
Market Update

September 2008 Review

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A Market in Turmoil

Orderly and efficient capital markets typically focus on numerous economic indicators. Reading on inflation, unemployment, GDP, housing, exports, etc. judge the general mood of a particular economy. Alternatively, corporations are measured by fundamentals such as revenues, operating income, earnings per share, free cash flow, etc. Investors seek modest returns from corporations with stronger balance sheets, while demanding greater upside when they need to take on additional risk from younger or struggling firms. There are cyclical stocks that perform better in robust economic periods and defensive stocks that shine in downturns. These have been the basic characteristics of orderly and efficient markets historically.

Following the unprecedented change in our financial landscape, capital markets have increasingly focused less on fundamentals and more on both emotion and politics. A political flavor to the markets a month before the Presidential elections may not be uncommon, however the degree to which we have seen its implications are near historic proportions. Republicans and Democrats alike are split within their own respective parties as each Representative's political careers hang in the balance of the upcoming elections. As Congress has struggled to fine tune the deal first presented by Treasury Secretary Paulson, the delay has only added more uncertainty, which risks further deterioration in the markets.

Within any package, there will not be a magic pill to cure all economic woes; however it is a critical start to getting the economy back on track, and maybe more importantly, confidence back into both the credit and equity markets. The term for this package, which we will avoid using here, is that ugly word that has irresponsibly turned many Americans against Wall Street. The plan is not for Wall Street, it is not for Republicans and it is not for Democrats. The plan is designed to help Main Street America. The key to this plan is to get liquidity flowing again through our system, for without this, or any other plan, credit will likely continue to be non-existent. Given the dependence of our economy and society on credit, the inability to provide necessary credit, both short and longer term, is a tremendous threat to the well-being of our entire system. Therefore, the message of the rescue plan must be more appropriately communicated as a design to stimulate the credit markets rather than a bail out of Wall Street.

The combination of bank instability and political gridlock drove equity market returns noticeably negative in September, as the Dow Jones Industrial Average and Standard & Poors' 500 Index dropped 6.0% (before dividends) and 9.1% respectively. The DJIA was hit with both its worst ever point loss days, as well as its best ever one day point gain during this month. Small cap US stocks faced similar losses as the Russell 2000 Index declined 8.0%. Top US sectors for the month were Consumer Staples, Consumer Discretionary, Healthcare and Financials, while the worst performing sector was Materials. Like the US, all major international indices were down substantially. The MSCI EAFE Index lost 14.7% and its emerging markets counterpart, the MSCI EM Index fell 17.7%. Returns in US dollar terms on international stocks were hurt by a combination of the slowing global economy and a strengthening US dollar. Fixed Income markets were also not immune to volatility or losses, as investors once again shunned riskier strategies and fled to treasuries, sending yields sharply lower. By the end of the month, the Lehman Brothers U.S. Aggregate Index fell 1.3%, the Lehman Brothers U.S. TIPS Index dropped 3.8% and the Lehman Brothers Global Aggregate Index lost 2.4%.

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Whenever the political uncertainty subsides, markets will once again focus on fundamentals, which unfortunately continue to be somewhat mixed to less than favorable. In September, 2nd quarter GDP was revised downward to 2.8% from 3.3%, jobless claims continued to rise as unemployment reached 6.1% and housing showed continued weakness both in price and turnover. Despite the tough headlines, consumer sentiment was up (although this poll was conducted prior to the initial House rejection of the financial package) and inflation as measured by CPI and PPI actually declined, creating room for the Federal Reserve to take additional policy actions. In the near term, political intervention, or lack thereof, will directly impact October market returns. Looking down the road, financial cooperation with any potential Congressional action, yielding an easing of credit and stabilizing economic fundamentals, is necessary in restoring investor confidence.

Definitions & Disclosures:

An index is a measure of value changes in a representative grouping of stocks, bonds, or other securities. Indexes are used primarily for comparative performance measurement and as a gauge of movements in financial markets. You can not invest directly in an index and, for comparative purposes; they do not reflect the effect of the various fees inherent in actual investment vehicles.

The S&P 500 Index is a market value weighted index showing the change in the aggregate market value of 500 U.S. stocks. It is a commonly used measure of stock market total return performance.

The Dow Jones Industrial Average is a price weighted index comprised of 30 actively traded blue chip stocks; primarily industrial companies, but including some service oriented firms.

The MSCI Europe and Australasia, Far East Equity Index (EAFE) is a market capitalization weighted unmanaged index developed by Morgan Stanley Capital International to measure approximately 1,100 securities in 21 major overseas stock markets. It is a commonly used measure for foreign stock market performance.

The MSCI Emerging Markets Index (EM) is a free-float-adjusted market-capitalization index developed by Morgan Stanley Capital International. It is designed to measure the equity market performance of 26 emerging market countries.

Market Capitalization – A company's market capitalization is equal to the number of company shares outstanding multiplied by its current stock price. Large-cap stocks are often classified as companies with market capitalizations of more than \$10 billion; Mid-cap stocks between \$2 billion and \$10 billion; and Small-cap stocks with less than \$2 billion.

Consumer Price Index (CPI) – The CPI is a cost of living index, released monthly, and published by the U.S. Bureau of Labor Statistics within the Department of Labor. It measures prices of a fixed basket of goods hypothetically bought by a typical consumer. This basket of goods includes food, shelter, utilities, transportation, medical care, clothing, entertainment, and other items.

Producer Price Index (PPI) – The PPI is a wholesale price index, released monthly, and published by the U.S. Bureau of Labor Statistics within the Department of Labor. It tracks the prices of oil and gas, metals, lumber, food, and many other commodities. It does not measure the price of services. The PPI is monitored by economists seeking to identify trends delineating upward or downward pressure on wholesale prices, as these price movements are usually passed through to consumer prices over time. Therefore, the PPI can be an accurate precursor to changes in the CPI.

Gross Domestic Product (GDP) is the market value of the goods and services produced by labor and property in the U.S. It is comprised of consumer and government purchases, net exports of goods and services, and private domestic investments. The Commerce Department releases figures for GDP on a quarterly basis. Inflation adjusted GDP (or real GDP) is used to measure growth of the U.S. economy.

The Russell 2000 Index is a market capitalization weighted index consisting of approximately 2000 small cap U.S. stocks. It is a subset of the larger Russell 3000 Index and is often used as a benchmark for small cap stocks.

The Lehman Brothers U.S. Treasury TIPS Index measures the performance of inflation protected securities issued by the U.S. Treasury that are designed to provide investors with inflation protection through adjustments to principal and coupon payments.

The Lehman Brothers U.S. Aggregate Index covers the U.S. Dollar denominated investment grade, fixed-rate, taxable bond market of SEC-registered securities.

The Lehman Brothers Global Aggregate Index covers the most liquid portion of the global investment grade fixed-rate bond market, including government, credit and collateralized securities.