3rd Quarter 2007 Market Review

As has been the case throughout most of the year, volatility continued to be the theme in the third quarter. The credit crisis of 2007, whose genesis lay in the decline of the sub-prime mortgage market (and the securities linked to them), whipsawed the major indices. By mid August, the S&P 500 and DJIA fell -9.3% and -8.04%, respectively, off their all-time highs in late July; the NASDAQ fell -9.8% from its six-year high. By late August, a confluence of events led the same indices to eventual rebound, leading to solid gains for the quarter (S&P 500: 2.0%; DJIA: 4.2%; and NASDAQ: 4.0%) and year. [Please refer to the performance illustration below for complete year-to-date ("YTD") returns.]

Growth continued to outperform Value at all capitalization levels through the third quarter. Mid Cap Growth again dominated the other categories, increasing 16.5% YTD. Small Cap Value trailed all categories, barely producing a positive return for the year (0.65%).

Energy maintained its superiority during the third quarter, gaining 9.4%, as commodity oil prices reached all-time highs due to continued anxiety in the Middle East, Atlantic storm season supply disruption fears, perceived global supply/demand imbalances, and the falling U.S. currency (which makes oil cheaper for foreign buyers). The Technology sector benefited from an apparent sector rotation, rising 6.1%. Housing weakness and the slowing economy led the Consumer Discretionary sector to retreat -6.53%. Financials fell -4.93% as the sector was unable to shake off continued weakness in the mortgage markets.

International markets overcame similar third quarter volatility to continue their year-long good performance. Emerging markets climbed 31.7% for the year with strong contribution from the frothy Chinese market, growing Asian economies, and commodity-driven Latin American countries. International Large Cap and Small & Mid Caps continued to perform well, gaining 14.3% and 15.0%, respectively.

What was once considered a well contained housing problem became a wide-spread one that induced the Federal Reserve to lower its discount rate (the rate at which banks can borrow from the Fed) in August and implicitly suggest a possible Fed funds rate (the rate at which banks can borrow from other banks) cut. In September, the Fed ultimately surprised the market with an unexpected 50 basis point ("bps") reduction in the Fed funds rate as well as an additional 50 bps cut in the discount rate. Flight to quality became a top priority for most as evidenced by option-adjusted spreads in a Merrill Lynch high-yield bond composite which rose from 255 bps over U.S. Treasury yields at the beginning of the third quarter to over 400 bps towards the end of the quarter (coinciding with the Fed funds rate cut). Short-term bonds benefited most, climbing 1.46% during the quarter while High-yield bonds fell -0.08%. Global bonds, while experiencing a generally benign interest rate environment worldwide, gained 4.5%, mostly due to the falling U.S. dollar which was exacerbated by the cut in the Fed funds rate.

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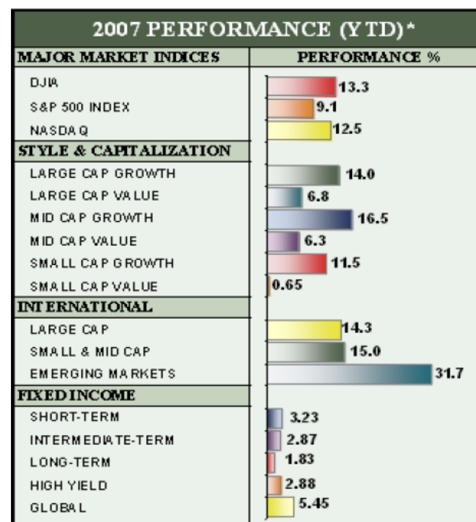

Source Data: Morningstar, Inc. (Investment category performance)
*Year-to-date as of 9/28/2007