North Star Group

Newsletter

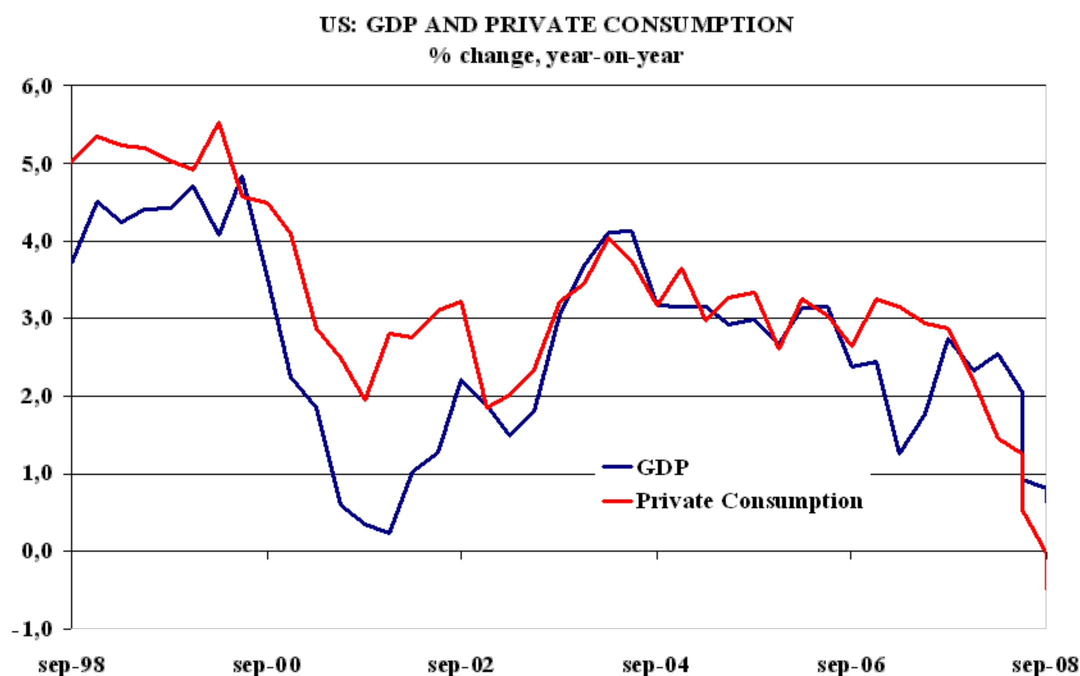
November, 2008

Dear Investor / Intermediary,

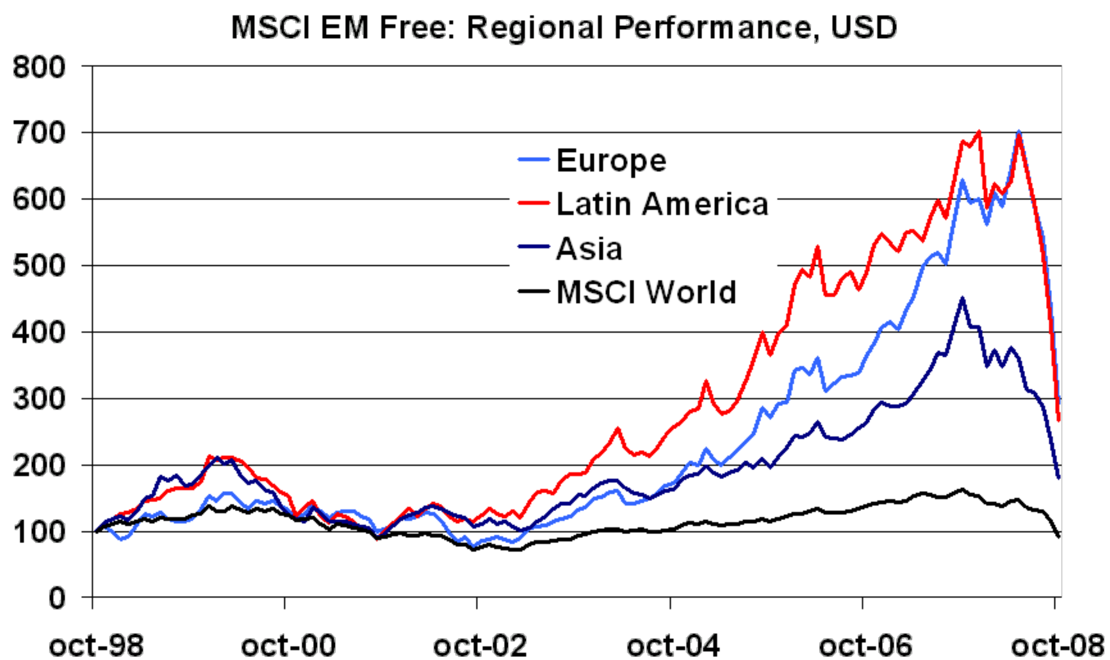
The crisis *juggernaut* has now hit all of the developed economies, most of the emerging markets, and practically all business sectors. We will start with a review of the major economic blocs and the measures undertaken by economic authorities, followed by an assessment of where the crisis is likely to move from here, and what it implies for financial markets.

The US, Europe and Japan: united we fall

All notions of 'decoupling', the idea that part of the world economy would somehow be insulated from the US downturn, have now been put to rest. On the latest official data the US is not technically in a recession since its GDP began contracting only in the third quarter of this year. But all short term indicators point to a second contraction in the fourth quarter. The Eurozone, for its part, is in a recession as a whole having seen its GDP contract during both the second and the third quarter, with sharp contractions in both Germany and Italy, and growth close to zero in France and Spain. And Japan, otherwise considered somewhat independent of this predominantly Western crisis, has similarly succumbed to the economic downtrend and is now in a recession.



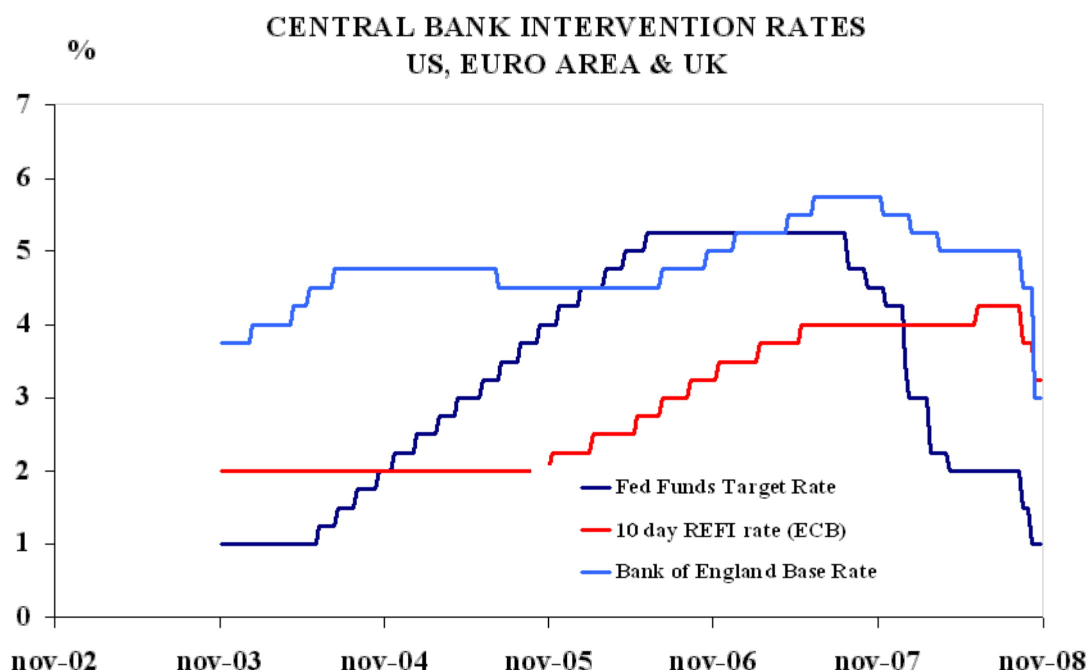
The crisis has left clear marks outside of the developed world as well. Countries in Latin America, Eastern Europe and the Middle East are suffering from the weakening demand for energy and raw materials and the huge drop in their export prices, and China and other Asian countries are seeing their trade balances deteriorate and domestic demand lose momentum. Financial markets across the board of the emerging economies are subjected to repatriation of capital from international investors and sharp falls in their stock markets. In some case this has prompted pressure on their currencies and the need to intervene or raise rates on the part of their central banks.



Even if the epicentre of the crisis was and remains the US, the American crisis has in many ways been a *trigger* for a downturn elsewhere rather than the exclusive cause of it. Parts of the Eurozone, the Nordic countries and the UK have seen a housing boom and a growing indebtedness of their households for several years, in much the same vein as the US. And financial institutions in core-Europe have exposed their balance sheets to those same structured products backed by residential mortgage that are currently haunting US institutions. The crisis travels both via trade and capital flows and is now all but world-wide. This makes it even more self-reinforcing.

Countermeasures: old tricks and new

Despite its international character it is clear that the solution to the crisis must inevitably address the housing market and the ailing banking sector in each domestic market. The excess supply of both new and existing homes, especially in the US, exerts a constant downward pressure on residential house prices and undermines household balance sheets while higher financing costs continue to spur a rise in both delinquencies and loan defaults. Banks for their part are struggling with the so-called “toxic assets” (mostly securitised residential mortgages) on their balance sheets prompting them to hold back on new credit and thereby adding to the difficulties of both households and smaller and medium-size businesses.



Measures by monetary authorities have been unprecedented, from vast injections of liquidity into the banking system in both traditional and novel ways to interest rate cuts in concerted moves by central banks. Lately, fiscal authorities have moved to the fore with rescue-plans ranging from deposits guarantees and guarantees backing banks' refinancing to direct injection of capital into the banking system. But while these measures have no doubt softened the crisis the fact remains that they have so far proved insufficient. Bank balance sheets remain the Gordian knot. Despite the injection of capital, most banks are reluctant to channel the liquidity created by the central banks onto the private sector since this would add to their already excessive leverage ratios. De-leveraging in toxic assets must necessarily precede any re-leveraging of balance sheets with more traditional credit. But banks are finding it exceedingly hard to find buyers for the structured products on their balance sheets which are often over-the-counter vehicles, tailor-made for specific investors. In the US the final approval in Congress of the "Troubled Asset Relief Program" (TARP), which purported to let the US Treasury purchase such assets directly from banks, gave hopes that the problem could be eventually tackled. But the Treasury Secretary, Henry Paulson, subsequently announced that the initial plan would be aborted to by substituted by direct share participation by the state.

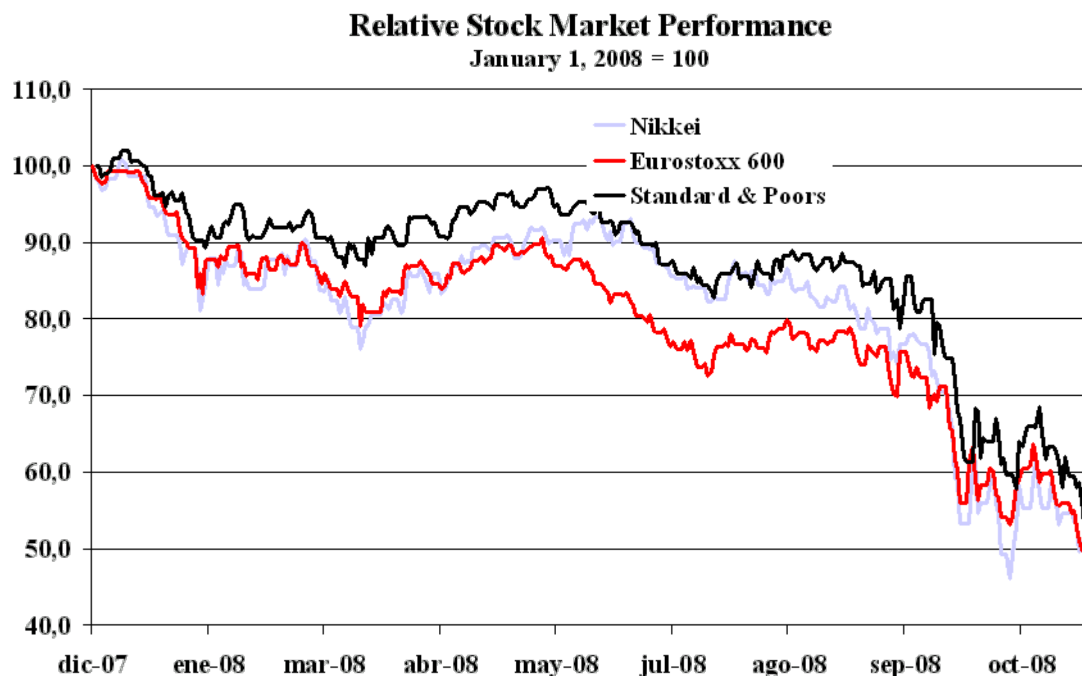
Looking Ahead: getting worse before it gets better

It would no doubt be erroneous to conclude that measures implemented by authorities are to no avail. But it is likely that under the current circumstances their impact is both weaker and slower to manifest itself than in normal circumstances. As discussed, bank balance sheets remain trapped by their toxic assets and this is likely to prolong the credit crunch despite the injections of new capital by the government. Because of this, consumers are struggling to get access to all sorts of credit while feeling the general economic slowdown both in terms of a slower growth in incomes and a weaker job market. Even if governments across the board are likely to implement fiscal relief by

means of tax cuts and increased spending, the downward momentum in both the US and the European economy is likely to persist, especially since it is enhanced by the credit crunch. 2009 thus looks likely to see a deepening of the crisis from where we now stand and possibly the worst recession in the Western world since WWII. The usual mechanisms will eventually work to drag the developed economies out of their crisis. Toxic assets will slowly but surely mature, the drop in house prices and long term interest rates will make homes more affordable for new buyers, and cheaper energy and raw materials prices will improve profit margins for businesses. But in the current scenario this whole process is likely to require more time than usual because of the nature of the crisis.

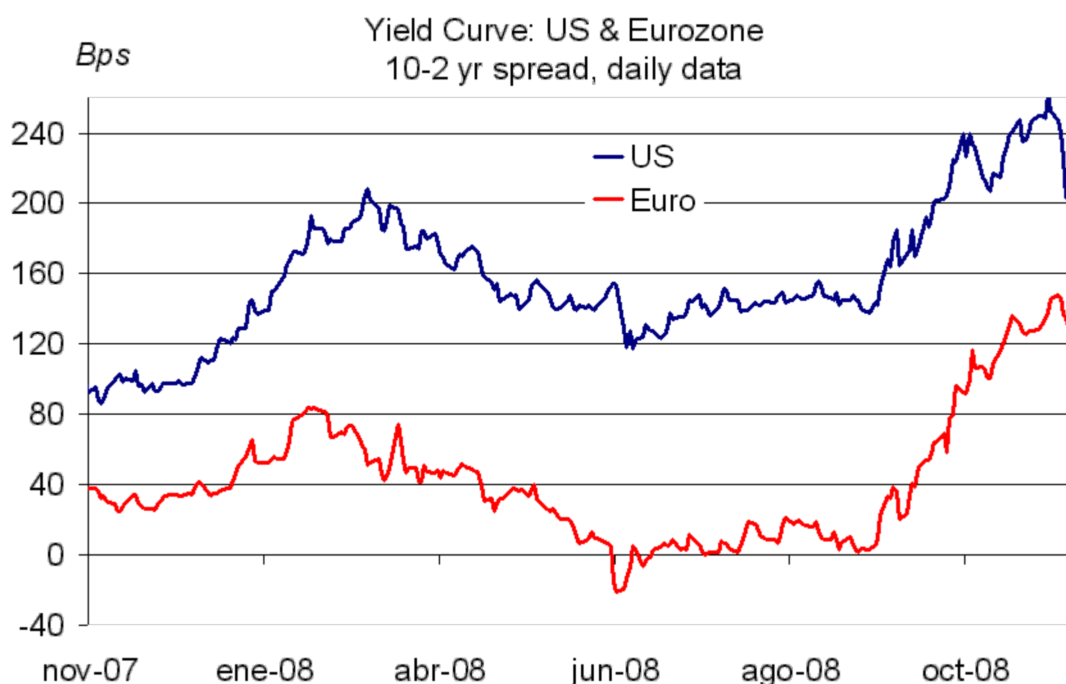
Financial Markets: visibility wanted

Markets are normally quite capable of dealing with recessions. To be sure, stock markets and corporate credit invariably take a hit, but at some point valuations are deemed to express the impact of the slowdown adequately and a bottom is formed. This point has been particularly long in waiting in the current scenario. The financial complexity of the toxic assets involved has made a sober valuation of bank balance sheet losses very hard to make, and stock markets have been disheartened by the unrelenting flow of bad news from financial institutions. US and European stocks are now down by a little over 50% from their peak last year and discount a decline in company profits of around 40% for 2009.



This projected drop in profits is arguably more than sufficient even given the grim macroeconomic outlook. But stock markets are unlikely to stabilize until longer term visibility returns. This in turn depends critically on an improvement in the credit markets which is not yet at hand. The upshot is that stocks will remain highly volatile and unsuitable for retail investors for a further while.

In the government bond market two principal effects have been at play. The first is the simple ‘flight to quality” flow into government securities as both corporate bonds and stocks sold off. The second, and more important, is the easing of monetary policy and the general macroeconomic slowdown. Both effects have worked to make the yield curve steeper as investors sought exposure to the shortest dated issues which benefited directly from the rate cuts by the central banks. Year-to-date, 2-year European government bonds have seen yields drop around 180 bps against only 90 bps for the 10-year sector. Still, the total return on the longer-dated bonds has actually been greater due the effect of their longer duration. We expect the yield curve to eventually flatten going forward to the benefit of long-dated bonds. In our estimate, taking into account both the growth and inflation scenario and the likely monetary policy in 2009, European 10-year yields could go as low as 2.5% or even lower.



In the FX market, the dollar has benefited from the repatriation of capital which has been a consequence of the sell-off in US markets. US investors have de-leveraged their foreign investments and foreign investors in the US have unwound part of their currency hedges as a result of the drop in the value of their US investments. This might continue to some extent as long as financial markets remain weak. Going further into 2009 we believe the dollar will return to weakening against the backdrop of an economic slowdown in the US which looks likely to be more protracted than markets are currently discounting.