

## Financial markets back from the abyss – but will it work?



### Oliver's insights

#### Key points

- The move to a comprehensive solution to the financial crisis by US authorities substantially removes the risk of a financial meltdown.
- The ride for investors will remain rough though as the solution does little to prevent further economic deterioration over the year ahead.
- However, with shares already cheap and the risk of a meltdown/global depression likely to recede there is now a good chance that we have seen, or at least come very close to, the low for the bear market.

#### Introduction

The last week or so has seen an extraordinary set of events which saw shares first plunge following the failure of investment bank Lehman Brothers and the “rescue” of American International Group (AIG), only to surge on the back of plans by the US Government to buy bad and illiquid debt from financial companies along with bans on short selling. But the big question is – will the rescue efforts work? This note looks at the key issues.

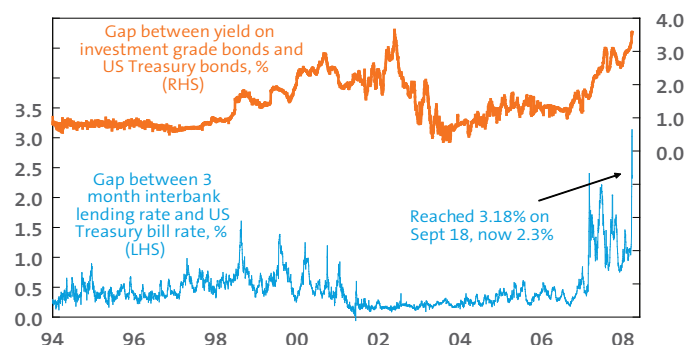
#### A quick summary of what has gone down

The events of the last few weeks have their origin of course in the sub-prime mortgage crisis in the US which has led to massive financial losses so far – about US\$521 billion and still counting. This has seen numerous flare ups since February 2007 when the problem first came to prominence, then in August last year when banks and other financial institutions first started to balk at lending to each other for fear that their counterparties may have sub-prime skeletons in the closet. This occurred again in January this year as losses started to really mount, and again in March when US investment bank Bear Stearns had to be rolled into JP Morgan and more recently in mid July.

The ongoing mortgage losses had all led to a situation where Fannie Mae and Freddie Mac, two US mortgage lenders and guarantors which are associated with 50% of US mortgages, had to be taken over by the US Government in early September as their capital was running down. This “rescue” was well and good, but then Lehman Brothers had to file for bankruptcy after US authorities refused to bail it out. Merrill Lynch put itself up for sale to Bank of America (presumably to avoid the same fate) and one of the world's largest insurers AIG had to be granted a loan by the US Federal Reserve (Fed). This all led to a perception that the US authorities were losing control, and there was talk of a financial meltdown.

As a result of all this, shares plunged early last week, private sector borrowing rates surged and investors piled into government debt pushing government borrowing rates down (in fact to near zero in the case of US 3-month Treasury bills). The upshot was that the credit crunch that has now been running for a year or more intensified and on many measures was looking more serious than ever. See the next chart.

#### The latest blow out in money market and credit spreads



Source: Bloomberg, AMP Capital Investors

The initial reaction by US authorities was more of the ad hoc responses seen over the last year such as widening the collateral the Fed would accept in return for loans and a coordinated move by global central banks to increase the amount of US dollars they will lend. However, when it became increasingly obvious these were not working, US authorities announced that they were working on a plan to buy bad debts that no one wants from financial companies and warehouse them until they can be sold in more normal conditions in the years ahead. This move is something like the Resolution Trust Corporation (RTC) did in response to the crisis in US Savings and Loans companies in the late 1980s or early 1990s. Talk of this along with bans on short selling in financial stocks in the US, UK and several other countries (with Australia banning all short selling) saw shares rebound dramatically, with many developed markets up 8% to 9% over two days and the Chinese and Russian share markets up by far more (helped by moves to boost their markets).

#### Ideology

The extraordinary intervention by US authorities raises a number of issues from a philosophical point of view. Some have said that we now seem to have “capitalism on the way up, but socialism on the way down”. Why shouldn't financial companies that take on too much debt and make bad investment decisions pay for their mistakes? Some complain that market forces should be left to run their course. What signal are we sending – that if you are too big to fail you will be rescued and the government will relieve you of your bad debts or ban investors from short selling your shares? Why just bail out financial companies – what about auto companies? Why are the authorities in so many countries so eager to ban people from short selling shares but didn't stop people from buying shares with money they didn't have on the way up?

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But the US authorities would argue that if they didn't move towards a bank bailout the money markets would continue to meltdown as they were starting to last week. And this would have real economic consequences for Main Street as the cost of borrowing would have gone higher and the availability of money to borrow would have spiralled down. This would be in no one's interest. I agree.

### Will it work?

As such, for pragmatic investors the real issue is: will it work? Our assessment is that it will. Bad debt is the problem. Right now it has to be sold at fire sale prices as no one wants it. And its presence is hindering normal interactions between financial institutions and their ability to raise necessary capital. So it makes sense to take it out of the system and warehouse it for a few years until the market calms down and only the Government can do this. Certainly it worked with the RTC in the early 1990s.

To be sure, the euphoric initial bounce in share markets proves nothing – we saw a similar post plunge rebound in late January only to see the bear market resume. **Several considerations will ensure a rough ride going forward:**

- Firstly, the bailout itself has yet to pass Congress (and needs to do so quickly given the coming election) with Democrats already seeking to add provisions relating to areas such as executive pay and helping people stay in their homes. In the interim there could be more financial institutions that run into trouble.
- Secondly, there is the issue of the price that the US Treasury or new RTC-like entity will pay for the bad debt. This will be set by reverse auctions with those offering the lowest prices for their debt achieving the sale. If the price is too high it will entail more risk for taxpayers, but if the price is too low it won't help the financial companies and in fact will only force more asset write downs to the new low price. So the right balance will need to be struck. Note that this issue was not faced by the original RTC in the late 1980s/early 1990 as it only had to dispose of assets from savings and loans companies that had already gone bust.
- Thirdly, the bailout is estimated to require US\$700 billion (although this is not the cost to the taxpayer which will only be known after the assets are sold). Coming on top of other initiatives already announced (such as the US\$85 billion loan to AIG) the "cost" will be over US\$1 trillion on top of a budget deficit already running around US\$380 billion. While issuing bonds is not directly inflationary there is a risk that such a massive increase in bond issuance will put upwards pressure on bond yields and downwards pressure on the US dollar which will in turn push commodity prices up – this is what we are already seeing. In all likelihood the upwards pressure on bond yields will be more than offset by the weakness in economic growth, but the risk is certainly there, and partly explains why US bond yields have surged in the last few days.
- Fourthly, it is unclear the extent to which financial institutions in other countries will be able to participate. While the US Government says foreign institutions will be eligible, this will be controversial and Congress may not approve it. This is particularly an issue in Europe where mortgage related losses continue to mount alarmingly.
- Finally, and most importantly, the US Government's bank bailout plan won't do anything about the unfolding global economic slump already underway. Europe and Japan are still on the brink of recession and growth in the emerging world has slowed by two to three percentage points from last year. Additionally, the slump in US house prices and rising unemployment is gradually feeding through to weaker US consumer spending and increasing the likelihood that the US will itself soon slip into recession.

In this regard, it is noteworthy that the August 1989 start up of the original RTC did not prevent the US economy sliding into recession in 1990 or the US share market falling until October 1990.

However, while there is much to fret about and the ride will not be smooth, our assessment is that the US bailout package (by removing much of the toxic debt from the system and allowing banks to recapitalise) will likely remove the risk of a major financial market meltdown and the flow-on to economic activity that would have entailed. Combined with global money market cash injections and "coordinated" efforts to boost share markets it highlights that the authorities will do whatever is necessary. So yes, the world economy is in for a rough ride. But the latest actions by US authorities indicate that a re-run of the Great Depression is unlikely.

### What does all this mean for shares?

Unfortunately the ride for share market investors will likely remain very rough and it is too early to give the all clear with complete confidence. But, there is a good chance that we have actually seen the bottom in shares; if not we have come very close. Given that major bear market lows often involve some sort of retest of the low, a fall back to last week's low levels is a distinct possibility. But after expecting a slump into the normally weak September / October period which we have now seen, I am now more confident that shares will stage a decent rally into year end and then through 2009.

- After 30% or so falls shares have already had typical bear market falls. This is different to the situation in 1989 when the first RTC was established at which point shares had not really fallen.
- Shares are also now very cheap with global shares trading on a forward PE of 10.9 times versus a ten year average of 17.2 times and Australian shares trading on 10.8 times versus a ten year average of 15.1 times;
- The investor panic and corporate carnage we have seen in the last week or so is the sort of thing normally seen at major bear market bottoms;
- The US bank rescue plan if implemented successfully will likely remove the risk of a complete financial market meltdown; and
- The slump in growth and downtrend in commodity prices will take pressure off inflation, clearing the way for lower interest rates worldwide.

So while the short term outlook is messy, this suggests better returns from shares on a one year view.

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### Contact us

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