



Newsflash

A new month and the twenty seventh issue of Viewpoint from FP.

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October 2008 began with the US Senate voting on a revised economic rescue package of USD700 billion, and their European counterparts still pondering whether they should join this effort. Now, at the end of a tumultuous month, we are speaking of a global stimulus effort exceeding USD4 trillion (including China's USD586 billion plan), and some market players wonder if even this is enough. Even if it is theoretically sufficient to finance the required bailouts, questions also remain on whether it will be used to create liquidity and restore trust rather than just propping up banks' balance sheets. How much the world as we know it has changed over the last couple of weeks!

The storm in the markets started with the sub prime crisis amongst mortgage lenders, and then moved on to large banks and other financial institutions. From the United States the effects quickly spread to Europe, Latin America, Asia and Africa, with several well known investment banks and insurance companies having to be rescued, and Lehman Brothers being left out in the cold. Add to this a number of countries that are on the brink of bankruptcy, following in Iceland's footsteps. This promises to fuel unemployment and inflation, and these countries' ability to raise much needed capital is severely impaired, no matter how much they increase their interest rates. Notable countries on this list are Argentina, Pakistan and the Ukraine. In the rest of the world short-term deflation is being priced into markets, with implied default rates in the high yield markets as high as 50% over four years. Against this background markets showed historically unrivalled volatility in October.

Globally equity markets were hit, and hit again, going into October. Most major indices saw daily declines all the way to 10 October, the dates on which the S&P 500 bottomed in 1907 and again in 2002. Defying history, markets went on to hit new lows on the 27th of the month. The S&P 500 closed October at levels last seen in 2002, and before that in 1998 (fig 1). In all of this the Dow Jones Industrial Average recorded four of its top ten largest

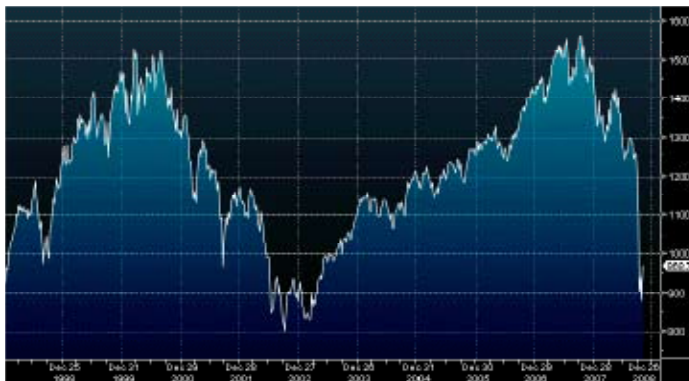


Fig 1: S&P 500
Source: Bloomberg

daily point losses, and three of the top ten largest daily point gains in its 112 year history. Equally it recorded one of the top ten largest daily percentage losses, and two of the top ten largest daily percentage gains ever. This unprecedented volatility once again underlined the old adage that it is time in the market, and not timing the market, that produces returns over the long term.

Overall global equities lost -19% during the October blood bath, taking the YTD contraction to close on -39%. The major indices were hit across the board, with Japan leading the pack losing more than a fifth of its value during the month. US markets

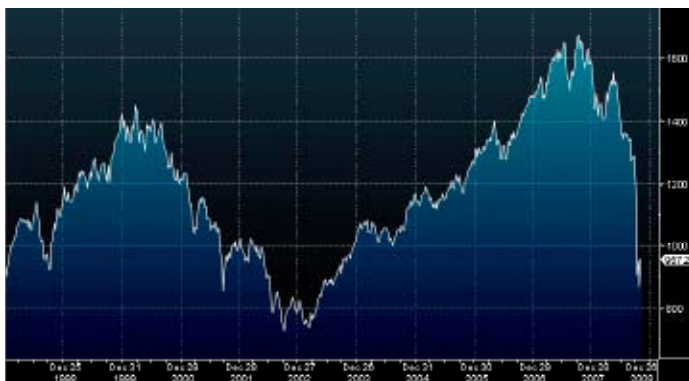


Fig 2: MSCI World
Source: Bloomberg

returned -16.8%, with the United Kingdom and Continental European equities returning -11.9% and -13.9% respectively. The currency losses of the European and UK markets against the US dollar had a further negative impact for global investors on these markets' equity returns. Bullish investors looking for a re-entry into equity markets saw the same volatility going into November, with most indices now at levels similar to or below the October closing values, but still up from the lows recorded on 27 October. At the time of writing the rate cuts that we saw across a number of central banks have not yet managed to rekindle investor confidence that has all but disappeared through the course of this year. An increase in inter-bank lending and sustainable reduction in inter-bank lending rates will be a good leading indicator of trust returning to the markets.

The performance of emerging markets as of late has dealt a serious blow to the decoupling theory (at least with regards



Fig 3: BRIC equity indices
Source: Bloomberg

to stock markets and not necessarily the economies), as they continue to follow in the footsteps of the major indices. In most instances they have in fact surpassed the losses of the economic powerhouses with the BRIC countries (Brazil, Russia, India and China) giving up between -50% and -70% of their value at the start of the year. Emerging markets in general lost more than -27% in October, taking the year to date decline to -53.2%. With historically low levels of confidence in the ability of companies in emerging markets, and even emerging countries, to repay debt, volatility is sure to continue in emerging markets.

Short term yields in government backed securities have declined in line with the flight to quality that we saw in October, but a sell off on the longer end of the yield curve saw US bonds in negative territory at -0.1%, and a year to date return of 4.6%. Japanese and European bonds were in positive territory, returning 0.9% and 0.5% percent respectively, in local currency terms. This means that bonds in the land of the rising sun have now returned 1.5% to their holders since the start of 2008, with European bond holders sitting pretty at 4.2%.

Looking at the corporate credit and bond markets we continued to see spreads remaining at very high levels. Up to around July 2007 the option adjusted spread of high yield corporate bonds was between 200 and 400 bps over US treasuries. These are currently sitting at close on 1600 bps.



Fig 4: Option adjusted spread of US High Yield Corporate Bonds
Source: Bloomberg

This spread implies a default probability of 50 out of every 100 bond issuers over a four year term, an extremely unlikely event in our view. These assets experienced the same level of sell-off as seen in the equity markets, and as a result left investors in these instruments nowhere to hide in the last month's storm. This is certainly an asset class on which one should keep a very close eye as opportunities for solid returns off a relatively low risk base are sure to arise.

Currency markets mimicked the main theme of fixed interest – a flight to safety. Stores of value in the currency markets were viewed as US Dollar and Japanese Yen holdings, with emerging market and European currencies, including pound

sterling, bearing the brunt of this move. Both the euro and Sterling lost close to 10% against the Greenback, and more than 17% against the Japanese currency, as investors look to the States to lead us out of the recession gripping the world at the moment. Dollar strength appears unsustainable in the medium term given a number of factors, including their fiscal deficit reaching 6% of GDP in the next year.

Emerging market currencies had a difficult time during the last month, and for the year to date even the developed world's currencies have shown a lot of weakness against both the Dollar and the Yen. The chart below shows the performance of a basket of currencies against the US Dollar for the year to date. Not shown here is the Iceland Króna which has lost more than 40% in value against the dollar following the near collapse of its financial system.

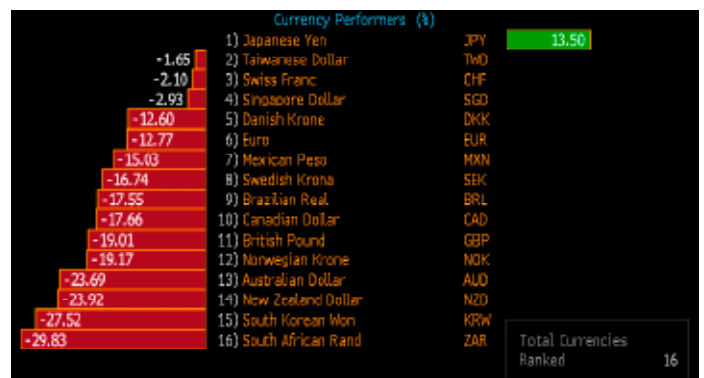


Fig 5: Currency performance vs the US Dollar
Source: Bloomberg

The US listed property equity market held up well to the end of September, but lost in the vicinity of 32% during October to join the UK and European markets in the sub 30% loss category for the year to date. Asian property has had a particularly tough time in the last year, recording a 20% plus loss for October, taking the decline for the year to date to over -50% of its value at the end of 2007.

Physical and agricultural commodities continued their slide losing around -25% and -17% respectively in the last month. The impending global recession has negatively impacted commodity prices, and inflation fears are, at least for the time being, relegated to the past. Oil has continued its drop



Fig 6: US Crude oil
Source: Bloomberg

that started from over USD140 per barrel at the end of June to around USD60 at the end of October. Even gold, which

traditionally is viewed as a safe haven in volatile markets, was down 17.4% for the month taking it into negative territory (-12.5%) for the year.

There has been a lot of publicity on the deleveraging taking place in the markets, and most of this through the actions of investors who borrowed money to invest in assets now worth a lot less than what the purchase price was. The USD2.5 trillion hedge fund industry is part of the scramble to sell distressed assets in order to create liquidity to meet the growing call for redemptions. Credit downgrades of securities across the board have also added fuel to the fire. In our Focus section we investigate this phenomenon in more detail.

Asset Class Performances

Asset Class Performance (%)	October 2008	2008 YTD
US Equities \$	-16.8	-33.2
UK Equities £	-11.9	-31.3
Cont. European Equities €	-13.9	-38.1
Japanese Equities Yen	-20.3	-40.1
Global Equities \$	-19.0	-38.6
Global Emerging Markets Equities \$	-27.4	-53.2
US Bonds \$	-0.1	4.6
European Bonds €	0.9	4.2
Japanese Bonds Yen	0.5	1.5
Global Bonds \$	-3.4	-2.8
US REITs (property) \$	-31.8	-30.6
FTSE Real Estate £	-22.3	-36.8
FTSE EPRA Real Estate ex UK €	-21.3	-38.2
FTSE EPRA Real Estate Asia \$	-20.9	-52.9
Euro vs. US Dollar	-9.7	-13.3
Sterling vs. US Dollar	-9.4	-18.8
Yen vs. US Dollar	7.9	13.6
Rand vs. US Dollar	-15.9	-30.6
Commodities \$	-24.9	-29.1
Agricultural Commodities \$	-17.3	-30.6
Oil \$	-34.6	-32.6
Gold \$	-17.4	-12.5

Source: Bloomberg, Lipper, Citigroup, November 2008.

FOCUS: Deleveraging – who’s to blame?

Much has been written about deleveraging in the markets since the collapse of two Bear Stearns hedge funds in July 2007, and the topic continues to make headline news more than a year down the line. In essence the current deleveraging is a consequence of investors’ need for liquidity and search for safe havens, which in turn was caused by a lack of trust between counterparties.

Many investors, and more particularly hedge funds and investment banks, have borrowed (and extended loans) extensively and at spectacularly low risk premiums, leveraging their balance sheets in the search for alpha (or profit in the case of investment banks). Loan to value ratios were based on the perceived quality of the asset backing the loan, and quality in most instances would be defined by the rating assigned to the asset by one of the ratings agencies. Once the market realised that some assets were of much lower quality than its rating suggested, large sell offs and rating downgrades happened in tandem, and it became a vicious spiral as confidence evaporated, initially quite gradually, and then at a blistering pace into September and October of this year.

Market commentators, investors, asset managers and regulators have attempted to determine who should be blamed for this calamity, but it is a lot more difficult to name the culprit (or culprits) than one may think. In the United States regulations around hedge funds have been slightly more relaxed relative to the rest of the world, but recent reports suggest that there is growing pressure on the US administration to create a much more regulated framework in which hedge funds must operate. Hedge fund managers indicated in a hearing of the US Congress House Committee on Oversight and Government Reform that they were not culpable in the financial meltdown. They suggested that those to blame may be the “financial system itself”, or even credit ratings agencies who facilitated the sale of “sows’ ears ... as silk purses” through “fanciful” ratings of mortgage-backed securities (or more specifically the structures containing these securities).

In his testimony George Soros said “the first and foremost point is that the regulators must accept responsibility for controlling asset

bubbles.” He went on to suggest five other main implications of the new paradigm for the regulation of financial markets:

- To control asset bubbles it is not enough to control the money supply – credit must also be controlled
- Controlling credit requires reactivating policy instruments which have fallen into disuse, notably, margin requirements, and minimum capital requirements for banks
- New regulations are needed to ensure that margin requirements and the capital ratios of banks can be accurately measured. The alphabet soup of synthetic financial instruments (CDOs, CDSs, ETSs, and the like) have made risks less transparent and harder to measure. These new products will have to be registered and approved before they can be used and their clearing mechanism has to be regulated in order to minimize counterparty risk
- Since financial markets are global, regulation must also be international in scope, and
- Limits on credit and leverage will have to be set substantially lower than those that have been incorporated in the Basel Accords on bank regulation. Basel II, which delegated authority for calculating risk to the financial institutions themselves, was an aberration and has to be abandoned. It needs to be replaced by a Basel III which will be based on the new paradigm

Mr Soros’ suggested course of action should be read in the light that he, and the four other hedge fund managers that testified with him, broadly agreed that largely unregulated financial vehicles ought to be subject to greater disclosure, though they warned of excessive regulation. He also estimated the approximate USD2.5 trillion hedge fund industry to contract by between 50% and 75% over the next couple of months.

Short selling has also been mentioned as a culprit that initiated the current market turmoil, but Philip Falcone, Senior Managing Director of Harbinger Capital Partners Funds, stated that “short selling is a valuable, longstanding feature of our markets”. He added that it was not the short selling that put companies out

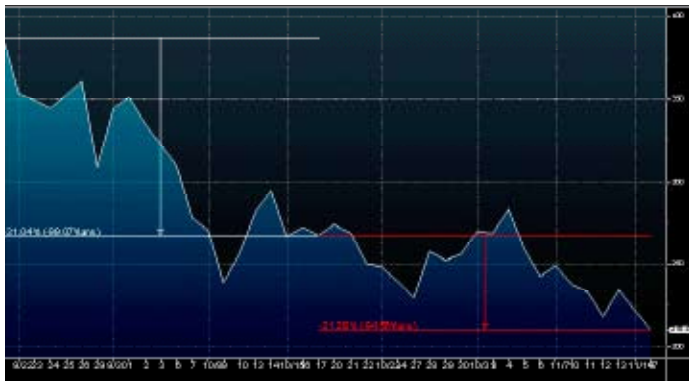


Fig 1: Dow Jones US Financials
Source: Bloomberg

of business, but rather over-leveraged balance sheets, poor management decisions and flawed business plans that need to carry the can. The US Securities and Exchange Commission (SEC) imposed a ban on short selling on 19 September, and while it was in place the Dow Jones US Financials Index lost more than 30%. Since the ban was lifted on 17 October, the index gave up 20% to 17 November.

Crucial to the survival of hedge funds are the banks acting as prime brokers – they provide a range of key services from custody to lending to the alternative strategy industry. For reasons explored earlier they have become more risk averse and have in some cases withdrawn financing for new or impending



Fig 2: HFR Convertible Arbitrage Index
Source: Bloomberg

deals, or the refinancing of existing positions. This action from banks, combined with clients' nervousness following recent negative performance of hedge funds lead to redemptions. This meant that some hedge funds had to sell more assets into falling markets. This growing momentum on the supply side causes

further losses and increasing negative sentiment from investors – a vicious circle which will change the hedge fund industry as it exists today. In September Morgan Stanley and Goldman Sachs announced that they were increasing their required margins which meant their clients were forced to use less leverage. This action from the prime brokers contributed to a 50% decline in the convertible arbitrage index in a couple of weeks, illustrating the impact of deleveraging on markets.

This is not to say that the hedge fund industry is to take all the blame for the recent market turmoil; investment banks have been just as involved, through facilitation of, as well as participation in, the same investment practices used by hedge fund managers. One could argue that these banks had even fewer regulations to adhere to, but Lehman Brothers' shareholders et al paid the ultimate price for less than astute lending, borrowing and market making practices.

Ultimately the result of deleveraging is that many managers are forced to sell assets into falling markets at large discounts – a matter of distressed sellers much more than distressed assets. Through the higher price of credit and much stricter lending practices being applied there are fewer buyers in the market to stop the fall. Funds with spare cash and investors who have fewer liquidity concerns such as private equity and sovereign wealth funds, as well as national treasuries, will ultimately be able to purchase good quality assets at distressed prices. There will consequently be a major transfer of ownership from market players searching for liquidity to those that have liquidity, which begs the question whether the disregard paid to liquidity risk premiums as of late has also played a role in exacerbating this crisis.

The ultimate culprit in one of the major market shocks of all time may never be pinpointed. What is important though is that all investors, whether affected or not, take note of the factors that were overlooked in the build-up to the turmoil. Liquidity (or the lack thereof) has a price, and many investors have paid it recently. A number of sectors in the investment industry will have a permanent change of face, and more consolidation is sure to take place. Hedge funds

and investment banks can expect a much more regulated operating environment and the creation of clearing houses for the trading of a number of derivative instruments are already being discussed.

In conclusion it is clear that hedge funds were by no stretch of the imagination the only actor in the drama that unfolded in the last year. That this industry will emerge in a different

shape than before is very likely, and in what form exactly will soon be clear. Even then hedge funds will still be valuable in constructing efficient portfolios, if used correctly, let us not forget that hedge funds are only down -11.82% as of end of September (HFR Fund of Funds Index). Most importantly investors must be aware of and able to accept the liquidity constraints that are associated with this asset class, because liquidity, as we have all clearly seen, has a price.

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