

# The Fairlead Quarterly

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## Quarterly Overview

Let me start by saying I will try to keep this newsletter brief – as I expect to keep you updated through periodic e-mails, in light of the significant volatility the market has experienced over the last few weeks. In short, the only market sectors that had been working in the first two quarters – materials and energy – began unraveling at a furious pace in early July. On July 2<sup>nd</sup>, the DBC, an exchange traded fund (ETF) that tracks the Deutsche Bank Commodity Index ended the day at \$46.44 per share. On September 30<sup>th</sup> it traded at \$33.89 – a 27% decline. For the quarter, large-cap stocks (based on the Russell 1000 Index) were off by 9.35. Value outperformed (lost less than) growth in all capitalization categories, but only REITs, small cap value and Money Markets posted positive returns for the quarter. Foreign and Emerging Markets significantly underperformed. The MSCI EAFE (foreign index) was down 20.5% for the 3<sup>rd</sup> quarter – down 28.91% for the year and the MSCI Emerging Markets index was down 26.86% – just for the quarter! The Lehman Bros. Aggregate Bond index was off slightly for the quarter with investors shunning risk and shifting to Treasuries. High Yield bonds were down 8.89% for the quarter, but down 7.98% in the month of September alone corresponding to the significant collapse and consolidation that took place in the financial industry in September.

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## Collapse and Consolidation Timeline

March 2008 – Bear Stearns, America's fifth largest investment bank collapsed and was taken over by JP Morgan. While this was a shocking event at the time, it paled in comparison to the series of failures that occurred in September, and that have left the credit markets in a state of turmoil.

September 7<sup>th</sup> – Fannie Mae and Freddie Mac, the very cornerstones of the mortgage industry, by some estimates accounting for forty percent of all the mortgages in America, were essentially taken over by the US Treasury, nationalized and placed in conservatorship.

September 14<sup>th</sup> – Lehman Bros. filed for bankruptcy and Merrill Lynch was taken over by Bank of America.

September 16<sup>th</sup> – AIG, the nation's largest insurer was bailed out by the Federal Reserve and Morgan Stanley and Wachovia initiate merger talks – a deal that will never be done.

September 25<sup>th</sup>- Washington Mutual was sold to JP Morgan.

October 1<sup>st</sup> – the senate passes a \$700 billion dollar “rescue/bailout” package (\$850 billion including the “goodies”) and on,

October 3<sup>rd</sup> – the bill was passed by congress and signed into law.

## Market Segments

**Housing & The Adverse Feedback Loop:** The housing market continues to be the lynchpin in what has become an...

*Adverse Feedback Loop* – Weak Housing leads to a weaker Economy which leads to a weaker Financial market which lead to a weaker Credit market – which the leads to weaker Housing.

**Credit Markets:** The events of September only served to exacerbate the lack of confidence in the credit market. In the month of September fear spread rapidly and investors rushed out of all forms of debt securities to the safe haven of Treasuries. This impacted not only corporate and municipal bonds, but spread to the commercial paper market which is the foundation for bridging short term differentials between payables and receivables for things like payroll and is also the backbone of the money market. When it was announced that one institutional money market had broken down below a dollar, it created such a run on money markets that the Fed came out and announced that it would provide certain guarantees for money market funds.

The good news is for those focused on income, bonds are trading at a greater spread to Treasuries than we have seen in years, and dividend yields on many stocks exceed the 10

year Treasuries – the bad news is nothing feels safe.

**Fed :** The Fed is pumping money into the banking system and with the deteriorating global economy any hint of near term inflation risk is off the table. But the beneficial effects of the Fed’s actions will not be fully felt for some months to come.

**Oil:** In the last quarterly newsletter I suggested that “a solid case can be made that we are in a bubble.” and it appears that may have been the case as Arab Light Crude dropped 28.22% during the quarter. This may be one bright spot as the decline in energy prices and natural resources will provide some relief to consumers and producers in this recessionary environment.

## Going Forward

There is no doubt that we are in a recession and it is probable that the fundamental economy will be slow to emerge. Once the credit markets begin to normalize, we will continue to see lenders employing tighter standards, which makes a V-shaped economic recovery less likely. But it is very important to remember that the stock market anticipates the economy and the best investing opportunities will occur when fear is rampant. We will only recognize the bottom in hindsight – but for the long term investor this downturn may well present the best investing opportunity we see in our lifetime.

As always I am available to discuss the markets, the economy, your portfolio and your concerns.

JOHN VREELAND

## SUMMARY OF INDEX RETURNS 2008

Global Markets Year to Date				
INDEX	3rd QTR of 2008	Year to Date 2008	Calendar Year 2007	UNMANAGED INDEX DESCRIPTION
Russell 1000	-9.35%	-19.5%	5.77%	<i>US Large-cap Stocks</i>
Russell 1000 – Growth	-12.33%	-20.27%	11.81%	
Russell 1000 – Value	-6.11%	-18.85%	-0.17%	
Dow Jones Industrials – Total Return	-3.71%	-16.59%	8.88%	
S&P 500 – Total Return	-8.37%	-19.29%	5.49%	
NASDAQ Composite	-9.19%	-21.49%	9.81%	
NASDAQ – 100	-13.2%	-23.52%	18.67%	
Russell Mid-Cap	-12.91%	-19.50%	5.60%	<i>US Mid-cap Stocks</i>
Russell Mid-Cap – Growth	-17.75%	-23.35%	11.43%	
Russell Mid-Cap – Value	-7.52%	-15.46%	-1.42%	
Russell 2000	-1.11%	-10.38%	-1.57%	<i>US Small-cap Stocks</i>
Russell 2000 – Growth	-6.99%	-15.29%	7.05%	
Russell 2000 – Value	4.96%	-5.37%	-9.77%	
MSCI World ex USA	-20.61%	-28.06%	12.92%	<i>Morgan Stanley World ex USA (US\$)</i>
MSCI Emerging Markets	-26.86%	-35.37%	39.78%	<i>Morgan Stanley Emerging Mkts (US\$)</i>
30 Day Money Market – All Taxable	0.45%	1.71%	4.55%	<i>Cash</i>
Consumer Price Index – US	0.12%	4.31%	4.15%	<i>Measure of Inflation</i>
Lehman US Corp. High Yield Index	-8.89%	-10.07%	1.88%	<i>High Yield (Junk) Bonds</i>
Lehman US Aggregate Bond Index	-0.48%	0.64%	6.96%	<i>General US Bond Index</i>
FTSE NAREIT REIT: All	-4.53%	-1.25%	-17.83%	<i>Real Estate Investment Trusts</i>
Dow Jones – AIG Commodity Index Tot Ret	-27.71%	-8.01%	16.23%	<i>Basket of Commodities</i>
Crude Oil – Arab Light Crude	-28.22%	12.97%	51.3%	<i>Price of Arab Light Crude</i>
Gold – London PM	-4.92%	6.69%	31.17%	<i>London Spot Price</i>

Source – Thomson Financial Company