

# Schwab Market Perspective: Takeover Helps, Troubles Remain

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September 12, 2008

- **Turning point for credit markets?** The nationalization of Fannie Mae and Freddie Mac should help, but it doesn't sound the "all clear" in the credit arena.
- **Does the takeover of Fannie and Freddie mean a housing turnaround?** The government takeover of the GSEs is a step in the right direction, but still-high inventories of unsold homes, increasing foreclosures and tight lending standards are problematic.
- **Inflation concerns put on the back burner.** Slower growth and weaker commodity prices point to a pullback in inflation—likely keeping the Fed on hold.
- **Pros and cons add up to subpar economic growth.** House price declines and financial strains have spurred a self-feeding cycle of slow growth. There are no quick fixes.
- **Dollar rally has a downside.** While the dollar rally could continue a while longer, don't abandon international stocks.

## Summary

In the good old days—like mid-March when the Fed orchestrated the sale of Bear Stearns—global markets used to rally when the government cast its safety net. But now, like a toddler who learns a temper tantrum can get desired results, the market seems to be trying its hand at an old trick. To be fair to toddlers, it's really the fault of the parents. They condition such behavior—much like the government may be doing in our market today.

The Treasury used its newly granted powers to nationalize government sponsored entities (GSEs) Fannie Mae (FNM) and Freddie Mac (FRE) in the latest week. There was really no alternative, given their government-coddled position in the nearly \$12 trillion U.S. mortgage market. Global markets all but demanded the takeovers, as it became clear that the GSEs would not be able to fund their ongoing operations with new and rollover debt. While these takeovers should eventually stabilize the U.S. mortgage and housing markets, the rally in global stocks lasted just one day.

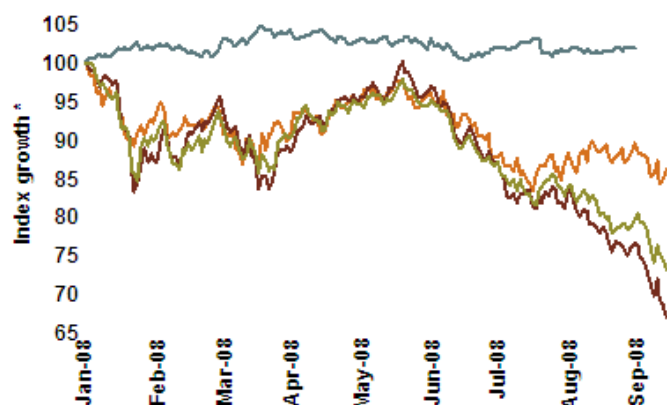
A new temper tantrum ensued as investors questioned whether Lehman Brothers (LEH) could survive. The Lehman situation is basically a test: Can the private sector deal with this potential failure without direct intervention by the Federal Reserve or U.S. Treasury?

Meanwhile, inflation concerns are now on the back burner as oil and other

commodity prices continue to fall. And, as U.S. and global growth slow further, inflation worries are becoming a distant memory. Strength in the U.S. dollar—and resultant U.S. stock market outperformance—in recent months can be attributed to deteriorating expectations of economic growth around the globe, not to an improvement in U.S. growth. While the dollar could continue its advance in the short-run, we caution investors not to abandon international stocks. Not only are there arguments against long-term strength in the dollar, but the short-term U.S. economic cons are more than offsetting the pros. This week's dour U.S. retail sales report is a reminder of that!

### Dollar rally helps U.S. stocks but economic worries spread abroad

— S&P 500 Composite Index  
— Lehman Brothers Aggregate Bond Index  
— MSCI Emerging Markets Index  
— MSCI EAFE Index



\* Rebased to 12/31/2007 = 100

Source: FactSet, MSCI, Lehman, S&P.

As of 12-SEP-08.

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### Turning point for credit markets?

The credit markets cheered the federal takeover of Fannie Mae and Freddie Mac, at least in the early stages. It had been a nervous few weeks in the credit markets—indicated by widening credit spreads—thanks largely to growing concerns about Fannie and Freddie. The skittishness had led to tighter credit conditions—firms were more reluctant to extend capital to counterparties with unconvincing balance sheets.

The growing concern in the market—especially from increasingly vocal foreign entities such as China—reportedly convinced U.S. Treasury Secretary Henry Paulson that it was time to act. Apparently, Fannie and Freddie would soon face problems raising new capital and rolling over the existing debt that was coming due. With the GSEs owning or guaranteeing roughly half of the \$12 trillion worth of outstanding mortgages in the United States, their ability to stay afloat was top of mind for investors around the world.

The government takeover immediately achieved the desired effect, at least to some degree. The day after the announcement, the yield on 30-year agency-backed mortgage bonds dropped 0.41 points, the biggest one-day move since 1990, according to *The Wall Street Journal* and FTN Financial.

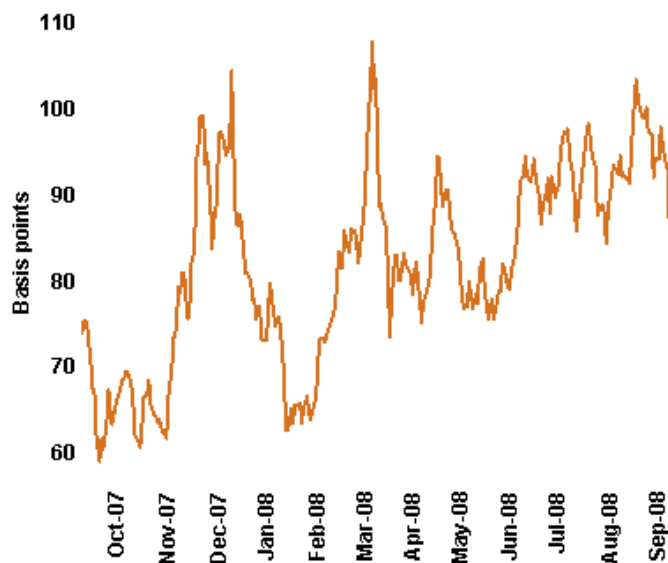
The hope is that the federal takeover of Fannie and Freddie will:

- Push mortgage rates lower while increasing lenders' confidence in the overall financial system.
- Allow more potential buyers into the housing market, helping to stem the tide of rising inventories and falling prices (which continues to threaten the balance sheets of financial firms).

Indeed, as shown below, we've seen the spread in swap markets narrow, indicating greater confidence in the market. (Swap markets involve two parties agreeing to exchange periodic interest payments, one based on a fixed rate and the other based on a floating rate. Swap market activity is a useful gauge of expectations for credit risk and loan demand.) What's more, mortgage rates fell by nearly 50 basis points.

### GSE takeover easing financial strains

— 2-year Treasury swap spread



Source: FactSet, Reuters. As of 10-SEP-08.

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Although this giant step by the government certainly helps calm the waters in the credit markets, issues remain. Lending standards continue to tighten, which reduces the availability of credit despite lower rates and indicates continued concern in the market. Additionally, as mortgage problems continue to move through the financial system, many believe we haven't seen the last of the write-downs or bank failures. In our opinion, housing needs to stabilize (we're starting to see some glimmers of hope) before we can look for the end of the credit crisis. The recent action by the federal government is certainly a step in that direction, but in our opinion it doesn't sound the "all clear" in the credit arena.

In what is starting to become a far-too-regular occurrence, the market is waiting to hear how the expected sale of Lehman Brothers turns out this weekend. There are reports that the Treasury Department and the Federal Reserve are trying to help bring the appropriate parties together, although both are likely resistant to backing any deal with government money or guarantees. However, a precedent of

sorts was set when the government backed \$29 billion in debt in the deal between JPMorgan and Bear Stearns. Therefore, any potential buyer of Lehman may balk at proceeding without at least some assistance from federal authorities.

This could prove to be an important weekend in the development and resolution of the financial crisis: We may see the feds draw a line in the sand, or they may determine they have no choice but to step in again. If they were to allow the various private-market parties work this out on their own, it could indicate increased confidence that the financial markets are becoming stable enough to handle at least some disruption to the way they do business. However, if the feds feel they have no choice but to step in, it could set up further expectations of government bailouts going forward.

We tend to believe it's important for private markets to take care of these matters, and we would likely feel more optimistic about an end to the current crisis if we're able to get through this Lehman mess without substantial government intervention.

### Does the takeover of Fannie and Freddie mean a housing turnaround?

The government takeover of Fannie Mae and Freddie Mac initially caused a sort of euphoria in the market, as investors hoped (and in many cases believed) it signaled a bottom in the housing market. We believe the government's action will likely help establish that bottom by providing confidence to the credit markets. That in turn will help bring down mortgage rates, expanding the pool of potential homebuyers as monthly payments become cheaper.

#### GSE takeover should lead to lower mortgage rates

— Freddie Mac mortgage spread \*



Source: FactSet, Freddie Mac. As of 10-SEP-08.  
\* mortgage spread = 30-yr Freddie Mac mortgage yield minus 10-yr Treasury yield.

Additional capital and lower rates will also likely help troubled homeowners refinance their current mortgages into something more manageable. Such a move would be welcome—the Mortgage Bankers Association recently reported that

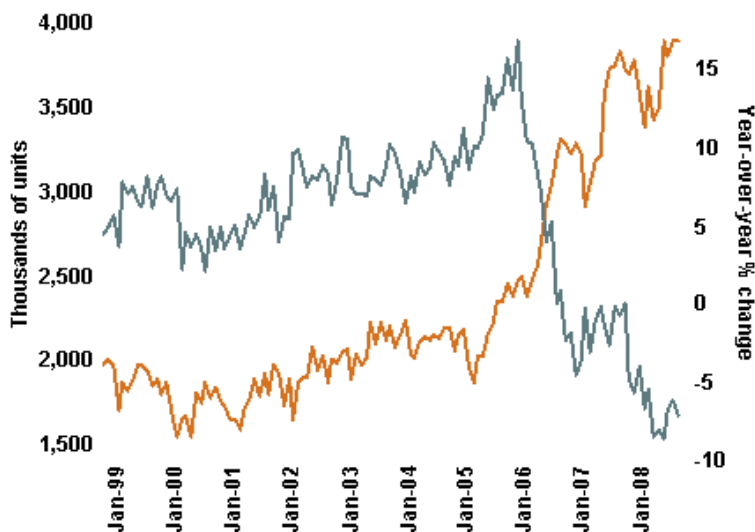
over 9% of outstanding loans on one- to four-unit family homes (2.75% of all loans) were delinquent or in the process of foreclosure. This is certainly not a positive situation given the already robust inventory of homes for sale, which pushes prices lower, leading to more trouble for homeowners and continuing the downward spiral that needs to be broken.

Although we saw existing home sales rise by 3.1% in July, home prices continued to fall and, perhaps more importantly, inventories expanded to 11.2 months' supply from 11.1 months' supply in June. As noted above, before we see a true bottom in the housing market, we believe this inventory number will need to come down.

However, as we get closer to that bottom and some homeowners start to reengage, we may see inventories move higher as owners who had been waiting to put their homes on the market do so. But we don't believe we're at that point yet, given that much of the increase in inventories and existing home sales appears to be condos, which we view largely as speculators attempting to unload disappointing investments.

### Rising inventories depress prices

— Existing home inventory (Left)  
— Median price of existing homes (Right)



Source: FactSet. Nat'l Assoc. of Realtors. As of 10-SEP-08. ©FactSet Research Systems

While the government takeover of the GSEs should help make credit a bit more accessible, it doesn't affect the problem of tighter lending standards, which narrows the pool of homebuyers. It doesn't matter what mortgage rates are if borrowers can't get approved despite the lower payments. The latest Federal Reserve survey of banks' senior loan officers indicated that roughly 75% have tightened standards on prime mortgages, noticeably higher than the 60% seen in the previous survey. Additionally, weakening labor markets and lackluster wage gains undermine the ability of potential buyers to get the mortgages they need.

The takeover of Fannie and Freddie is a welcome step, but more needs to happen before housing will begin to recover. (Read more about the housing market and

the GSE takeovers in Liz Ann Sonders' cover story in September's *Schwab Investing Insights*® newsletter.)

### **Inflation concerns put on the back burner**

Concerns about inflation, which had been building, have given way to more urgent matters. Quite obviously, Fannie Mae and Freddie Mac stole the headlines, but renewed fears of a slowing global economy, combined with easing commodity prices, had already pushed inflation to the back pages. But recent data shows that inflation remains an issue:

- The July reading of the Consumer Price Index (CPI) rose 5.6% year over year, the highest level since January 1991.
- The core CPI, which excludes food and energy, moved from 2.4% to 2.5%, well above the Fed's implied comfort range of 1%–2%.
- The Producer Price Index (PPI) rose 9.6% year over year in August, just off of the 9.8% rise posted in July—the biggest rise in 27 years. And the core rate (excludes food and energy) rose 3.6%, up from 3.5% in July.

But the fall in commodity prices is becoming more evident:

- The PPI fell 0.9% month over month in August—the biggest drop since October 2006.
- Import prices, although still up 16% year over year, fell a record 3.7% from July to August.

Despite hawkish (and sometimes over-the-top) talk, the Federal Open Market Committee (FOMC) is hesitant to fight inflation aggressively. The Fed's uncertainty is due in part to a U.S. economy that's sluggish at best, a slowing global economy, the continuing credit crisis, and the ongoing woes in the housing arena. These same issues lead us to believe that inflation will move lower in the coming months without the Fed needing to act.

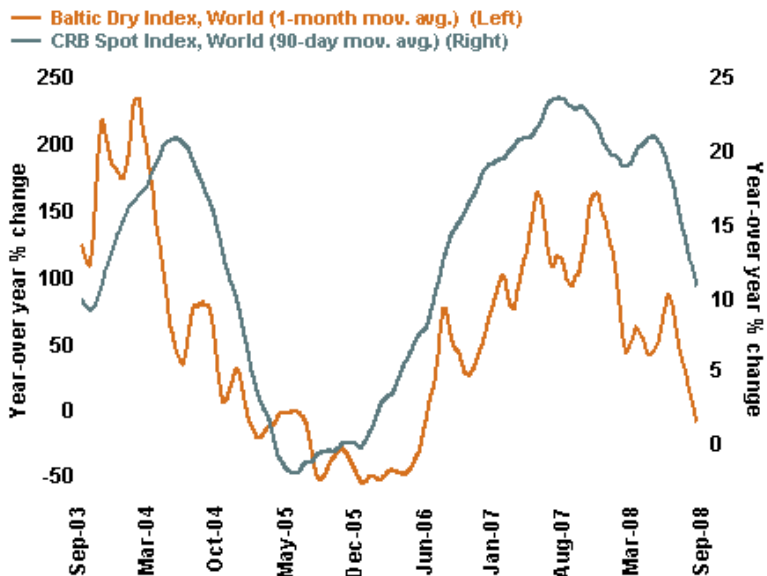
Note that both the CPI and PPI are lagging indicators while some of the more forward economic indicators are showing economic weakness, which has typically led to lower inflation going forward. In fact, the latest summary of leading economic indicators fell by 0.7%, indicating further weakness in the U.S. economy in the coming months.

What's more, we're seeing signs that commodity prices will continue to fall.

- The decline in the Baltic Index is a good indication that international economies will slow, which has typically led to lower commodity prices.
- Strength in the dollar, due more to weakening foreign economies than strength in the United States, also contributes to softening in commodity prices—and we believe the dollar could get stronger as the global economy continues to deteriorate.

As the charts below show, these two factors typically lead to lower commodity prices, which would, in our opinion, help cut inflation relatively quickly. This would allow the Fed to focus more on the economic issues that continue to plague the United States.

## Global slowdown affecting commodities



Source: FactSet, Commodity Research Bureau, The Baltic Exchange. As of 10-SEP-08.

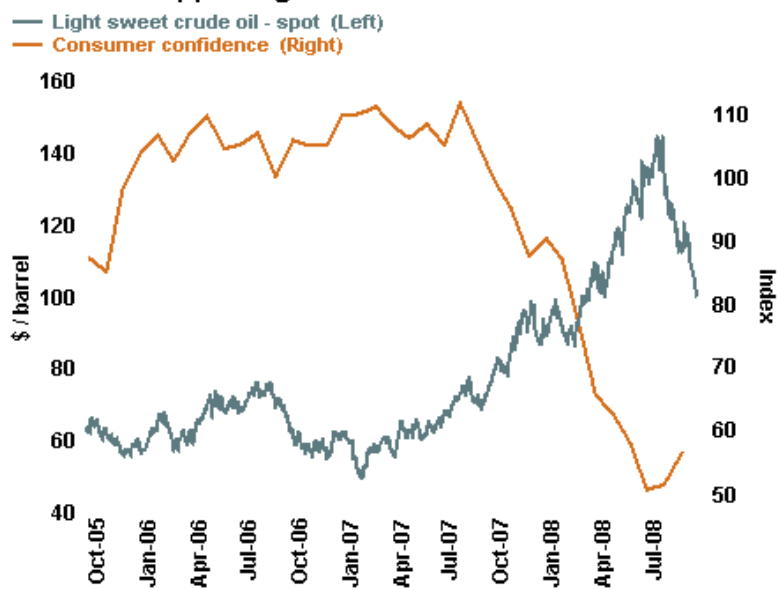
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## Pros and cons add up to subpar economic growth

Recession or not, the economy's protracted crawl makes it feel like one. Other than time, there are no noteworthy catalysts or silver bullets to get the world economy out of its funk quickly. Deleveraging is a long, painful process that will likely take years to unfold.

Fortunately, the price of oil has finally subsided. The chart below clearly shows how oil prices affect the psyche of consumers. Even though the price of oil is the big wild card, we believe it will continue to subside (along with other commodity prices) because global aggregate demand continues to slow, reinforced by tighter monetary policy in many developing nations.

## Lower oil supporting consumer confidence



Source: FactSet, Conference Board, Nymex. As of 12-SEP-08.

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What are the primary pros and cons in today's economy?

### Pros:

- Oil and other commodity prices have cooled, which could quell inflation concerns and keep the Fed focused on supporting growth. But still-lower commodity prices may be needed before they can be considered an economic tailwind.
- The dollar has strengthened, which is also alleviating inflation concerns and keeping the Fed from raising rates too soon. Despite this new trend, net exports will likely still be supportive of the U.S. economy for several more quarters, as the lagged impact from when the greenback was weak has not fully played out.
- The Fed's various liquidity-enhancing facilities have taken some of the sting out of the financial crisis.
- While a taxpayer bailout of Fannie Mae and Freddie Mac is tough to swallow, the alternative could have been much worse. The resultant lowering of mortgage interest rates and explicit government guarantee of GSE bonds will likely help stabilize the housing market and financial system.

### Mixed:

- Wage inflation is tame: Average hourly earnings, in a softening trend for nearly two years, were up a modest 3.6% in August from a year ago. Real disposable personal income was up just 1.2%! While not supportive of consumer spending, these trends take pressure off inflation and also keep labor costs under control for corporations.
- We see risks to corporate earnings growth, but if our expectations of lower inflation prove correct, it could be a meaningful offset in terms of stock market multiples (price/earnings ratio).

### Cons:

- Falling home prices continue to strain financial markets. Bloated inventories of unsold homes continue to hold prices down. Rising delinquencies and foreclosures also hurt home prices.
- Employment is softening—payrolls have fallen for eight consecutive months and the unemployment rate rose to 6.1% in August, placing the cash-strapped consumer at even

greater risk.

- Tight lending standards continue to hamper growth. According to the Fed, loans to large businesses tightened in the second quarter of 2008 at the fastest rate ever (excluding the first quarter of 2001).
- Still-high input costs and slower consumer spending continue to crimp corporate profits, and capital spending is being held back by dour corporate sentiment.

Retail sales results bolster the case that U.S. economy is slowing substantially, and may be close to contracting. Advance retail sales fell 0.3% in August, versus the Bloomberg estimate of a 0.2% gain. Ex-autos, which were weighed down by heavy incentives and severe discounting, sales were off 0.7%, compared to expectations of a 0.2% decline. Adding to the downbeat tone, July's results were revised substantially lower, now showing a 0.5% decline, versus the original report of a decline of 0.1%. In what could be considered a bit of a bright spot, sales in August excluding gas stations were flat. Overall, these numbers make it more likely that the Fed will at the very least be on hold for the foreseeable future, and that rate cuts may soon be under consideration.

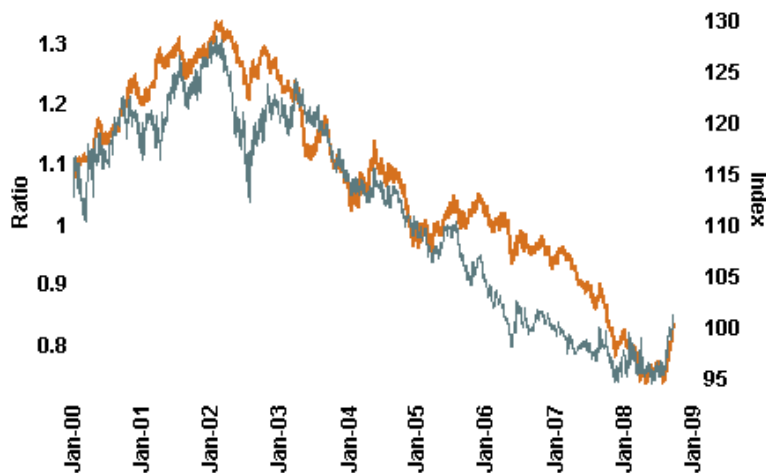
Other than oil, lending standards appear to be the key to economic growth, because they relate to both consumer and corporate spending. We've gone from one extreme to the other: from extraordinarily loose lending standards to extremely tight underwriting criteria. Eventually, lending standards could become significantly less strict, but yesterday's heyday is gone.

### Dollar rally has a downside

The rising dollar has been instrumental in the outperformance of U.S. equities in the last few months. Its strength is not due to improvement in the U.S. economic outlook, but the deteriorating outlook around the world. While a pullback in the dollar can be expected at any time, given the rapid rise and overbought conditions, further gains cannot be ruled out.

### Dollar rebound boosting U.S. relative performance

— Ratio: S&P 500 Composite Index, total return to MSCI World ex-USA (Left)  
— Broad dollar index (Right)



Source: FactSet, Federal Reserve, MSCI, Standard & Poor's. As of 12-SEP-08.

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Outside of the United States, growth expectations continue to fall from the pedestal, and it's possible that global currencies will follow those expectations lower. The European Union (EU) growth forecast for 2008 has been cut from 2.0% to 1.4%, with several countries expected to fall into recession. Although the European Central Bank (ECB) has kept its benchmark interest rates at 4.25% due to ongoing inflation concerns (particularly wage-based inflation pressures), the euro has fallen more than 13% from its July high as a growth slowdown has become readily apparent. The British pound is also in a downtrend as falling house prices make it evident that lower interest rates will be needed. Japan's second-quarter gross domestic product (GDP) was revised to an annualized decline of 3%, as Asia (China included) feels the pain of slower growth in developed economies.

And the fall in commodity prices, reinforced by slower global growth expectations, is weighing on resourced-based economies, such as Canada, New Zealand, Australia and most Latin American economies.

While the recent rise in the dollar is not helpful in supporting U.S. economic growth, it's still cheap by historic standards. The dollar's still-low level keeps U.S. products and services relatively competitive, which supports U.S. exports. Granted, slowing global growth will likely weigh on exports, but the trade gap should continue to shrink. Typically, currency valuations have a lagged impact; foreign growth is slowing but still growing; and U.S. import growth is likely to remain relatively weak—particularly with the drop in oil prices. Thus, there is still room for the dollar to rise and support relative U.S. outperformance.

That said, don't abandon the international asset class. At some point, investors need to peer across the valley. The headwinds to international performance may continue as expectations for lower commodity prices and inflation—and commensurately lower interest rates—are priced into the market, weighing on those currencies. However, there's no compelling argument for significant strength in the dollar over the medium term—to say nothing of the long-term debt challenges facing the United States.

Easier monetary policies—such as New Zealand's surprise 50 basis point cut this week—should eventually provide some underpinning to global growth. It's expected that even the staunchly hawkish ECB will move to support economic growth. Commodities, which as we noted above have been under sharp downward pressure, still have a longer-term tailwind from maturing economies. Short of an all-out collapse in the global economy, this should set the stage for eventual stabilization and recovery in resource-oriented markets.

It's our opinion that the recovery scenario could still be months or quarters away, but that's no reason to get overly pessimistic about global investments in the meantime. If your allocation to international stocks has dipped below your long-term target (25% of equities), then consider taking advantage of the current weakness in the global market to begin bringing those allocations back up to target.

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**Our Time-Tested Approach to Investing**

In every kind of market, for every kind of investor, we recommend a consistent three-step approach to investing based on 10 fundamental principles that have a proven track record for helping investors achieve better outcomes.

1. Create a plan.
2. Put it into action.
3. Stay on track.

**3 important steps. 10 effective principles.**

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#### **Create a plan**

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1. Having an investment plan that is realistic and actionable is crucial to meeting goals.

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2. Understand your plan, follow it and adjust it when things change in your life.

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#### **Put it into action**

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3. Saving and spending rates have the greatest impact on success.

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4. Diversification is the second most important factor in reaching goals.

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5. Select the asset allocation that's right for you, and stick with it.

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6. Choosing professionally managed investments can be a better way to invest.

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7. Acting now generally beats waiting.

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#### **Stay on track**

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8. Periodic checkups keep a portfolio healthy.

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9. Progress toward goals is more important than short-term performance.

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10. Use the right benchmarks to evaluate performance.

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If you have an investment plan in place, take important steps now so you can stay on track. If you don't have a plan, create one now.

Ask yourself these questions:

- **Given the swings in the markets, is my portfolio out of balance?** For example, a portfolio on target with an allocation of 5% to cash, 35% to bonds and 60% to stocks one year ago, could have as much as 39% in bonds and only about 56% in stocks. Although that might sound good if the stock market continues to decline, nobody knows for sure when it will recover. A Schwab Center for Financial Research study found that annual rebalancing of a portfolio with a moderate risk profile from 1970 to 2006 not only reduced overall portfolio risks, but also increased returns.
- **Am I saving (or spending) at the rate specified in my investment plan?** In the case of an individual in the spending phase of life, is your withdrawal rate sustainable after an 8% decline in your portfolio during the past year (using the earlier portfolio example). If you're concerned that it's not, consider following the [4% solution](#) (spending 4% of your first-year portfolio value adjusted for inflation).

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As always, if you have questions or need help, please contact your Schwab consultant. If you're not yet a Schwab client but would like to learn more, a Schwab consultant can help. Call **800-435-4000** to get started.

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