



Reflections on Q4 2008

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Reflections on Q4 2008 : We Shall Not See Its Like Again

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The final quarter of 2008 will long be remembered as one of the most disastrous periods for asset price performance for many decades. The "credit crunch" which started in 2007 took a new leg downwards after the failure of Lehman Brothers in mid September, and for a while during the fourth quarter liquidity disappeared from many financial markets. This triggered widespread redemptions from financial products, and shifts away from risk assets, as investors scrambled to raise cash and pay down debt.

As a result, risk premia rose dramatically throughout the global markets. For example, US equities (measured by the Dow Jones Industrial Average) declined by 19.1% during the quarter, a drop which has been exceeded in only three 3-month periods since the Second World War. Furthermore, at one point in the quarter, the decline in the Dow was even worse. At the low point for global equities, reached on 20th November, the Dow was 30.4% below the level reached at the end of the previous quarter, and was 46.7% lower than the peak reached in the bull market which ended a year earlier. Prior to the equity rally which took place in the last 5 weeks of the quarter, the 2008 calendar year was shaping to be the worst for US equity returns in recorded history. Even after that late rally, the year-end return of -38.5% for the S+P 500 means that there have only been two worse years for US equity returns since 1825!

Most global equity markets suffered similar falls during the quarter, with the markets discriminating very little between different countries. Declines of 20-24% were experienced in all of the major geographical regions, with the single exception of the emerging European markets, which fell by 40.7% (on the MSCI local currency index). Among US sectors, the largest declines were recorded in financials (-37.6% on the Amex index) and materials (-31.2%), while more defensive sectors like telecom (-3.9%) and pharmaceuticals (-7.4%) offered better protection. Hedge funds in the equity space also recorded sharply negative returns - according to the CS Tremont indices, equity long/short funds lost 7.5% during the quarter.

Other risk assets were certainly not spared from the market melt-down. Most credit spreads widened dramatically during the quarter. For example, the spread on Moody's Baa benchmark in the US widened to 601 basis points at quarter end, a rise of 239 basis points during the quarter. The resulting spread at quarter end was more than 200 basis points higher than anything previously seen during the post war period. Sovereign spreads in the emerging markets were also impacted by the general shift towards risk aversion. The J.P. Morgan index of EMBI spreads widened by 282 basis points, reaching 724 basis points at quarter end. All parts of the credit space, including mortgage and ABS securities, suffered similar mark-downs. With spreads widening and market liquidity drying up, hedge funds relying on fixed income arbitrage strategies recorded negative returns of 19.5% in the quarter (on the CS Tremont index).

Even more remarkable events were observed in commodity prices. Energy prices (GSCI energy total return index) fell by 55.2% during the quarter. Overall commodity prices (GSCI total return index) ended the year 46.5% below the level seen at the start of the year. This represented a remarkable reversal, since

at their peak on 7 July commodity prices had been 47.0% higher than they were at the end of 2007. As commodity prices tumbled, so too did shipping rates. For example, the Baltic Dry spot index fell from a peak of 11,648 in July to a year end level of 911, a drop of 92.2% in a matter of months.

As investors shifted dramatically towards risk free and liquid assets, government bonds and gold were the only asset classes which enjoyed a good quarter. Government bonds rose by 9.1% (J.P. Morgan dollar governments index), with 10 year yields on US Treasuries falling by 161 basis points during the quarter. The closing 10 year yield of 2.21% was the lowest seen since the 1940s. Such was the fear of loss and illiquidity in the private financial markets that investors were fleetingly willing to accept negative yields for the privilege of holding US treasury bills for the first time in known financial history. Apart from the flight to safety, these lower yields were influenced by aggressive easing in global monetary policy. Both the Federal Reserve and the European Central Bank reduced their policy rates by 175 basis points during the quarter, and both increased the size of their balance sheets as they injected liquidity into the financial markets. The assets of the Federal Reserve almost tripled in the second half of 2008, reaching \$2,088 billion at the end of the year.

This dramatic action by the central banks was designed to restore liquidity to the money markets, and to drive inter-bank rates more closely into line with the short term rates which the policy makers had set. Libor rates widened sharply following the bankruptcy of Lehman Brothers in mid September, but concerted central bank action started to reverse the process after 13 October, and money market rates partially normalised after that date. Commercial paper markets in the US also showed signs of returning to normal, but other symptoms of the global credit crunch continued to worsen throughout the quarter.

By the end of the quarter, the risk premia on global equities and credit were both at exceptionally high levels, implying that investors required the promise of unusually high future returns in order to be willing to hold risky assets. On our estimates, the forward looking risk premium (ie expected excess return) on equities relative to government bonds was around 6%, which compares to a long term "equilibrium" of around 3%. Meanwhile, in the area of corporate credit, investment grade and near investment grade instruments were offering risk premia even larger than those available on equities, probably because liquidity in the credit space had dried up completely. Adjusted for likely default risk in a bad scenario for the global economy, BBB credit seems to be offering a possible excess return of around 8% compared to government bonds. It is very abnormal for the risk premium on credit to be higher than it is on equities, because credit is higher in the capital structure than shares (ie it gets repaid first in the case of bankruptcy). If the world economy falls into a depression, these risk premia might prove justified. But if the global economy hits bottom in 2009, risk premia could fall sharply, producing much stronger returns from risky assets – and credit is starting from a cheaper position than equities.

The global economy was severely impacted by the financial market catastrophe during the quarter. Until the autumn of 2008, the downturn in global activity had been fairly gentle, with serious setbacks being largely confined to the housing and auto sectors of the US economy. The threat of financial failure, and the tightening of credit markets, in 2008 Q4 produced a sudden rise in risk aversion in the household and corporate sectors, just as it had in the financial sector. Consumers reduced their real spending levels across the global economy, despite the fact that declines in energy and food prices were boosting real incomes by almost 3% in the US, and by somewhat less elsewhere. In previous periods, lower commodity prices had been rapidly translated into extra spending on other goods and services, but this time consumers decided to increase their savings ratios instead. For example, in the US the personal savings ratio rose

from zero to 3.6% in the second half of 2008. Corporations also curtailed their spending drastically, in an effort to restrict the rise in inventories which took effect as final orders fell. The decline in global leading indicators and business sentiment surveys was among the sharpest and most co-ordinated experienced in the post-war period, and many countries saw declines in economic activity which approached those seen in the two worst recessions since 1945 (in 1975 and 1982).

No country escaped the savage nature of the global downturn. We estimate that global GDP in the developed economies declined at an annualised rate of about 6% during the quarter, with Japan (-13%) and the Eurozone (-6%) being hit even harder than the US (-4%). Manufacturing sectors, and particularly autos, were as usual hit much harder than service sectors, and global industrial production probably fell at a rate of around 17% during the quarter. Nevertheless, inventories were still rising as the quarter ended, suggesting that manufacturers would need to continue to curtail output in order to bring inventories into line with declining order books. Furthermore, corporations were embarking on a major program of cost shedding, with employment declining by 500,000 per month in the US, and capital goods orders plummeting in every corner of the globe. The annualised rate of decline in global capital goods orders at quarter end was over 50%, roughly twice the worst rate of decline seen in the 2001 recession.

Policy makers initially seemed rather stunned by suddenness of the deterioration in economic activity, but during the quarter there were significant moves towards fiscal easing. The budget deficit in the G7 will rise from about 3.5% of GDP to around 10% of GDP this year, the highest rate of government borrowing seen outside wartime. More than two-thirds of this increase in budget deficits will be due to the automatic effects of the recession on the government accounts, while the rest (about 2% of GDP) will come from deliberate acts of fiscal stimulus. Furthermore, the increase in official measures of the budget deficit tell only part of the story, since governments have also made a series of huge financial commitments to rescue their banking sectors. Only a relatively small part of these commitments are likely to appear on either the debt ratio or the budget deficits of the major economies in the near term. Nevertheless, public sector debt ratios are likely to rise by at least 20% of GDP in the next two years in the major economies. While most of this increase in public debt has replaced private sector debt holdings which would otherwise have been written off, and has therefore not added to the total debt ratio in the economy as a whole, the long term effects of such a large rise in global public sector debt are unknown.

The quarter under review was therefore dominated by recessionary forces and by a shift of historic proportions in asset markets towards risk aversion. The new year begins with these recessionary forces still gathering momentum, but they are now being met by an easing in fiscal and monetary force which seems potentially to be even bigger. Irresistible force meets immovable object, with the outcome of this battle looking likely to determine the behaviour of asset prices for many years to come.



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