Financial MARKET COMMENTARY

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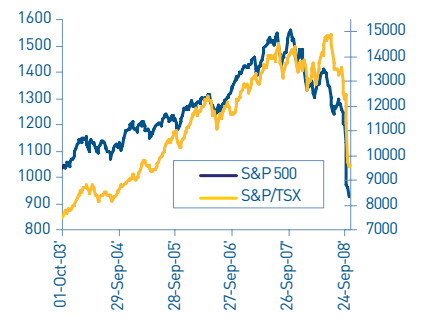
What Are We To Make Of The Current Financial Turmoil?

Since early September, hardly a day goes by without some major financial event hitting the headlines: from spectacular bank failures to government bailouts, from commodity price freefall to stock market meltdown and unprecedented currency volatility. The search for adjectives to properly describe this "once-in-a-lifetime" confluence of events is almost as intense as the events themselves...

The sequence of events is well known by now: Concern about the broadening economic and financial impacts of the deflating U.S. housing market bubble first hit markets in the summer of 2007. What was particularly shocking was the rather lax underwriting standards behind many residential mortgages that were then heavily securitized and widely distributed globally. Central banks in North America and Europe reduced policy interest rates massively (at least in North America), injected huge amounts of liquidity to support the financial system and dealt with weakened financial institutions on a case by case basis.

Up until the summer of 2008, this approach appeared to be working as markets were able to "absorb" the collapse of Bear Stearns and an intensifying housing market correction. Nevertheless, increasingly higher (and deeply abnormal!) commodity prices, energy in particular, were beginning to undermine this approach. In retrospect, a real or perceived inflationary threat resulting from the commodity price spiral proved to be the straw that broke the camel's back. Market interest rates, mortgage rates especially, started rising again in June, which led directly to the near collapse of Fannie Mae and Freddie Mac. This, in turn, set in motion a cascading series of events.

Canadian and US Stock Indices



Source: Haver Analytics

In unbelievably quick succession from September 7th, Fannie Mae and Freddie Mac were nationalised, Lehman Brothers went bankrupt, and AIG was taken over by the U.S. government. The focus then quickly shifted to Europe but not before other large American financial institutions were either taken over by competitors (Merrill Lynch, Washington Mutual and Wachovia) or forced to restructure (Goldman Sachs and Morgan Stanley). Market confidence plunged, equity values crashed, interbank lending seized up and consumer and business confidence melted like snow in July. Investors were left numb by the scale and speed of market movements: the S&P/TSX went from 13,771 on August 29th to 9,150 two short months later, a 33.5% plunge; the U.S. S&P500 lost 26.7% in the same period.

But Did Something Fundamentally New Happen In October To Justify The Sharp Declines?

Other than sheer panic, it is hard to point to any one specific factor that would satisfactorily explain the turmoil of the past month. Increasing uneasiness about the state of the global economy has something to do with it but, it cannot truly be said that the real possibility of a global recession is a new development. For about one year now, many analysts, ourselves included, have been pointing to the fact that **there is no decoupling**, that whatever happens in the United States still has a huge impact on the global economy. With the U.S. economy already in a consumer-led recession, it would be unreasonable to expect the global economy to escape unscathed, even if the global banking system were functioning normally. Having said that, we also doubt that the coming global recession will be anywhere as severe as markets are currently pricing in. To be sure, a recession is always a serious event, characterized by a damaging rise in unemployment, business bankruptcies and loan losses. But the very aggressive policy measures taken by governments and central banks in North America and Europe will pay dividends in due course. Moreover, the large emerging market economies, namely India and China, are more resilient than what the pessimists give them credit for, particularly regarding the strength of their domestic demand.

Finally, it is also entirely possible that the "great financial panic of October 2008" was made worse by unrealistic expectations about the speed with which extraordinary policy measures start to pay dividends.

How Much Further Down Can The Markets Go?

Picking market bottoms is obviously a tricky and uncertain process. Like most investors, we believe in the idea of **capitulation**, that is to say, the point at which large numbers of investors give up all hope of recovering their losses and are willing to bail out of the market at any price. This is usually marked by a sudden burst in the volume of transactions and volatility. The point is that there comes a time when all those desperate to get out have done so, a bottom is reached, bargain hunters move in and markets start to recover.

Credit Risk: TED Spread Spread Between 3-month T-Bills and Eurodollar Rates

Source: LBS Economic Research, Haver Analytics

Might that time be now? Impossible to say for sure! Nevertheless, with confidence slowly but surely returning to the interbank market (as shown by the narrowing "Ted Spread"), we may well be nearly there. **Restoring confidence**, then, is the necessary first step in this recovery process. And that is precisely the primary objective of the extraordinary policy measures undertaken on both sides of the Atlantic in October. While nobody can be certain **when** these measures will start to gain traction, and hence great caution is still required, it would also be a mistake to assume they will have no effect at all.

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