entered the property with little or nothing down – there is little incentive for them to make an inflated monthly mortgage payment.

### **New Home Sales Have Fallen To The Lowest Level Since 1971**

Economists are split on how much the latest massive Wall Street bailout will do much to alter the fundamental problems plaguing the housing market. While home prices have fallen considerably, they are still nearly 40% above the pre-boom 2001 sales price. Once home prices do stabilize, it should help the entire economy recover at an accelerated pace. Industry figures indicate borrower's stricter credit score guidelines alone have squeezed 13% or 21 million potential buyers out of the home buying market. Fewer potential buyers will result in more homes remaining on the market for an extended period of time and place more downward pressure on prices.

### **Until The Bottom Is Found In Housing Prices, The Foreclosure Crisis Won't End**

Fannie and Freddie, in an effort to shore-up investor trust, have instituted new fees and underwriting rules which will make it harder to qualify for traditional mortgages. It is becoming increasingly difficult even for people with good credit backgrounds to qualify for a traditional mortgage as lenders demand larger down payments. Keep in mind that even with the recent large drop in home prices, today's prospective home buyer is required to put down more than two or three times greater a down payment than the buyer of just a couple of years ago.

In addition to requiring a greater down payment, consumer sentiment appears to be turning sour on housing as an investment – a recent Gallup poll found only 27% of the population now view a home as being their best long-term investment, down from 50% in 2002. Housing is more affordable in 2008 than in 2007, and the prevailing attitude of most buyers seems to be that it will be even more affordable in 2009 and beyond – so why buy now? Until potential buyers feel assured that home prices have stopped falling, the housing market will remain troubled.

### **U.S. Economy**

It seems self evident the U.S. economy has slipped into a recession. Markets are being guided by fear and some skittish investors are scrambling to find a safe harbor to park their money. The recent run on money market funds seems to have subsided. After seeing investors yank billions of dollars out of money markets, the federal insurance plan appears to have stabilized the funds and the latest numbers actually show some money returning to the funds. Retail sales slumped in August, falling 0.3% from July.

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Analysts had been anticipating a bigger boost from back-to-school shopping. The gains from this summer's stimulus checks were fleeting and much weaker than had been anticipated.

### **Gains From The Summer's Stimulus Checks Were Weaker Than Expected**

Many forecasters predict consumer spending is poised to decline this quarter for the first time since 1991 and caution spending could be anemic late into 2009. Business inventories increased more than expected in July. Inventory buildup could indicate businesses trim back future production to meet the lower demand. Wholesale prices plunged in August by the largest amount in almost two years. Indications are the economy will remain under pressure for the remainder of 2008 and early 2009. When confidence does return to markets and investors sense Wall Street has put the worst behind - the overall economy could rebound very quickly.

## **SUMMARY**



- **Credit Crisis Exacerbates Economic Recession**
- **Expect U.S. Economy To Remain Weak Through 2009**
- **Stock Market Volatility To Remain Elevated For Remainder of 2008**
- **Stock Valuations Are Very Attractive, But Stock Market Will Remain Under Pressure Until Signs Of Economic Stabilization**
  - **Stock Investors Should Keep 3-5 Year Time Horizon But Be Aware The Next 6-18 Months May Be Exceptionally Difficult**
  - **Continue Emphasis On High-Quality Assets. Short-Term U.S. Treasuries, Dividend Paying Stocks And Covered Call Writing Afford Investors Some Stability In Coming Months**
  - **Avoid Junk Bonds and Investment Grade Corporate Bonds Until Some Sign Of Economic Stability**
    - **Prefer Large Cap Stocks Over Small Cap Stocks**
    - **Prefer Domestic Stocks Over Non - U.S. Stocks**

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