

> General Comments

- Global markets will be forever changed after the credit crunch took a dramatic turn in the third quarter of 2008, leaving the financial system on the verge of collapse. Several large global financial firms experienced either bankruptcy, mergers, or federal intervention leading to nearly frozen credit markets. (Timeline of events on pg. 2)
- The U.S. government sought to shore up future losses and stabilize the economy by proposing a \$700 billion bailout to purchase bad mortgage assets from struggling financial companies. After the House of Representatives rejected the initial federal bailout plan on September 29th, the Dow tumbled 779 points, representing the worst single day point loss in the history of the index.
- After reaching an all-time high of \$147/barrel in July, oil prices plummeted in response to declining global demand brought by the economic slow-down. Oil closed the quarter at \$102/barrel on September 30th, down 27% in three months.
- Despite the turmoil in the U.S. markets, non-U.S. markets fared far worse in the third quarter of 2008. In September, the MSCI EAFE index recorded its worst monthly return in the history of the index (1969-present), while the MSCI EM index experienced its lowest monthly return in the past 10 years.
- The Fed held the key short-term interest rate steady at 2.0% in the third quarter. An emergency meeting was called in the opening weeks of the fourth quarter, and rates were reduced by 50 basis points.
- In the third quarter of 2008, the U.S. Dollar significantly gained against the euro (+10.6%) and the pound (+10.6%) but remained relatively stable against the yen (-0.2%).
- The State Street Investor Confidence Index® measures investor confidence by analyzing buying and selling patterns of institutional investors. After reaching a peak of 84.0 in July 2008, the index dropped dramatically to close the quarter at 70.7.

## Q3 2008 EVENTS

### Timeline of Events in Global Financial Crisis

- Sept. 7: Fannie Mae and Freddie Mac taken over by the U.S. government
- Sept. 12: Lehman Brothers is on the verge of collapse, U.S. officials scramble to find a buyer
- Sept. 14: Merrill Lynch agrees to sell itself to Bank of America
- Sept. 15: Lehman Brothers declares bankruptcy  
Dow plunges 504 points
- Sept. 16: AIG suffers a liquidity crisis after a down-grade in its credit rating  
U.S. government agrees to give AIG, the world's largest insurance firm, \$85 billion  
The Reserve Money Market Fund breaks \$1 due to exposure to Lehman securities
- Sept. 17: Russia suspends stock market trading  
LIBOR hits a seven year high  
Dow loses 449 points
- Sept. 18: Russia suspends stock market trading for the second consecutive day  
Central banks around the world pump \$180 billion into the markets in a joint effort to curb the crisis
- Sept. 19: The SEC and FSA ban short selling  
The U.S. Treasury offers temporary insurance to money market funds
- Sept. 21: The U.S. Treasury announces plans to take over distressed assets from the financial system in a \$700 billion bailout plan
- Sept. 22: Investment banking giants Goldman Sachs and Morgan Stanley are converted to commercial banks
- Sept. 25: Washington Mutual is seized by federal regulators and sold to JP Morgan, representing the largest U.S. bank failure
- Sept. 29: Citigroup announces plan to take over Wachovia  
The House of Representatives defeats the \$700 billion bailout plan  
Dow plummets 777 points, the largest ever one day point loss
- \*\*\*\*\*
- Oct. 3: The Emergency Economic Stabilization Act of 2008 is passed by the House and Senate, providing \$700 billion in federal aid (The approved version includes provisions such as \$150 billion in tax breaks for individuals and businesses as well as an increase in FDIC coverage up to \$250,000 from the current \$100,000 coverage amount)  
Wachovia turns down offer of takeover by Citigroup in favor of merger with Wells Fargo
- Oct.13: U.S. Treasury announces Troubled Asset Relief Program (TARP) which will give \$250B to nine leading financial institutions: Citigroup, Bank of America (with Merrill Lynch), Goldman Sachs, Morgan Stanley, JP Morgan, Wells Fargo, BONY, and State Street

## MARKET SUMMARY

### Equity Markets

|                                | <u>QTR</u> | <u>1 Year</u> |
|--------------------------------|------------|---------------|
| <b>U.S.</b>                    |            |               |
| S&P 500                        | -8.4       | -22.0         |
| Dow Jones Industrial Average   | -3.8       | -19.8         |
| NASDAQ                         | -9.0       | -22.1         |
| Russell 1000                   | -9.4       | -22.1         |
| Russell 2000                   | -1.1       | -14.5         |
| Russell 3000                   | -8.7       | -21.5         |
| <b>Non-U.S.</b>                |            |               |
| MSCI EAFE (Net)                | -20.6      | -30.5         |
| MSCI Emerging Markets (Net)    | -27.0      | -33.2         |
| MSCI All Country World ex U.S. | -21.9      | -30.3         |

### Bond Markets

|                             | <u>QTR</u> | <u>1 Year</u> |
|-----------------------------|------------|---------------|
| <b>U.S.</b>                 |            |               |
| Lehman Aggregate            | -0.5       | 3.7           |
| Lehman Gov/Credit           | -1.6       | 2.4           |
| Lehman Universal            | -1.2       | 2.3           |
| Lehman Corporate High Yield | -8.9       | -11.2         |
| <b>Non-U.S.</b>             |            |               |
| CG Non-U.S. World Govt.     | -4.3       | 5.2           |

### Non-Public Markets

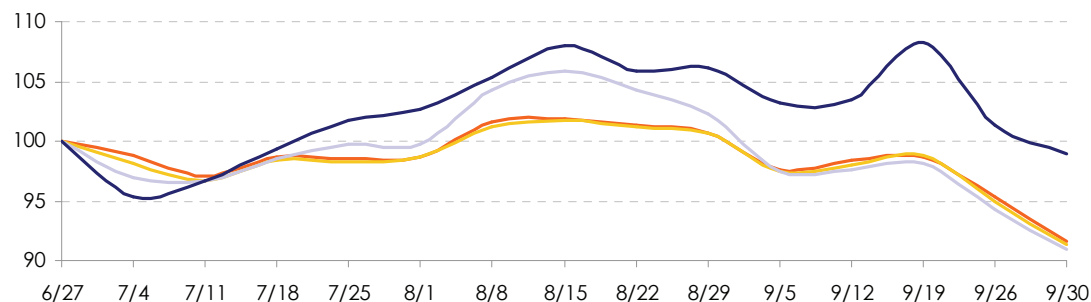
lagged quarterly

|                 | <u>QTR</u> | <u>1 Year</u> |
|-----------------|------------|---------------|
| NCREIF Property | 0.6        | 9.2           |

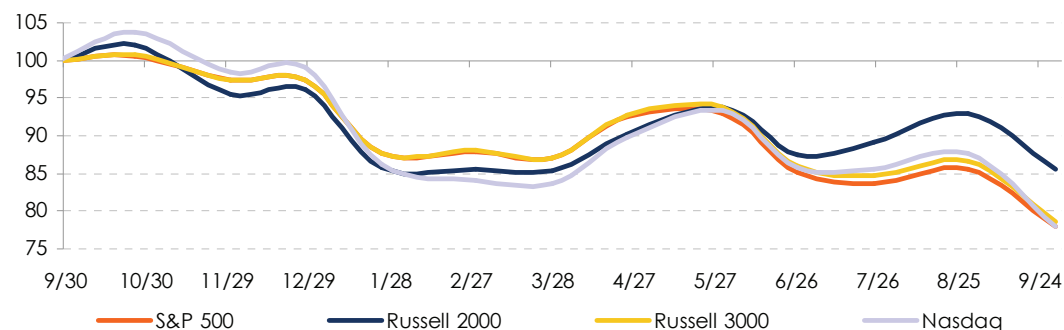
### U.S. Equity Market

- Markets held steady for the first two months of the quarter, before the dramatic downturn in September. In the past year, markets steadily dip further and further into negative territory.
- Small-cap stocks have held the advantage in the down markets as the Russell 2000 holds the top return for both the quarter and the past year.
- The Dow Jones Industrial Average fared better than the S&P 500 or NASDAQ, returning -3.8% for the quarter and -19.8% for the past 1-year.

Equity Index - Quarter Growth Rate



Equity Index - 1-Year Growth Rate

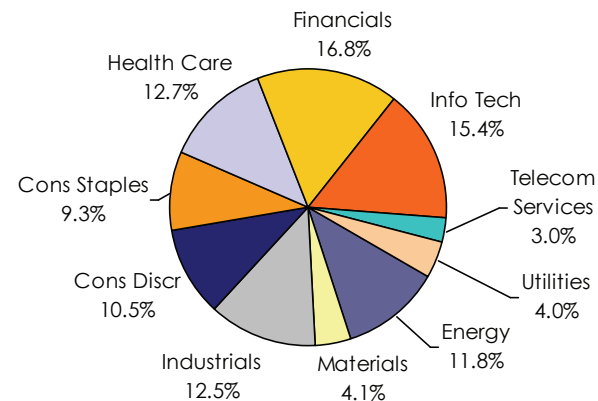


## DOMESTIC MARKETS

### Domestic Equity - Russell 3000

- Despite the crisis in the financial sector in the third quarter, it managed to grow +2.8%. Nevertheless, the past year has taken its toll as the sector is down -34.4%, the worst 1-year return in the index.
- Consumer staples continues to be the most reliable sector in the down markets of 2008, posting the best quarter and 1-year returns in the index (+4.3% and -4.0% respectively).
- Oil prices plummeted during the third quarter and the energy sector followed suit, falling -25.9%. The materials sector faced a similar downturn after success in the second quarter of 2008. It returned -27.4% for the quarter, representing the worst return in the index.

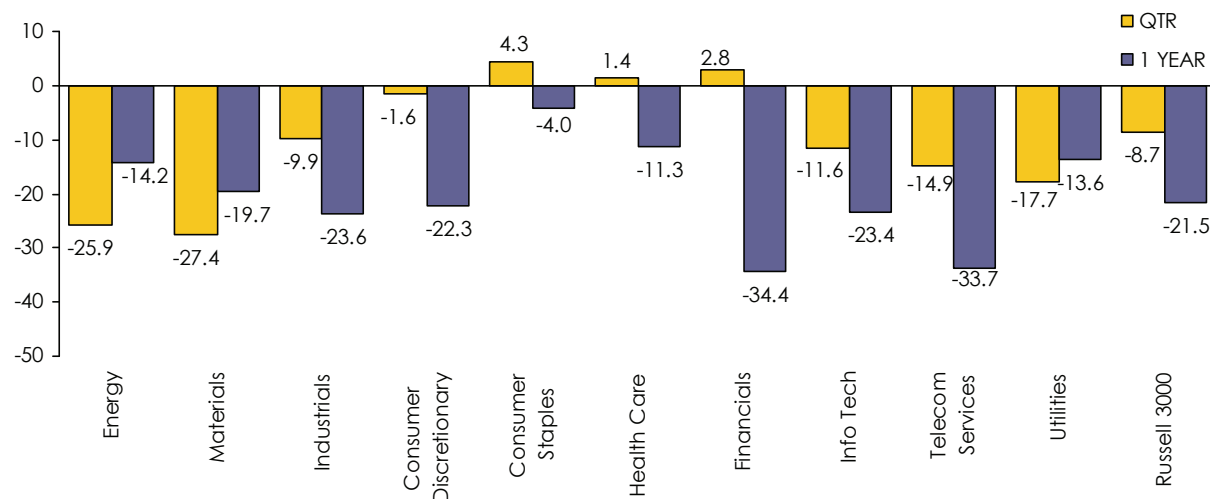
Ending Sector Weights



#### Characteristics

|                   |        |
|-------------------|--------|
| Div Yield (%)     | 2.2    |
| P/B Ratio         | 3.3    |
| P/E Ratio         | 16.0   |
| Fundamental Beta  | 1.1    |
| Market Cap \$(MM) | 70,828 |

#### Sector Returns (%)



#### Contribution to Return:

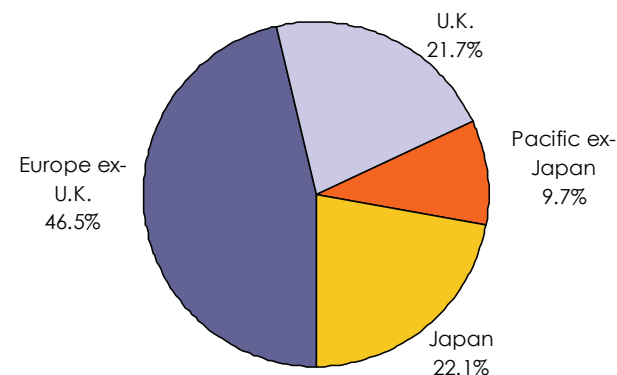
|      |      |      |      |      |      |      |      |      |      |      |       |
|------|------|------|------|------|------|------|------|------|------|------|-------|
| Qtr  | -3.7 | -1.4 | -1.2 | -0.1 | 0.3  | 0.2  | 0.4  | -1.9 | -0.5 | -0.8 | -8.7  |
| 1 Yr | -1.5 | -0.8 | -3.0 | -2.5 | -0.3 | -1.3 | -6.8 | -3.6 | -1.2 | -0.5 | -21.5 |

## INTERNATIONAL MARKETS

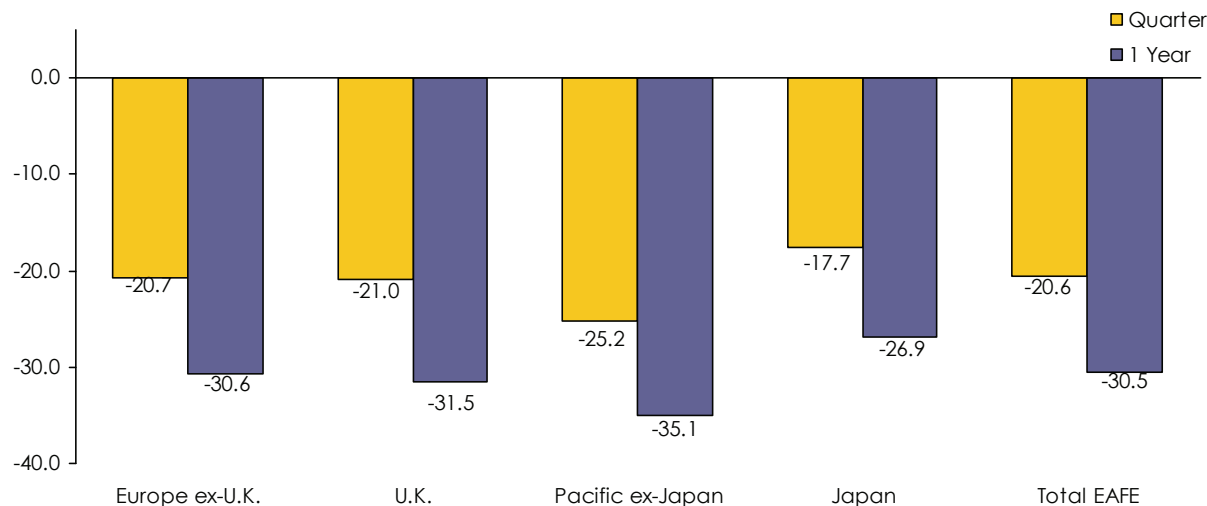
### Developed Equity—MSCI EAFE (Net)

- The MSCI EAFE Index returned -20.6%, posting the worst quarterly return in 18 years. The index's 1-year return, -30.5%, is the lowest in over 30 years.
- Japan's markets have remained relatively stable during the turmoil of the past quarter, the country has the highest regional return (-17.7%) for the second consecutive quarter.
- Pacific ex-Japan had the worst regional return of the quarter as Hong Kong, Australia, and Singapore all lost over 20%. The region had the best 1-year return just one quarter ago, yet now holds the worst return of -35.1%.
- This quarter's poor performance has pushed both Japan and the U.K.'s 3-year return into negative territory.

Ending Regional Weights



Regional Returns (%)



Contribution to Return:

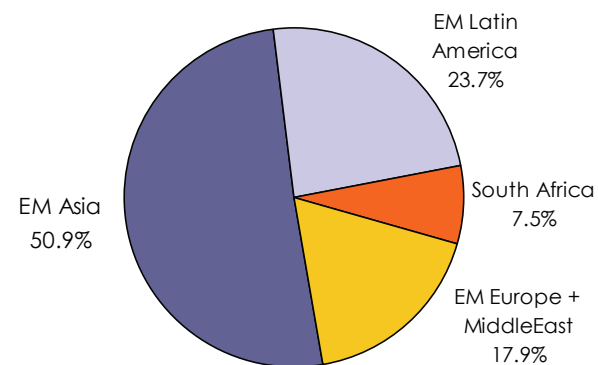
|      | Europe ex-U.K. | U.K. | Pacific ex-Japan | Japan | Total EAFE |
|------|----------------|------|------------------|-------|------------|
| Qtr  | -9.6           | -4.6 | -2.6             | -3.8  | -20.6      |
| 1 Yr | -14.4          | -7.0 | -3.5             | -5.6  | -30.5      |

## INTERNATIONAL MARKETS

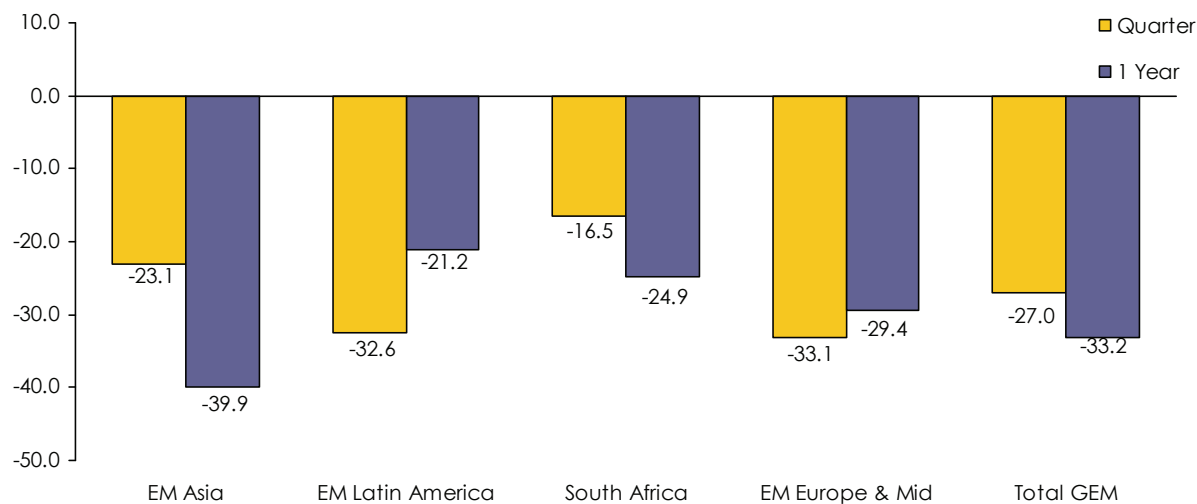
### Emerging Markets Equity - MSCI EM (Net)

- MSCI EM fell for the third straight quarter, posting the worst quarterly return in the 20 year history of the index (-27.0%). The 1-year return of -33.2% is the lowest since 2001.
- Natural resource heavy Russia and Brazil had significant difficulties in the third quarter, returning -45% and -38% respectively. Since each country comprises a large portion of their regions, Europe & Middle East and Latin America experienced the worst returns of the quarter (-33.1% and -32.6% respectively).
- EM Asia out-performed the broad index due to China and India's returns for the quarter (-25.2% and -13.9% respectively). These two countries however, experienced significant down-turns in the first two quarters of the year. India has returned -37.8% in the past 1-year and China has the lowest 1-year return of any country in the MSCI EM Index (-46.9%).

Ending Regional Weights



Regional Returns (%)



Contribution to Return:

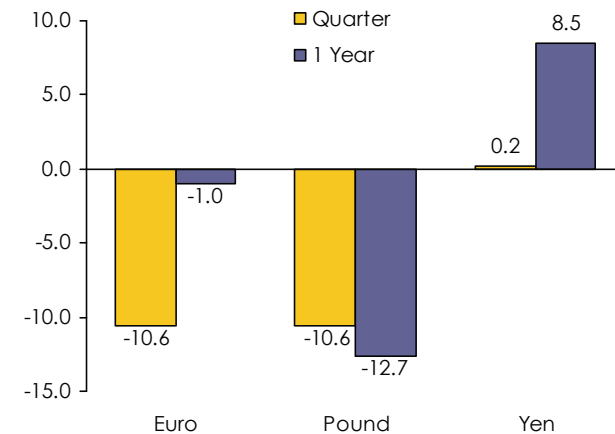
|      | EM Asia | EM Latin America | South Africa | EM Europe & Middle East | Total GEM |
|------|---------|------------------|--------------|-------------------------|-----------|
| Qtr  | -11.2   | -8.3             | -1.1         | -6.4                    | -27.0     |
| 1 Yr | -22.2   | -4.2             | -1.7         | -5.1                    | -33.2     |

## CURRENCY AND BOND MARKETS

### Currency Markets

- The dollar enjoyed its best quarter against the euro since the inception of the currency in 1999, and the best quarter against the pound in over a decade. This success was not due to U.S. strength but rather a pessimistic outlook for the other currencies.
- After the gains made this quarter, the dollar has halted its recent trend of devaluation. The dollar is now trading at the same level versus the euro as one year ago, and at the same level versus the pound as 2.5 years ago.
- The financial crisis weighed significantly on the dollar in September, however overall the currency fared well. The yen, long considered a safe haven in uncertain times, posted large gains in September closing out the quarter with a slight edge over the dollar.

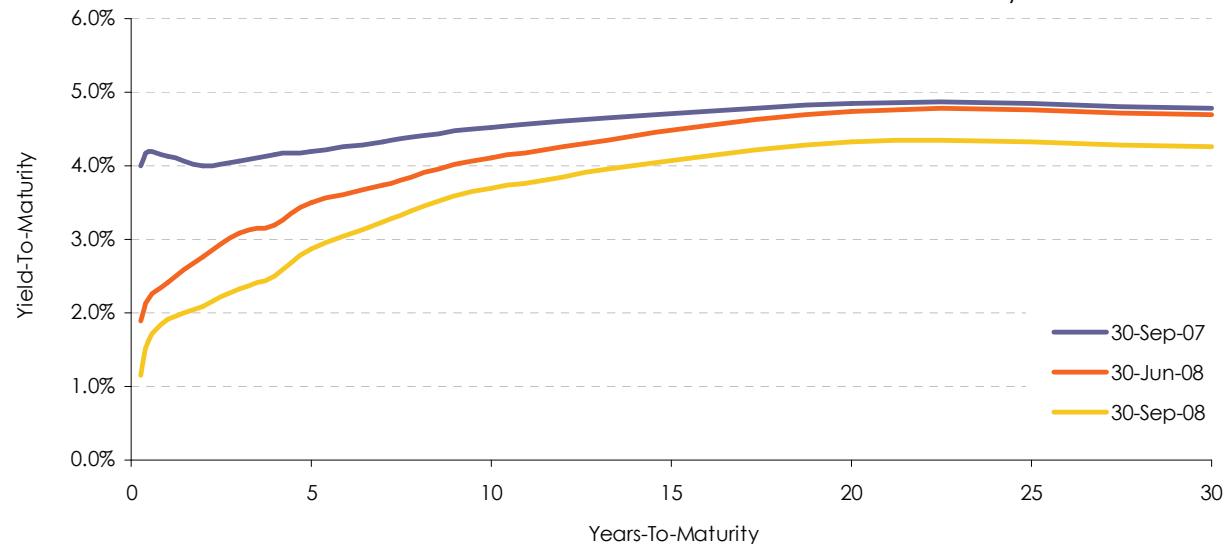
Currency Returns (%)



### Yield Curve

- Interest rates were held steady at 2.0% during the entire third quarter. Emergency action was taken in the opening weeks of the fourth quarter in response to the financial crisis. The Fed lowered the key interest rate to 1.5% on October 8th.
- The Fed remains in a tough position going forward as a balance must be made between cutting rates to spur economic growth and lending between banks, and raising them to calm inflationary pressures.

INTEREST RATE TERM STRUCTURE  
Government Issues - 3 Months to 30 Years Maturity

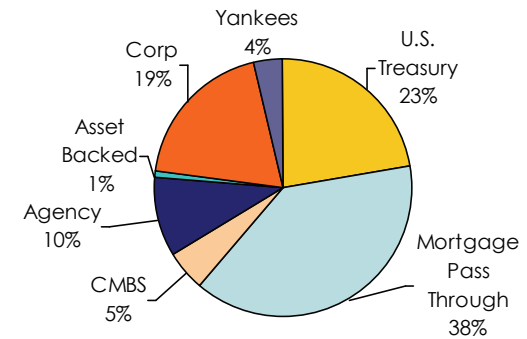


**BOND MARKETS**

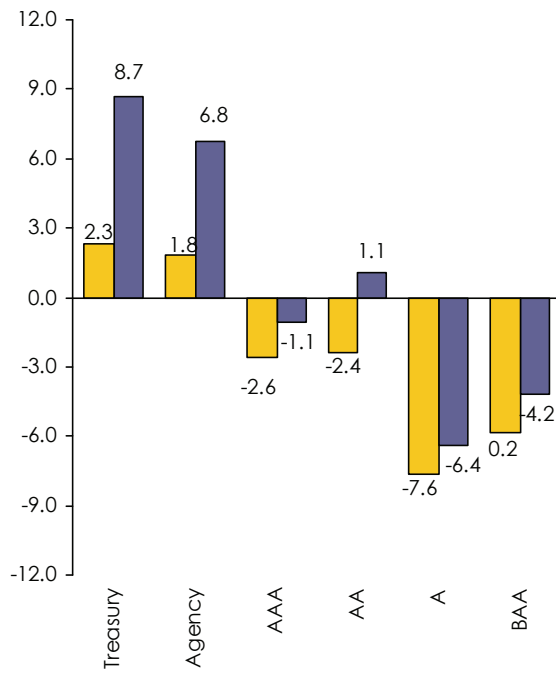
# U.S. Bond Market Returns - LB Aggregate

- Bond markets survived the turbulent third quarter quite well, posting only a minor loss. The performance was split along quality lines, as investors abandoned potentially defaulting low quality instruments in favor of high quality treasuries, thus pushing values up and yields down.
- Treasury instruments rebounded from a poor second quarter by posting the best return in all sectors and qualities. The corporate sector provided the worst returns of the quarter (-7.6%). Considering the sector's 20% weighting within the index, this poor performance weighed heavily on the index overall.
- The Lehman Brothers Aggregate Bond Index returned -0.5%, out-performing the shorter duration Lehman Brothers Intermediate Government/Credit Index return of -3.4%.

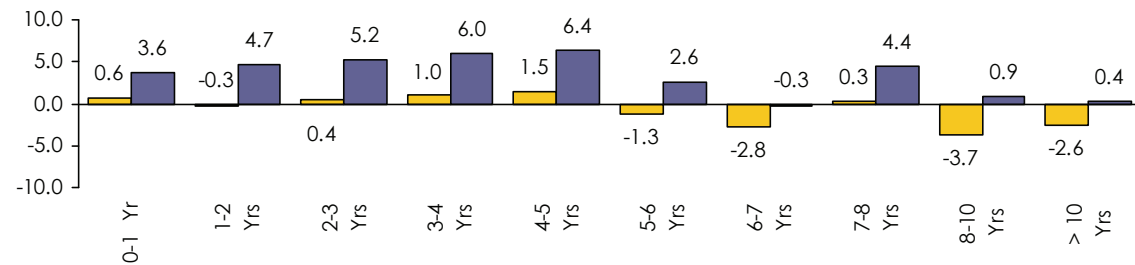
Sector Weights



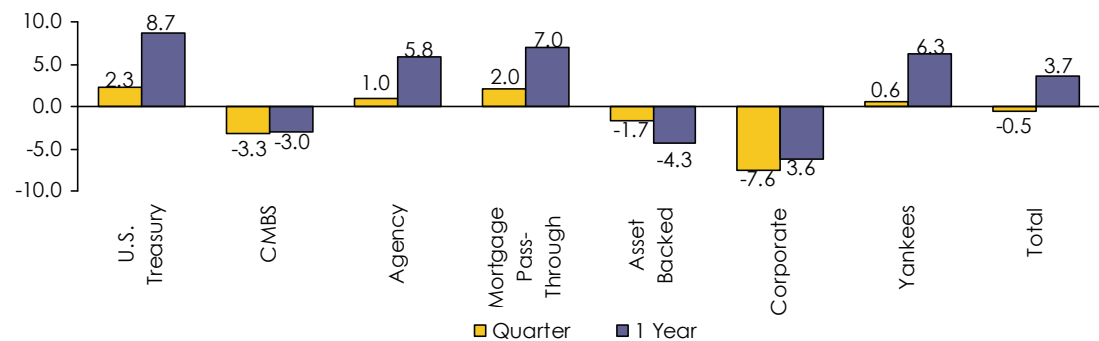
Quality Performance (%)



Duration Performance (%)



Sector Performance (%)

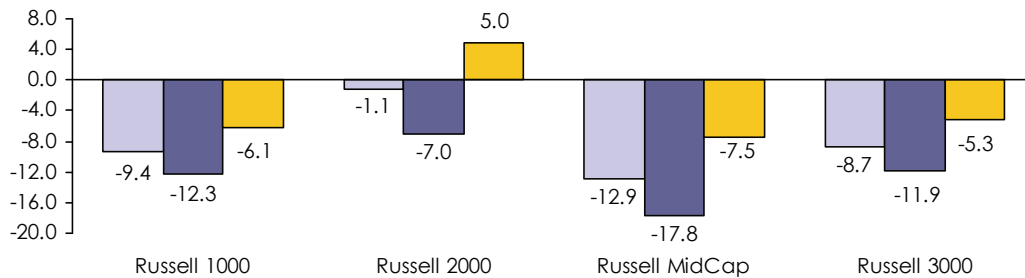


**STYLE & CAPITALIZATION**

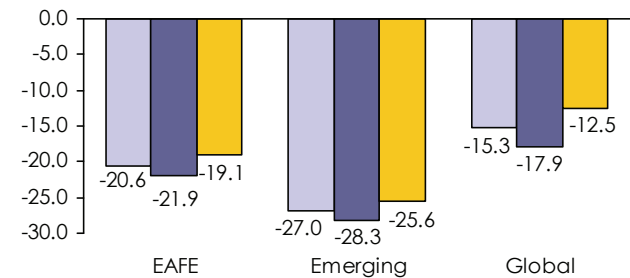
# Style & Capitalization Returns

- Value stocks provided the best returns in the down-markets of the third quarter, recording the top return in each capitalization size. Growth stocks struggled, erasing a large portion of their previous lead over value in the 1-year return.
- Small-cap stocks provided the best returns in all styles in the third quarter. The Russell 2000 Value Index recorded the only positive return of the quarter (+5.0%). At the end of the second quarter, small-cap stocks held the worst 1-year returns. Just one quarter later, this capitalization size holds the top return in all styles.
- Global markets provided the best returns of the quarter, as the U.S. out-performed international markets. For the first time since the fourth quarter of 2006, value stocks provided the best quarterly returns in EAFE, global, and emerging markets.

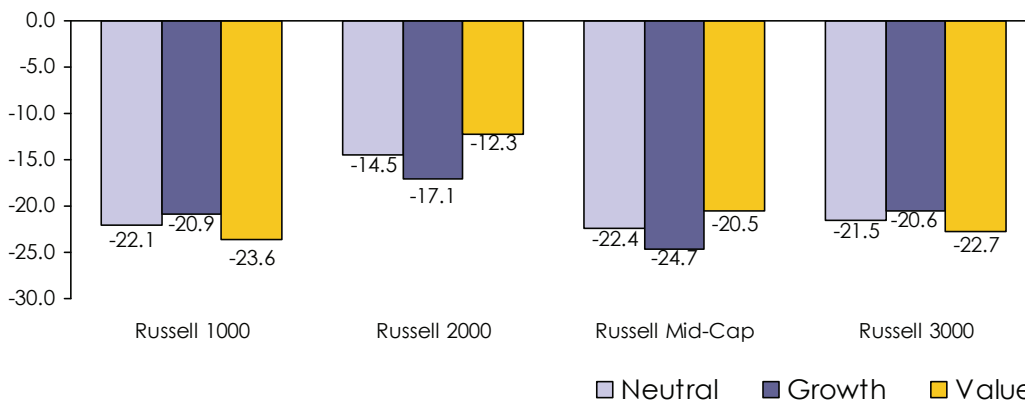
**Russell U.S. Style Returns - Quarter**



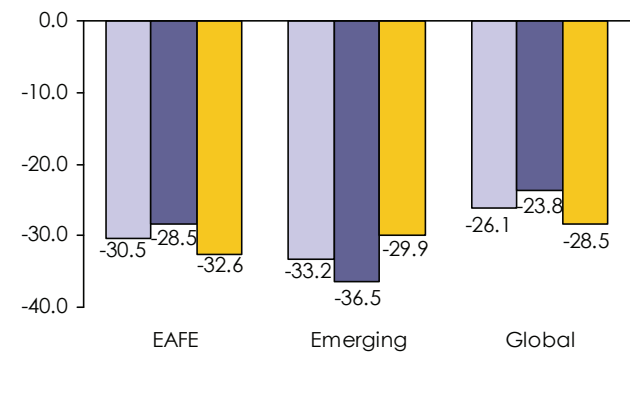
**MSCI Non-U.S. Style Returns - Quarter**



**Russell U.S. Style Returns - 1 Year**



**MSCI Non-U.S. Style Returns - 1 Year**



■ Neutral ■ Growth ■ Value

# ENVIRONMENT

Independent Consultants Cooperative (ICC)

MARKET ENVIRONMENT is published quarterly by:

State Street Corporation  
State Street Investment Analytics  
Institutional Investor Services  
Post Office Box 5501  
Boston, MA 02206-5501

[www.statestreet.com/analytics](http://www.statestreet.com/analytics)

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