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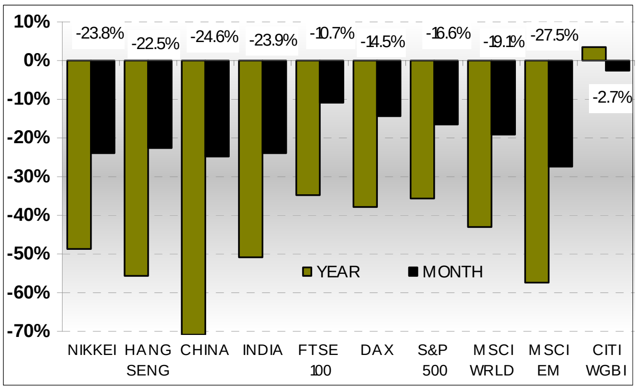
Investment Letter | 8th Edition | November 2008

October in perspective – global markets
Investors around the world, and investment managers in particular, will remember October 2008 as one of the most brutal, wild and devastating months in living memory. Were it not for a big rally in the last few days of the month the returns would have been even worse. The damage is clear from Chart 1 and Table 3. The market behaviour in October should be seen in the context of the tumultuous events during September, which we covered in depth in [last month's *Intermezzo*](#) - the two months represent one long nightmare for investors.

Given the positive feedback we received on our "Chronicles of Chaos" appendix last month (thank you to all of you that sent in comments) we have decided to continue the series – at least for October. For the sake of continuity I have retained Appendix 1, which documented the events of September and remains unchanged from last month, but have separated October into Appendix 2. I would encourage you to read it if you want an idea of how wild the market was, and historic too. Day after day, new records were set – mostly on the downside – in terms of largest daily declines, daily trading ranges, volatility, etc. As many managers have already commented and to which we add our humble voice – *we have simply never seen anything like it - and hope we never will again*. We covered a lot of the events in the September Quarterly Report. If you wish to read it, you can find the Maestro Equity Fund September Quarterly Report on our website by clicking here.

Chart 1: Global market returns to 31 October 2008



Appendix 2 contains a lot of comment so I will refrain from commenting further on October's events, other than to list the salient features of the month. The declines wiped about $10 trillion off global equity markets. US retail investors withdrew an estimated $75bn from equity mutual funds (unit trusts), which compares with outflows of $56bn in September and $19.7bn in August. This is relevant because retail investors are the quintessential contra-indicator i.e. they almost always do the wrong thing at the right time. For example, they poured $135bn into equity funds in March 2000, which turned out to be the all-time peak in the US equity market following the tech bubble. US investors also withdrew a record $145.2bn out of money funds during September.

During October the MSCI world index declined 19.0% and the MSCI Emerging market index -27.5% (having been down 40.0% prior to the last week's huge bounce), bringing their respective annual returns to -43.1% and -57.4%. The US equity market fell 16.6%, the UK 10.7%, Germany 14.5%, China 24.6%, India 23.9%, Russia 36.2% and Hong Kong 22.5%. Most equity markets registered the worst monthly declines since either October 2002 or in many cases October 1987. Things would have been a lot worse had it not been for the huge bounce experienced during the last week of October – the US equity market, for example, posted its largest *weekly gain* since 1974 during the last week of October. The losses were not confined to equities; high yield bonds also suffered big losses, with declines of 15.5% in the US and 22.7% in Europe. Commodities suffered even more, having missed out on last week's rally. The CRB Commodity index fell 22.3% in October and the S&P GSCI 27.3%. The Baltic Dry index fell an astonishing 73.6% in October alone and has now fallen 92.2% in the past year. Gold declined 17.4% (what does that tell you about its "safe haven status?), platinum 18.9%, oil 33.5% and silver 28.4% - remember these are *monthly* declines.

A feature throughout the month was the dollar, which continued to surge amidst a worldwide demand for the greenback, partly related to the liquidity crisis. It gained 10.8% against the euro and 10.3% against sterling – these are huge monthly movements for currency markets. Only the yen was stronger on the back of the carry trade being unwound; it rose 8.0% against the dollar. The rand declined 15.9% against the dollar, having fallen as much as 30.0% at one stage during the month.

The Japanese rout
Last month we focussed on the Russian rout. This month we turn to the Japanese rout. In the short-term the Japanese equity market decline is less spectacular than the Russian meltdown (Russia fell 36.2% in October) although its 23.8% decline in October is still no small matter. However, its long-term collapse is arguably more significant in terms of its economic impact and the lessons it holds with regard to policy making. Chart 2 depicts the Japanese Nikkei 225 index since 1989. The facts speak for themselves: this index peaked at 38 915 on 29 December 1989 (when the S&P500 was at 143 and the Dow Jones at 1 060!) That same index ended October 2008 at a level of 8 577 – that's a decline of 78.0% over a period of nearly 18 years. As they say in the US, "go figure…:

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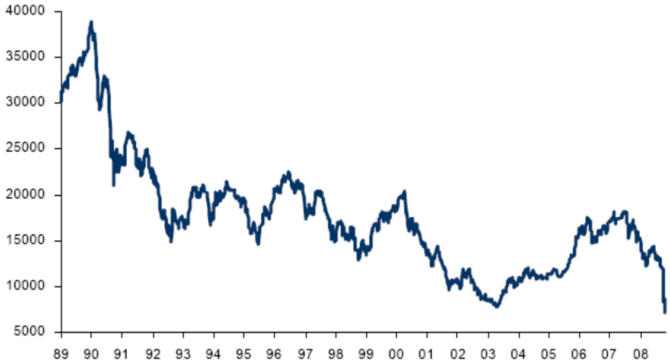
Chart 2: Kamikaze style – the Japanese equity market



Source: Merrill Lynch

What's on our radar screen?

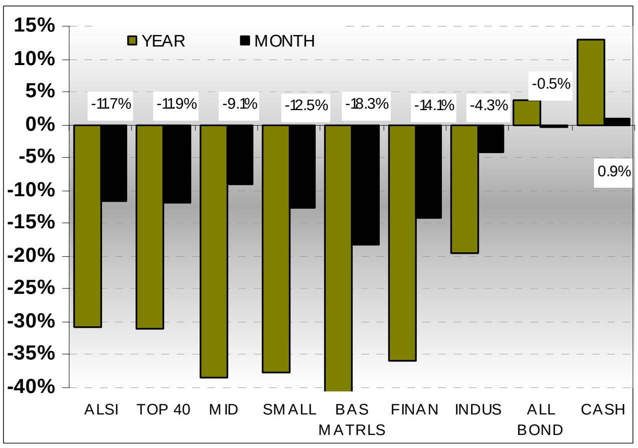
We remain focussed on the changing economic landscape and list below a couple of developments in this regard:

- *Chinese growth:* the rate of economic growth in China during the third quarter declined to 9.0% from 10.1% in the second quarter. We noted last month that inflation was moving in the right direction, having declined from a 12-year peak of 8.7% in February to 4.6% in September. Chinese growth is a critical factor in the world today. With the US now deep in recession and the EU and UK heading there at a rapid rate investors are looking to Asia in general and China in particular to prevent the *global* economy from moving into the recession. So far so good, but Chinese growth will remain a critical factor in the months to come.
- *Global interest rates:* not surprisingly, interest rates are being reduced around the world, with the exception of crisis-ridden countries like Hungary, which increased rates by 3.0%, Denmark and Iceland where rates rose by 6% to 18%. All in all, 23 countries lowered rates in October, including Canada, China (twice), Hong Kong, Iceland, India (twice), Japan, New Zealand, Norway, Sweden, Switzerland, the US (twice), UK and the EU.
- *SA inflation:* there was some good news on the SA economic front, in that the rise in inflation during September was lower than expected. The monthly headline rate increased by only 0.2%; although the monthly rate is volatile, the three previous month's increases were 1.3%, 2.1% and 0.7%. The annual inflation rate in September eased to 13.0% from 13.6% a month before. Deutsche Securities expects inflation to ease to 12.0% by year-end and 5.5% by the end of 2009.
- *The SA economy:* delivering his Medium Term Budget, Finance Minister Trevor Manuel revised SA's growth rate down to 3.7% this year and 3.0% for 2009. The planned budget surplus of 1.8% for 2009/10 was revised to a deficit of 1.6%. In addition the Treasury now expects the current account deficit, SA's Achilles heel, to reach 8.9% of GDP by 2011/12.
- *US economic growth* shrank by 0.3% during the third quarter, led by a 3.1% decline in consumer spending, the sharpest decline since 1980. Economic data emanating from the US during the month was almost entirely bad and we suspect it is going to get a lot worse. We retain our view that the US consumer is in serious trouble, that the US economy has been in a recession for most of this year already and that the recession is going to be worse and last longer than most market participants anticipate.

October in perspective – local markets

The SA markets were caught in the turmoil during October, most notably the currency market. The rand's 15.9% decline actually prevented the equity indices from declining even further. The basic materials index, which ended October down 18.3% (but posted far greater losses intra-month), was supported by the weak rand. Similar to overseas markets the local equity market rose sharply during the last week of October, which restored a modicum of hope to investors. At its worst the All share index was down 24.8% although the 14.3% gain in the last week resulted in the index declining "only" 11.7% for the month. The best performing sectors were food and drug retailers (Pick 'n Pay, Shoprite and Spar) up 40.2% and general industrials 5.7% (Remgro), while the biggest casualties were the industrial metals sector (Hiveld and Arcelor Mittal) down 44.2% and platinum 41.5%.

Chart 3: Local market returns to 31 October 2008



For the record

Table 1 lists the latest returns of the mutual funds under Maestro's care. You can find more detail, including the latest Maestro Equity Fund Summary, by visiting our website at www.maestroinvestment.co.za. Returns include income and are presented after fees have been charged.

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Table 1: Returns of funds under Maestro's care

	Period ended	Month	Year to date	Year
Maestro Equity Fund	Oct	**-15.2%**	**-25.6%**	**-30.2%**
Maestro equity benchmark *	Oct	-9.6%	-21.8%	-27.3%
JSE All Share Index	Oct	-11.7%	-25.3%	-30.9%
Maestro Long Short Equity Fund	Sept	**-5.1%**	**-13.8%**	**-12.4%**
JSE All Share Index	Sept	-13.2%	-15.5%	-18.0%
JSE Financial and Indus 30 index	Sept	-5.8%	-12.7%	-11.6%
Central Park Global Balanced Fund ($)	Sept	**-6.7%**	**-13.2%**	**-14.0%**
Benchmark**	Sept	-6.0%	-11.6%	-11.3%

* 50% JSE Top 40 Index, 50% JSE Financial & Industrial 30 Index
** 40% MSCI World Index, 20% each in Citi World Government Bond Index, Credit Suisse Tremont Hedge Index and 3-month US Treasury Bills

Whilst on the topic of returns, in the middle month of the quarter we traditionally list client's equity portfolio returns. Here then are the returns for the periods to 30 September.

Table 2: Maestro annual returns to 30 Sept 2008 (%)

SA equity returns	6m *	1 yr	2 yrs	3 yrs	4 yrs	5 yrs
Maestro long-term equity portfolios	***-12.8***	***-15.7***	***11.8***	***19.1***	***27.5***	***30.0***
Maestro equity benchmark **	-12.5	-14.4	6.4	14.7	22.1	25.8
JSE All Share Index	-17.9	-18.0	6.1	15.4	22.6	25.2

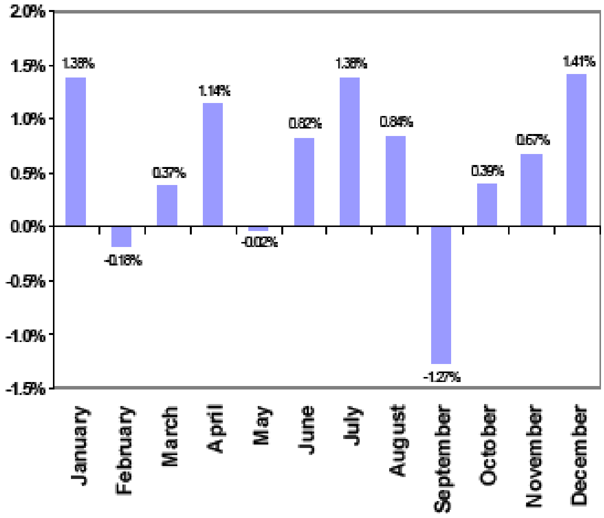
* 6-month returns are un-annualised
** 50% JSE Top 40 Index, 50% JSE Financial & Industrial 30 Index

Maestro clients would have seen our comments on their returns in the September Quarterly Reports. Note that despite the negative markets experienced so far this year (admittedly October is not included in the returns in Table 2) returns on both the indices and client portfolios over periods longer than two years are still positive. Compare this, for example, to the annual compound returns over two, three and five years to end-September of the US equity market of -4.4%, 0.5% and 5.3% respectively. The returns of the MSCI World index are -7.2% and -1.2% and 5.4% respectively, showing just how profitable the SA equity market has been *on a relative basis*, at least in local currency terms. And whilst on the returns for these markets, factoring in the month of October, the compound annual returns over the two and three-year periods ended 31 October 2008 for the US equity market are -7.3% and -4.9% respectively, whilst the returns for the MSCI World index are -18.0% and -7.1%. The damage inflicted by October is very apparent! These returns can be compared with the compound annual returns of the JSE All share index of -2.4% over the two-year period to end-October 2008 and 11.6% over the three-year period respectively.

Chart of the month

With another "negative" October behind us, one could be forgiven for thinking that October is the worst month for equity markets. History tells another story: Chart 4 depicts the average monthly returns of the US equity market during the past eight decades. It might come as a surprise to see that September is actually the worst month, with an average monthly decline of 1.27%. Less of a surprise is that December and January are the strongest, with average returns of 1.41% and 1.38% respectively.

Chart 4: S&P500 index returns by month (1928 - 2008)



Source: Merrill Lynch

Quotable quotes

The whole shipping market has crashed. *Steve Rodley, Global Maritime Investments, 15 October.*

History will show that George W Bush faced two big crises during his term of office: the terrorist attacks of September 11, 2001 and the financial meltdown of 2008. *John Gapper, Financial Times columnist.*

We have reached a critical point. We can see clearly the gulf to which our present path is leading. If governments do not take action we must expect the progressive breakdown of the existing structure of contract and instruments of indebtedness, accompanied by the utter discredit of orthodox leadership in finance and government, with what ultimate outcome we cannot predict. *John Maynard Keynes, March 1933* (note the date – in the midst of the Great Depression).

There's only one planet over which to spread the risk. *Graham Bell, Investec Securities Investment Strategist.*

I made a mistake in presuming that the self-interest of organizations, specifically banks and others, was such that they were best capable of protecting their own shareholders. I had been going for 40 years with considerable evidence that it was working very well. *Allan Greenspan.*

We are starting to eat blood sausages again – things our grandmothers made. It reminds us of a generation that came through a crisis with a strong set of values and helps us realize that these were the right values. *Andri Snaer Magnason, one of Iceland's leading novelists.*

You can buy the entire free float of China and India with today's market cap of Volkswagen and still have enough spare change to buy Turkey. *Michael Hartnett, Merrill Lynch Global emerging market strategist on 28 October, commenting on the absurd price rise in VW versus cheap emerging markets.*

We have no details of our derivatives exposure and neither do you. *A senior Lehman Brother's banker to government regulators during the weekend that culminated in Lehman's collapse*.

Consequences of the 2008 financial crisis
In recent correspondence we shared our initial thoughts on how the world will change once the financial crisis has passed. Although we are still in the midst of the storm, we are already seeing some of the change that is being foisted on market participants. Here are a couple of consequences arising from the turmoil – there are likely to be many more.

- *Accounting changes:* Deutsche Bank posted results on Thursday, 30 October. Analysts expected a significant loss but surprise, surprise, Deutsche Bank posted a profit; net income rose $530m. The reason was simple: recent changes in accounting rules, in response to the punitive action of marking assets to market value (the so-called fair value adjustments) allowed the bank to reclassify $32bn of assets on its balance sheet, thereby avoiding a $1bn hit to its income statement. Earlier in the week, UK-based asset manager Schroders used the new rules to avoid a $104m hit to its quarterly revenue. So, first we thought financial accounts were of some value, then new accounting rules introduced extra-ordinary volatility to earnings as companies were forced to mark their assets to prevailing market prices, and now we are completely confused and in the dark. If financial accounts were complicated and of little value before, after these changes they are pretty useless, to say the least.
- *Pension fund returns*: if you revisit the returns we listed in the discussion below Table 2, above, you will realise how dramatically the months of September and October have altered the short and medium-term returns of all investors, including retirement funds. To put this into context, it is fair to say that most global retirement funds are now staring into the face of the worst returns in recent history. This will pose enormous problems in terms of funding some of the funds i.e. being able to meet the pension commitments that the Funds have made to their members. According to Northern Trust, a US consulting firm, the average US state pension fund lost 14.8% in the nine months to end-September. The previous highest loss for state funds was 7.9% during the year to end-2002. Of course the extreme losses of October would have exacerbated this situation no end. California-based Calpers, the world's largest retirement fund, reported last week that it lost 20.0% of its assets between 1 July and 20 October – that works out to a cool $40bn loss! I would hasten to point out that Calpers is a very progressive investor, has an excellent performance track record and is seen as a leader in the US (and indeed global) retirement industry.
- *Pension funding problems*: an estimated half of the 1500 largest companies in the US still run defined benefit pension funds, where companies assume the risk of unfunded pension liabilities. With 2008 going down in history as one of the worst ever in terms of market returns, a lot of companies are under threat from a new source, namely to ensure that their pension funds are properly funded. A report from Mercer, one of the larger global pension consultants, estimated that US companies are facing a funding gap of about $100bn, at a time when they are under pressure from the economic slow down and when it has become very expensive to raise money.

File 13 – things almost worth remembering
As though investors did not have sufficient uncertainty to deal with, a situation arose on the German equity market in the last week of October that can only be described as bizarre, simply ridiculous. It would be funny were it not for the fact that a huge amount of money is involved, not to talk of the damage that has been done to Germany's reputation amongst foreign investors. Rather than sum it up in a few lines, I have summarised the story in Appendix 3. I hope you find it informative and will have a better understanding of why I commented in the recent Quarterly Report that, in some respects, "the markets are just not working properly".

Table 3: MSCI Emerging Market October ($) returns (%)

EM countries/regions	Oct-08	YTD
Morocco	-10.6	-10.7
Malaysia	-17.7	-48.7
Israel	-18.1	-29.8
Jordan	-18.8	-22.9
Taiwan	-18.9	-51.2
MSCI DM	**-19.0**	**-41.8**
China	-22.8	-63.7
Asia	**-24.2**	**-61.5**
Philippines	-24.3	-57.8
Chile	-25.7	-37.5
South Korea	-26.1	-65.0
South Africa	-26.6	-51.2
MSCI EM	**-27.5**	**-59.3**
India	-28.6	-67.4
Czech Rep	-29.4	-48.2
EMEA	**-30.1**	**-58.5**
MSCI EM Small Cap	**-30.3**	**-64.9**
Mexico	-30.7	-48.8
LatAm	**-31.8**	**-54.1**
Brazil	-32.4	-57.0
Egypt	-32.6	-52.3
Thailand	-33.1	-58.7
Poland	-33.9	-54.1
Turkey	-34.3	-65.4
Russia	-35.3	-71.9
Peru	-36.0	-59.1
Indonesia	-39.9	-65.9
Argentina	-41.7	-57.9
Hungary	-43.3	-59.3

Source: Merrill Lynch

Appendix 1

A chronicle of chaos – September 2008

It is impossible to explain September's tumultuous events in a few pages. In the letter that accompanies our monthly statements as well as the Quarterly Reports we will do our best to share some of those events with you. One of the purposes of *Intermezzo* is to document and record, for our own internal purposes, the salient features of the prevailing investment environment. To this end therefore I list below some of the extraordinary events of the past month, from which you will see that we are in the midst of the most remarkable market conditions for decades. Even a casual reading of the list below will highlight the sheer drama that transpired as we witnessed history being written before our eyes on a daily basis. For your benefit, I have listed a short glossary at the end of the report.

Here then is a selection of events that shaped the market returns – for the sake of completion I have included a few events prior to September in order to sketch the necessary background:

- **July 17, 2007:** two Bear Sterns hedge funds invested in sub-prime investments collapse.
- **January 21, 2008:** Societe Generale announces it has incurred a $7.5bn loss, the largest ever in history, executed on an unauthorised basis by a "rouge trader." Markets around the globe plummet, registering the widest trading ranges ever recorded. The German market fell 7.2% and the UK 5.5%. The SA equity market fell 0.1% but traded in a range of 8.2% on the day. The Fed cuts interest rates by 0.75% after an emergency meeting.
- **March 7:** the Fed injects $200bn into the money and bond market system to alleviate illiquidity.
- **March 10:** the Fed injects a further $236bn into the market.
- **March 14:** the Fed announces an emergency facility through JP Morgan for ailing Bear Sterns.
- **March 17:** Bear Sterns collapses and is sold to JP Morgan for $2.00.
- **September 7:** the Fed bales out Freddie Mac and Fannie Mae in a desperate measure to keep them solvent. It agrees to inject $100bn into each entity, *to start off with.*
- **Sunday, 14 September:** in an unprecedented move, US derivatives markets opens for a few hours on Sunday night to settle deals that might endanger the $65 trillion derivatives market in the event of US investment bank Lehman Brothers collapsing. The deals are carried out under supervision and are all dependent on Lehman filing for bankruptcy before midnight. In the event that Lehman doesn't collapse, the deals will be deemed null and void.
- **15 September:** 158-year old Lehman Brothers files for bankruptcy at 06h30 SA time after negotiations to rescue it fail. A strong feeling prevails that the US authorities let it fail – at its peak Lehman Brothers was worth $60bn. Bank of America buys Merrill Lynch, another US investment bank, for $50bn, after lightening-speed discussions held over the weekend. Attention now turns to AIG, the largest insurer in the US, amidst rumours that unless it can secure $80bn in the next day or two, it too, will go to the wall. AIG price declines 60.8%. The Russian equity market declines 4.8%, bringing its month-to-date decline to 24.0% amidst fears of a worsening liquidity crisis and possible bank failures. The oil price declines below $100.
- **16 September:** Fed keeps rates unchanged at their regular FOMC meeting but pumps $50bn into the market to improve liquidity. The ECB inject $150bn into the market and the BoE $34bn. Concerns grow about the health of Washington Mutual (WaMu), the US's third largest bank, as its bonds are downgraded to junk status and the Fed announces an $85bn rescue package for AIG, effectively nationalising it. The Russian equity market dollar-denominated RTS index drops 11.5% (the rouble-denominated Micex index falls 17.8%) as the oil price drops to $90. Trading was temporarily suspended earlier in the day. Russian authorities inject $10bn into the money market. HBOS shares fall 22% in London, after having been down 40% at one stage on concerns about its funding ability. The Japanese equity markets falls 5.0%.
- **17 September**: Russia closes both exchanges after the RTS drops 6% amidst the biggest falls since 1998. The MSCI emerging market index drops 7.0% and gold rises 11.4% - its biggest daily gain since 1980. AIG price drops 45.3% as the US and UK regulators ban "naked" short selling, the practice of selling shares without having first borrowed the scrip. That doesn't stop the S&P500 falling 4.7%. Morgan Stanley and Goldman Sachs drop 37% and 21% respectively on market concerns that they will follow other investment banks into bankruptcy. The UK government forces HBOS into merger talks with Lloyds TSB – HBOS declines another 19.1%. The TED spread, the difference between 3-month US Treasury Bills and LIBOR, rises above 3.0%. And in only the second time in its 37-year history, a US money market mutual fund (unit trust) run by industry pioneer Reserve Management Corporation (RMC) "breaks the buck" (declines below a level of $1.00), *sending shivers through global markets.* The US money market mutual fund has $3.5 trillion under management. The RMC fund in question was $63bn in size and had to write off

$785m of Lehman securities issued by the now-defunct bank. Russian markets remain closed.

- **18 September**: global central banks inject another $180bn into markets amidst increasing signs that all liquidity is drying up. The 3-month LIBOR rate declines slightly to 3.84% from 5.03% the previous day, but the 3-month US Treasury Bill declines to 0.1%, *its lowest level since 1941* (after the attack of Pearl Harbour) as lending between US and European banks seizes up. The Russian markets remain closed. Asian markets go into freefall – Hong Kong declines 7.7% at one stage – but then recovers slightly towards the close. China drops 6.0% before the government announces steps to prop up the market. Midway through US trade a report crosses the news wires that US Treasury Secretary Hank Paulson has mooted a Retail Trust Corporation (RTC) - style solution for the current crises. The RTC solution eventually brought the late-eighties Savings and Loans Crisis in the US to an end. US equity markets surge on the news; the S&P500 ends 4.3% up on the day. European and UK markets close flat, after having been down sharply before the US market opened. Putnam Investments, one of the oldest US investment managers, closes a $12bn money fund due to excessive redemptions.
- **Friday, 19 September: a**fter the Russian central bank injected $130bn of liquidity into the capital markets during the past five days to alleviate the lack of liquidity the Russian market reopens and end 22.4% up on the day, but still 3.5% down over the week. Other global markets rally strongly on continued optimism that an RTC-type plan will resolve the current crisis. The US Treasury announces its proposal, the $700bn Troubled Asset Relief Program (TARP), wherein it will buy up "toxic assets" from the banks in an effort to resolve the prevailing credit and liquidity squeeze. The US market rises 4.0% after trading in a 6.7% range. The German market ends up 5.6%, India 5.5%, China 9.5% and Hong Kong 9.6% in what is described as a "completely insane" week. The UK equity market ends up 8.8% - its biggest one-day rise in history. The FSTE100 index was started in 1984; its 8.8% gain is larger even than the 7.9% rise on 21 October 1987, just after the crash of Black Monday, 19 October 1987. The UK bans all forms of short-selling; the authorities in many other countries, including the US, follow suit.
- **Sunday, 21 September**: SA President Thabo Mbeki addresses the nation and resigns publicly after being recalled by the ANC in a dramatic putsch. The Fed announces that Goldman Sachs and Morgan Stanley's application to become bank holding companies was approved. The news is rushed out ahead of the Asian market opening on Monday.
- **22 September:** US investors pull $197bn out of money market funds last week as fears escalate about the security of the investment vehicle widely regarded as impermeable to bad news and negative returns. The oil price rises $25 or 17.0%, its largest one-day gain ever, and gold rises above $900 again as doubts begin to emerge about the success of the TARP. The dollar drops sharply to a three-week low.
- **23 September:** SA's Minister of Finance Trevor Manuel resigns, together with 10 other ministers and 3 deputies, as a purge of ousted President Thabo Mbeki's cabinet takes place. The rand falls 4% to R8.20 to the dollar on the news and the SA equity market closes 3.8% down. Manuel is subsequently reappointed into the new cabinet. It emerges that hedge funds have had about $40bn of assets frozen by the Administrators of now-defunct Lehman Brothers. Some of these assets were in the process of being settled when the bank filed for bankruptcy, while about $20bn had been used for Lehman's own cash-raising operations in a process known as rehypothecation, whereby the bank re-lends client securities held as collateral. These assets now become creditors of the bank and the Administrators indicate that it will be a "long time" before the final details are sorted out. It also emerges that the Japanese bank, Nomura, which bought the European and Middle East operations of Lehman Brothers for just $2 (two dollars) has created a bonus pool of $1bn for the 2 500 employees in an effort to stop them from defecting to competitors (*Ed*: will this profession never learn; does its greed know no end?) Global equity markets decline after two massive days of gains. China ends 1.6% lower, having gained 17.3% during the two previous days. The TED spread widens to a record 121.125%, its highest level since December 1987 as doubts about the TARP increase. Talks continue to find a buyer for Washington Mutual (WaMu), the third largest bank in the US.
- **25 September**: 59-year old Kgalema Motlanthe is appointed as SA's third black president since 1994. The infamous Dr Beetroot, Manto Tshabalala-Msimang losses her job as SA Minister of Health. The archbishop of Canterbury and head of the Anglican Church, Rowan Williams, says it was right to ban short selling and the outspoken archbishop of York, John Sentamu, calls traders who cashed in on declining prices "bank robbers and asset strippers." The comments are met with howls of "hypocrisy" when it emerges that the church's $10bn investment portfolio lends stock to foreigners (who obviously sell it short) and has a $22m investment in the Man Group, the largest listed hedge fund manager. GE issues its second profit warning of the year. Libor rises sharply to 3.77% amidst ongoing signs that interbank liquidity is drying

up. The TED spread rises to levels higher than when Lehman failed. UK lender Bradford & Bingley loses 25% on concerns that it is "on the way out." European Bank Fortis declines 22% to a 14-year low on the back of rumours that it is in trouble and about to merge – rumours it denies.

- **26 September**: 123-year old WaMu is forced to close by Federal regulators after $16.7bn is withdrawn by depositors in 10 days. JP Morgan buys Wamu's assets and branches for $1.9bn. WaMu's failure goes down as the biggest banking failure in US history. The Baltic Dry index declines 10% and is now 70% off its May peak.
- **29 September**: US politicians failed to ratify the $700 TARP, sending equity markets into a tailspin. The Dow Jones fall 7.0%, its worst daily percentage decline since September 11, 2001, after the World Trade Centre terrorist attack, and the S&P500 falls 8.8%, its worst daily decline since Black Monday in October 1987. The Nasdaq falls 9.1%. Some $1.2 trillion's worth of market capitalization is wiped off the US equity market alone. The oil price declines 9.8% to $95 and the Fed injects *no less than $630bn* via global central banks into the cash markets to keep them liquid. Libor rises to 3.88%, its highest level ever. All other rates of intra-bank overnight lending rise to all-time records. The UK market declines 5.3% and Germany 4.2%. The Brazil equity market falls 15% before trading is suspended. Netherlands and Belgian governments scramble to rescue Fortis and eventually take ownership of a 49% stake in the bank. The German government begins talks to rescue Hypo Real Estate, a large mortgage and public sector lender, after its share price collapses 70% and it reveals a $72bn funding hole. Bradford & Bingley collapses and the UK authorities step in and nationalise it. The Iceland government nationalizes Glitnir Bank after taking a 75% stake. Citibank undertakes to buy Wachovia, the sixth largest lender in the US, for $2.2bn after it collapses. Today goes down in history as "Meltdown Monday." The UK experiences its worst monthly decline in 20 years and the US its worst in 10 years. Zhai Zhigang returns to earth after having completed China's first space walk. Paul Newman passes away.

Appendix 2

A chronicle of chaos – October 2008

For the sake of ease I have separated market developments in September and October, but of course they form one continuous "vortex" of misery. The following represent a selection of salient features in October.

- **1 October**: after falling very sharply at the open, European and later US equity markets regain some poise in the belief that US lawmakers will re-work the Troubled Assets Relief Program (TARP). But Libor continues to rise, now at 6.87%, amidst month and quarter-end pressures. Volatility in equity markets reaches new heights; for example Anglo Irish Bank, which lost nearly 50% the previous day, rises 67.8% on the day. All other Irish banks soar as Ireland astonishes the world by guaranteeing the debts and deposits of its six largest lenders. Ireland's economic growth has been slowing and it runs a current account deficit equivalent to 8.0% of GDP. Ireland's guarantees equate to more than double its entire GDP. European governments step in to save Dexia Bank while the Reserve Bank of India steps in to prevent a run on ICICI Bank, India's largest bank.
- **2 October**: the European Central Bank (ECB) keeps interest rates on hold. US equity markets end 4% lower on weak employment data. Overnight interbank lending rates rise to new highs – clear evidence that banks are still not lending to each other and that the liquidity crisis is getting worse.
- **3 October**: global equity markets end one of their most volatile weeks on record. The S&P500 ends 9.4% lower, Germany 4.4%, Japan 8.0% and Hong Kong 5.4%. Widespread weakness also washes over the commodity complex amidst increasing concern about the effects of the liquidity crisis on the global economy. The agreement to save Fortis collapses and the Netherlands nationalises its portion of the bank. The Iceland krona ends the week 13% lower amidst increasing evidence that the country is running out of money.
- **6 October:** weekend talks to salvage Hypo Real Estate fail, causing the German government to guarantee all private bank deposits, which total $773bn. Denmark follows suit. US markets continue to decline – the Dow Jones ends below 10 000 for the first time since October 2004 - amidst ongoing failure of banks and the liquidity squeeze. The S&P500 ends 3.9% lower after having been as much as 9.0% lower at one stage. Germany falls 7.1%, the UK 7.9% and SA 7.3%. Asian markets decline by greater amounts; Russia ends 19.2% lower and Brazil, having been closed after trading "limit down" three times during the day, ends down 15.5%. The MSCI Emerging market index suffers its worst day since 1987 and commodity prices tumble. The Californian economy, the eighth biggest in the world, announces that it is within weeks of running out of money. It appeals to the US Treasury for interim finance after having been unable to continue its usual funding programme due to the credit crisis.
- **7 October:** the Iceland prime minister addresses the nation, advising them that the country is on the verge of bankruptcy. Their currency, the krona, declines 30.0% on the day. Trading in the country's financial sector is immediately suspended and a number of other measures are instituted, together with an appeal to the nation's retirement funds to repatriate capital. The three largest Iceland banks are subsequently nationalised and the government turns to Russia for a $4bn loan. The Reserve Bank of Australia cuts rates by 1.0%. UK banks tumble - RBS falls 39% after the previous day's decline of 20.0% and HBOS falls more than 50% in two days. In response the UK government announces a $61bn plan to recapitalise banks. Russia commits $37bn in long-term loans to its banks. The Fed announces it will start buying short-term (commercial) paper from banks in an attempt to unfreeze money markets. US markets decline further, ending down 5.7%; the S&P500 breaks below the 1 000 level, last seen in early-2003.
- **8 October:** the day begins with more declines; the Japanese equity market declines 9.4% to a five-year low, its worst one-day fall since 1987, while Hong Kong declines 8.2%, its worst one-day decline since 1973, despite the Hong Kong Monetary Authorities cutting interest rates by 1.0%. The Indonesian market is closed after a 21% plunge at the open. European markets drop sharply at the open, while the Russian market closes yet again – this time for two days - after only half an hour's trade, having fallen by 14.4%. Then in a major, co-ordinated announcement, the Fed, ECB and BoE cut rates by 0.5% each and the Banks of Iceland, Switzerland and China (for the second time in three weeks) also lower rates. The US market still ends down 1.1%, the UK 5.2%, Germany 5.9% and SA 2.8%. It is very clear that investors are paying no attention to any rescue plans or policy announcements.
- **9 October: t**hree-month dollar Libor rises to another record high of 4.75% - banks are still hoarding cash. As short sellers return after a three-week ban the US market declines sharply. A possible downgrading of GM by Standard and Poor's (sending GM to its lowest level since 1950) does not help sentiment; the S&P500 declines 7.6% to levels last seen in April 2003. The Fed pumps an additional $38bn into AIG, indicating that they clearly miscalculated the company's position with their initial $85bn injection. The UK market ends 1.2% lower and Germany 2.5%; the SA market gains 1.4%.

Iceland's woes continue, culminating in the suspension of trading on their exchange. The UK uses anti-terrorist legislation to seize the assets of the UK subsidiary of an Icelandic bank (Landsbanki) in order to protect the deposits of UK citizens. Today marks the anniversary of the current bear market – most markets peaked on 9 October 2007. Since that time Merrill Lynch calculates that $8.3 trillion has been wiped off the value of the US equity market alone.

- **10 October:** widespread panic grips all global markets as evidence emerges of capitulation by retail investors in mutual funds and investors shun further government measures to shore up falling markets. After opening 7.7% lower US equity markets end down 1.2% after having traded in a breathtaking range of 11.4%. The UK market ends 8.9% lower, Germany 7.0% and SA 3.1%. The week ends with the largest losses on record. Despite the sharp losses prior to this week, *weekly declines* in the US total 18.2%, in London 21.1%, Germany 21.6%, Spain 19.8%, France 21.5%, Tokyo 24.3%, China 12.8%, India 19.3%, Russia 21.1%, Brazil 22.5% and Mexico 12.9%. SA emerges slightly better off, having declined "only" 8.6% on the week. The commodity complex suffers an equally dismal week: oil ends the week down 14.2%, copper down 19.5%, nickel 20.1%, lead 14.0%, zinc 9.7% and aluminium 4.7%. To place the equity declines in perspective, the past week saw the US market drop 18.2%. In the week of Black Monday in October 1987, the market dropped 12.2% and during the tragic events of September 11, 2001, its weekly drop was 11.1%. In the Dow Jones Industrial Average's 112-year history, it has never endured a weekly decline of such magnitude – it fell 18.2%. Martti Ahtisarri, former Finnish president and UN envoy, who played a key negotiating role in the return of Namibia to independence, wins the Nobel Peace Prize.
- **13 October:** following emergency meetings of selected world leaders governments give the first signal that they understand the full extent of the crisis. The UK leads, announcing a plan to inject $65bn into the country's three largest banks, effectively nationalising them. The chairman and CEOs of HBOS and RBS are summarily booted out. Europe follows; France commits $450bn in credit guarantees and loan capital ($54bn of which will be used to buy equity stakes in banks) while Germany commits $680bn ($136bn of which will be used to buy equity in banks) with similar objectives. In total EU members commit $2.6 trillion on the day to the bank bail-out. Later in the day the US injects $250bn into buying stakes in their largest banks amidst reports that banks are told "they have no choice" but to accept the terms of the new deals. This leads to a massive rally on global equity markets, which post some of their biggest one-day gains in history. The UK ends up 8.3%, Germany 11.4%, Hong Kong 10.2%, China 3.7% and the US 11.6% (its largest daily gain since 1933). The SA equity market ends 4.2% higher but Russia declines another 6.3%. The 3-month Libor rate declines marginally. Princeton University professor Paul Krugman wins the Nobel Economics Prize for his work in trade theory, much of which he completed in the late 1970s before he was 30.
- **14 October:** the Iceland exchange reopens and ends 76% (that's seventy six percent) lower. But the momentum from the previous day carries through to Asian trade, where the Japanese and Hong Kong markets end 14.2% and 3.2% respectively. London ends 3.2% higher and Germany 2.7% despite very bad economic data. Australia and SA end up 3.7% and 3.1% respectively. New Zealand gains 6.0%, Russia 9.9% and South Korea 6.1%, but China falls 2.7% and the US can only muster a loss of 0.5% on the day.
- **15 October:** despite yesterday's gains, nervousness continues to dominate markets as the focus shifts to the health of the global economy, and the US economy in particular. The UK equity market ends 7.2% down and Germany 6.5%. The SA market ends down 7.0% on the back of a huge sell-off in resource shares worldwide - Anglo and Xstrata for example decline 20.0% each in London and Billiton falls 15%. Later that evening the rand plummets 17.1% to R10.66 to the dollar, after touching R10.81. Other emerging market currencies are subjected to the same pressure as a wave of "risk aversion" sweeps through the markets. The Hungarian equity market (the Bux index) ends 11.9% lower and its currency, the forint, falls 5.3% on concern about that country's large current account deficit and its foreign loans. Russia declines 9.3% as more than a dozen Russian banks report a sharp rise in withdrawals and account closures. The US market declines the most since October 1987 as the S&P500 ends 9.0% lower. The Baltic Dry index falls 10.7% on the day, bringing its decline since the end of September to 49.8%. Concerns increase about the $65bn of hedge funds assets "trapped" in the UK operations of Lehman Brothers, which is now under the control of PwC Administrators. Of this amount an estimated $20bn relates to short positions *on which managers are still receiving margin calls*! The $65bn includes assets of US-based hedge funds which thought that their assets were in Lehman's US operations but it now transpires that the funds were shifted to the UK and are now stuck in the bankruptcy proceedings. Mohamed El-Erian's *When Markets Collide* is named as the Financial Times Goldman Sachs 2008 Business Book of the Year. El-Erian is the co-CIO and co-CEO of Pimco, the largest bond manager in the world. Prior to that he worked at

the IMF and ran Harvard University's $35bn endowment fund.

- **16 October:** marks the anniversary of the peak of the Chinese equity market. Since that time the Shanghai Composite index has declined 68.7%. Fifteen banks in the US have failed so far; 117 are on government's list as "troubled institutions." Merrill Lynch reports that $27 trillion of market cap has been lost in the past year of equity market declines. Equity market weakness continues to be the order of the day, as the UK market falls 5.4% and Germany 4.9%. Mining shares and insurers in particular are sold heavily in London – Old Mutual falls 21.6% and Anglo down 13.1%. Hungary remains in a crisis - the Bux index declines another 8.6% and Ukraine joins the queue of countries running out of money. Its PFTS equity index declines 5.2%, bringing its decline for the year to date to 80%. Both Ukraine and Hungary approach the IMF for emergency funding. The South Korean Kospi index declines 9.4% and its currency, the won, falls 10.0%. Japan posts its largest daily decline since October 1987, falling 11.4%. Hong Kong ends 5.5% lower and China 4.3%. Russia ends the day 9.5% lower. The SA market declines 2.3% but in late trading US markets turn around and end 4.3% higher, *having traded in a 9.4% range on the day*. Interbank rates cross all periods and currencies decline for the fourth consecutive day (that's a positive, by the way) showing that recent government intervention may actually be having an effect. The International Accounting Standards Board (IASB) agrees to a request from the EU to temporarily relax the rules on "fair value" accounting although debate rages on about the advisability of demands for further relaxation on this issue.
- **17 October:** equity markets recover some composure, despite very bad US economic data. US consumer confidence falls to its lowest level ever since records began in 1978. Earlier in the week US industrial production posted its worst decline since 1974 and the NAHB housing market index falls to an all-time low. The Japanese equity market rises 2.8%, London 5.2% (Rio Tinto gains 9.8% and Billiton 10.4%) and Germany 3.4%. Russia ends the day 6.5% lower. The US market ends 0.6% lower *after having traded in a range of 8.9% on the day*. Volatility reaches extreme levels as another crazy week ends; major global equity markets registers their largest daily gains ever on Monday, only to follow them two days later with their largest daily declines since October 1987. Volatility at a "per share" level is even more extreme. By way of example Credit Suisse rises 41.5% on the week despite reporting a loss of SFr1.6bn and an additional SFr10bn injection from private investors but Fortis and Dexia tumble 83.9% and 21.0% respectively. ING Bank accepts a $13bn bail-out from the Dutch government and South Korea launches a $130bn rescue package for banks and companies suffering from the liquidity and currency crisis. France's third largest mutual bank, Caisse d'Epargne, reports a $810m loss after the bank's proprietary traders "ignore authorized limits".
- **20 October:** the 3-month Libor rate falls to 4.0% amidst ongoing signs that banks are beginning to lend to each other and that the massive government intervention is starting to gain traction. Equity markets respond positively: the UK and Germany rise 5.4% and 1.1% respectively. The London market in particular is buoyed by huge rises in banks and miners: ING rises 29.2%, RBS 23.2%, Lloyds 9.3%, Xstrata 9.2% and Rio Tinto 13.1%. The JSE rises 2.9%, led by resource companies, and Brazil rises 4.5%. Caisse d'Epargne's chairman and CEO resigns following last week's trading scandal. The Reserve Bank of India unexpectedly cuts interest rates by 1.0% to 8.0% - the first reduction in four years - in order to "alleviate the pressure and maintain financial stability". China's economic growth slows to 9.0% during the third quarter. Sweden announces a $205bn rescue package to stabilize its financial system.
- **21 October:** The Japanese market recovers some composure and rises 7.0% but the gains don't follow through to Europe where markets end 1% down. The rand loses 5.0% to R10.63 to the dollar enabling the JSE to post a 2.7% gain. SA finance minister Trevor Manuel tables the Medium Term Budget, in which he forecasts that SA's 2007 Budget surplus will fall to a deficit of 1.6% of GDP by 2010. He forecasts that economic growth is likely to be 3.7% in 2008 and 3.0% in 2009. The Brazil real falls 4.2% while the Turkish lira ends 4.5% lower. The Bank of Canada cuts interest rates by 0.25% to 2.25%. The Fed announces a $540bn package to buy back assets (short-term debt) from US money market mutual funds (unit trusts). The US market sheds another 3.1% despite a sharp sell-off in commodity prices, which sees gold and oil down 3%. Argentina's Merval index sheds 13.7% amidst concern that the government is about to nationalise private pension funds in order to meet large debt repayments, thereby preventing the country from defaulting on its foreign debt.
- **22 October:** South Korea's Kospi index sheds 5.1%, Japan closes down 6.8% and Singapore and Hong Kong 5.2% each. European equity markets decline sharply; the UK and German markets both end down 4.5%. Banks and materials shares decline about 10% on average across all markets. The Hungarian central bank increases interest rates by 3.0% to 11.5% in an effort to support their currency. The Brazil real declines 4.7%, the Turkish lira 4.3% and South Korean won

3.2%. The rand falls 8.7% to R11.58 to the dollar, after touching R11.80 at one stage, and the euro declines below 1.30 to the greenback. Sterling also slumps, ending the day 3.2% lower at 1.62 (a 5-year low) after BoE Governor Mervyn King warns that the UK is heading for a recession. The JSE ends down 4.6% as the slump in the currency begins to sink in. The US posts even larger declines; the S&P500 ends 6.1% lower following another scary day of trade that saw a range of 9.4% on the day! Wachovia (Bank), which is the in the process of being acquired by Wells Fargo, reports a third quarter loss of $23.9bn, its third straight quarterly loss. Argentina's Merval index falls 16.7% as government nationalises $29bn of private pension funds in a less-than-subtle move to stave off another debt default. Brazil ends the day 6.7% lower and Canada 5.7%. Copper and corn fall 7% each, gold 3.1% and the Baltic Dry index 4%, bringing to 90% its decline off its May peak. India launches its first unmanned mission to the moon.

- **23 October:** Reserve Bank of New Zealand cuts rates by 1.0% to 6.5% and the Swedish Riksbank by 0.5% to 3.75%. South Korea's Kospi index declines another 7.5% and its currency, the won, declines to a 10-year low. For the eighth day in a row the 3-month dollar Libor rate declines – now at 3.54%. The Russian market closes twice during the day following a down-grade of its debt and eventually ends down 4.4% on the day. European markets end mixed, up or down about 1%, and US markets end 1.3% higher. But that doesn't tell the whole story; volatility was greater than I have seen at any time this week (despite the S&P500 trading in a range of "only" 7.8%). Only a strong rally in the last half hour took the markets higher. Market sentiment and nervousness remains extreme. The "flight to safety" continues, with the dollar hitting two and five-year highs against the euro and sterling respectively. Copper ends down 4.0%, platinum 5.0% and gold 1.7%. And Libor rises for the first time in two weeks (that's bad, by the way).
- **24 October:** the proverbial budgie hits the fan as Asian markets open weak and end down even weaker. The Japanese market ends 9.6% lower, only 42 points higher than a level last seen in 1982, when the S&P500 was at 143 and the Dow Jones at 1 060!! It is worth noting that this index has now fallen 80.3% from its peak of 38 915 on 29 December 1989! (As a matter of interest, the Nasdaq is off 69.5% from its 10 March 2000 peak of 5048). South Korea falls 10.6%, Hong Kong 8.3%, China 1.9% and India 11.0%. Russia closes its markets, but not before the RTS index declines 13.7% on the day. European markets open very weak as well and before the US market opens trading in the S&P500 future is halted, due to it having traded "limit down" i.e. market rules dictate that once a certain percentage loss (on the S&P future) has been reached before the market opens, trading is suspended until the actual market opens. The world holds it breath, waiting for the US market to open. In the interim the UK announces that economic growth in the third quarter was negative, at -0.5% (but 0.3% higher year-on-year), sending the pound down 5%, its biggest decline since 1971. In the end, the US market ends down 3.5% (the trading range for the day was 7.2%) but not before a few heart-stopping moments as the world watched when the market opened. It fell sharply at the open, down more than 7.5% from its previous close, but recovered off its early lows and never went to retest them. The UK and German market were less convinced, recording declines of 5.0% each. The Vix index, which measures US market volatility, rises 32% to 89.5 – a new all-time record. Denmark raises its interest rate 0.5% to 5.5% in an effort to support its currency, the krone. All in all, another terrible week on global investment markets, with little in sight to indicate any sign of an end to the prevailing financial tsunami. On the week the following declines were recorded: the German Dax -7.3%, the UK 4.4%, Japan 12.0%, Hong Kong 13.3%, Russian 17.7%, China 4.7%, Brazil 13.5%, Argentina 26.8% and South Africa 8.3%. Commodity prices declined even more on the week: copper fell 21.4%, aluminium 10.4%, nickel 7.8%, lead 12.5%, zinc 6.1% and tin 9.6%. Iceland announces that it has secured a $2bn rescue loan from the International Monetary Fund (IMF). One final comment on the day's developments: Volvo issued a profit warning, citing tough economic conditions. Third quarter truck orders declined 55% year-on-year. In what can then only be described as shocking, it says that net orders in Europe for trucks totalled only 115 (that's one hundred and fifteen) from 41 970 a year earlier! It makes you wonder how bad the European economy really is.
- **27 October:** Asian markets get the week off to a very bad start. The yen strength – it has risen more than 40% against the euro so far this year – is becoming a major problem and is adding to the pressure on Japanese exporters. As the yen heads towards 90 yen to the dollar, the Japanese market ends 6.4% lower, now at a 26-year low. China ends 7.1% lower, Hong Kong 12.7%, the Philippines 12.3% and India 2.2%. Korea cuts interest rates by 0.75% to 4.25%. European markets go on a wild rollercoaster day again; the UK market ends down 0.8% but Germany's Dax, *which trades in an astonishing range of 10.6% on the day*, ends the day up 0.9% in bizarre fashion due to distortions created by VW's share price – refer to Appendix 3 for details about this crazy situation. Amazing stuff, to say the least, but tomorrow holds

even more shenanigans for the German market – as though we don't already have enough madness and uncertainty to deal with The US market spends most of the day in positive territory but then declines sharply in the last five minutes of trade to end the day 3.2% lower. The S&P500 trading range for the day is 8.3%. The IMF agrees to a $16.5bn rescue package for Ukraine.

- **28 October:** Markets in the East rally strongly after yesterday's large losses – the Hong Kong market gains 14.4% - its largest one-day gain in 11 years – China 2.8% and Japan 6.4%. *The Dax trades in another mind-boggling range of 14.0%* on the back on the ongoing nonsense in the VW and Porsche battle (*Ed:* where are the market regulators when you need them?) before ending the day up 11.3%. The UK market ends 1.9% higher and the JSE All Share index gains 1.1%. Russian reopens its market, which ends up 4.8% and Brazil ends 7.8% higher. US consumer confidence plunges to a 41-year low but the market seems unperturbed as it roars up to end 10.8% higher, *after trading in a range of 11.6%!* Back on the old days most investors would have been happy with that as an annual return! Iceland hikes interest rates by another 6% to 18% as the world prepares itself for the Fed's interest rate meeting tomorrow. Currency markets begin to experience significantly more volatility: after reaching a 13-year high, partly due to the unwinding of the "carry trade" whereby investors borrow yen and invest in higher yielding currencies such as the Australian dollar, the New Zealand kiwi and the rand, the yen declines sharply. It falls 5.6% against the dollar but even more against the Aussie dollar, which gains 12.4% against the yen. The kiwi gains 9.7% against the yen. Weakness also creeps in to the dollar. After having marched relentlessly upwards against virtually all other currencies since mid-September, it loses 6.5% against the Aussie dollar, 4.0% against the kiwi and 2.2% against sterling. The euro gains 1.3% against the dollar and the rand gains 7.0% to R10.24. These percentage movements may not seem that large, but for the currency markets they are huge. Commodity prices rise on the back of the weaker dollar. Copper rises 2.5%, lead 13.5% nickel 6.8%, oil 2.2% and tin 8.5%.
- **29 October:** In the face of strength in the US markets yesterday, the weak yen and rumours of a Bank of Japan (BoJ) rate cut tomorrow the Japanese market climbs another 7.7%. Hong Kong follows its record gain yesterday with another gain, this time by 5.8%, while China falls 2.9% to a new 25-month low and Korea and 3.0%. Dollar weakness – it declines 1.0% to EUR1.29 and 2.7% to GBP1.64 – helped commodity prices and shares. The UK market, which is dominated by financials and miners, rose 8.1% with daily gains in Old Mutual of 30.1%, Standard Charter 30.0%, Prudential 18.9%, Rio Tinto and Xstrata both 25.1%, Anglo 19.1% and Billiton 14.0%. These are *daily* gains remember. Ongoing shenanigans in the VW Porsche battle result in the Dax market ending 0.3% higher but the Cac40 in Paris gains 9.2%. The CRB (commodity) index rises 6.0% due to huge gains in commodity prices. Oil rises 8.3% to about $70 and most other metals gain about 10%. Gold and platinum disappoint with gains of around 2% only. The JSE All share index rises 6.7%, led by resources, which rise 11.2% on the day. The gold index weighs in with a gain of 9.7%. Brazil ends up 4.9%. As expected, the Fed cuts rates by 0.5% to 1.0%. The US equity market rallies on the news of the cut and is heading for another strong close when suddenly someone "switches the lights out" in the final minutes of trade to see the S&P500 decline 4.1% in the last five minutes of trade to end the day 1.1% lower. Yet again the final few minutes dominate the day's trade on the US market, exasperating investors and traders alike. On the interest rate front, Norway lowers interest rates 0.5% to 4.75%. China lowers rates for the third time in two months by 0.27% to 6.66% and as we mentioned earlier, the Fed cuts rates by 0.5% to 1.0%, the lowest level since June 2004.
- **30 October:** buoyed by strong markets overnight (despite the freak final minutes in the US), the weak yen and rumours of a BoJ cut, Asian markets continue their huge rally. Japan ends up 10.0%, Hong Kong gains 12.8% (it too lowers its rate, given that its currency is tied to the US dollar), Korea 12.0% (their biggest daily gain on record) and China 2.6%. The Taiwanese market rises 6.3% after the central bank also cuts its discount rate. And in an unusual arrangement, the Fed agrees overnight to lend South Korea, Brazil, Mexico and Singapore a total of $120bn to satisfy their demand for dollars. Real US GDP declines 0.3% in during the third quarter and consumer spending falls 3.1%, its first decline in 16 years and the worst decline since 1980 – but the markets don't seem to care: the UK market ends up 1.2%, the Dax 1.3%, the US 2.6% and the JSE 5.4%. The Depository Trust and Clearing Corporation (DTCC), a large US organization that clears and settles millions of trades each day in order to keep the markets going, announces that is has successfully closed out over $500bn of market participant's exposure included in or related to the Lehman Brothers' collapse.
- **31 October:** TGIF and THTMIO (thank heavens this month is over)!! Japan cuts interest rates for the first time in 7 years by 0.2% to 0.3%. On the day markets continue the momentum initiated at the beginning of the week: Japan declines 5.0% but the UK, German and

US markets gained 2.0%, 2.4% and 1.5% respectively. The SA market ends 0.6% higher. The returns bring to an end an historic and tumultuous month and week. It will go down in history as *the worst month ever* in history and also *the best week ever* in history. That sounds contradictory, but it epitomizes the volatility and turmoil experienced during October. Despite the awful returns for the month, this week saw the equity market in Japan gain 12.1%, Korea 18.6% and Hong Kong 10.7%. Not to be outdone, the UK rallied 13.4% on the week, Germany 16.6% and the US 10.5% (its biggest weekly gain since 1974). SA gained 14.3%. Just imagine what the monthly returns would have looked like it if wasn't for the massive returns experienced during the last week in October.

Glossary

Libor: the London interbank overnight rate, which measures the interest rate at which banks lend to each other. Libor is distinguished by a period, for example, three-month Libor, and by its currency denomination. Libor is set daily by the British Bankers Association around midday SA time.

Short-selling: the activity of borrowing scrip (shares) from traditional investors such as pension funds, and then selling them with a view to buying them back at a later (and lower) stage in order to make a profit. "Naked" short selling refers to the practice of selling shares without having borrowed them first, although this practice is banned in many jurisdictions.

The TED spread: measures the difference between the 3-month US Treasury Bill and 3-month Libor, and is often referred to as the "fear factor" as it indicates just how unwilling banks may be to lend each other.

The Libor – OIS spread: measures the extra interest that banks have to pay for three-month money above the average overnight rates. In effect this spread measures the cost of money out of central banks.

TARP: the Troubled Asset Relief Plan proposed by the US Treasury in September and voted into legislation a few days later. The plan allows, amongst other things, for the US Treasury to buy "toxic (bad) assets" from banks by means of market-related auctions. The assets would then be managed by private investment managers and held or sold at opportune moments. The hope is that by removing these bad assets from banks' balance sheets, banks will begin their normal lending assets again and allow them to restore their balance sheets (which would in most cases means raising more capital).

Appendix 3

And you thought Porsche made cars!

There have long been concerns about aspects of German corporate law and capital markets, in particular the levels of transparency, or rather the lack thereof. This was adequately demonstrated in a bizarre event during October that has raised many questions about the integrity of the German markets and has tarnished that country's reputation and future ability to attract foreign capital.

Whilst compiling the recent September Quarterly Report, I commented that "the markets are *simply not working efficiently*." I thought at the time that I was being a bit melodramatic, but then the events surrounding Volkswagen unfolded which, in my opinion, vindicated this view and provided at least one example (and there are more) of the manner in which so-called efficient markets have become very inefficient of late, in so doing making it very difficult for investment professionals to ply their skill. Here, then is a summary of the "VW saga."

Chart 3.1: VW share price: 1 July to 17 September 2008

Source: FT.com

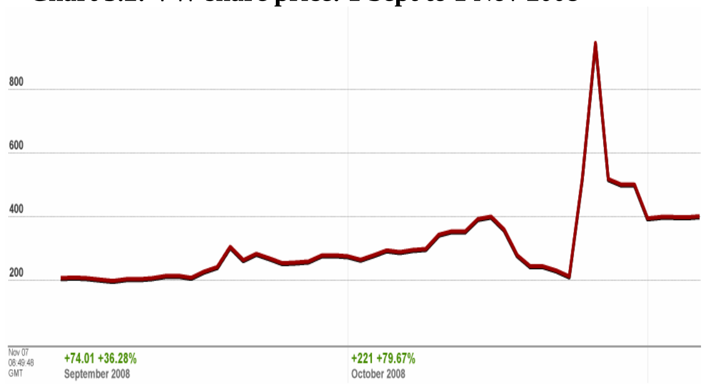
Through a long and acrimonious part-corporate, part-family battle, control of German automaker Volkswagen (VW) has passed into the hands of Porsche, which was, at least at the time it began its take-over of VW, a much smaller company (the latter makes 60 times more cars than former). Before the nonsense during the last week of October began, Porsche owned 35.0% of VW. Then on Sunday, 26 October it announced that it had increased this to 42.6% but more importantly had acquired options over a further 31.5%, taking its total stake to 74.1%. The fact that it was able to acquire such a large stake surreptitiously, gaining control of VW in the process, highlights the flaws that investors have for so long raised as a concern. In the period leading up to October and presumably in the process of Porsche acquiring its additional stake, the price of VW had risen sharply despite broad-based weakness in equity markets around the world, and automakers in particular. VW ended 17 September at a price of 304 (euros) shown in Chart 3.1.

One can understand the rationale for selling VW: it was expensive and over-valued on both an absolute and relative (to the rest of the market and other automakers) basis. Even the Porsche head of investor relations commented only a few days ago that a price of 300 "was unrealistic." So that's what many hedge fund managers did. Had they known what Porsche was up to, they would never have undertaken an activity like that!

Porsche's announcement that it had secured such a large portion spread immediate panic on Monday, 27 October. The German state of Lower Saxony holds 20.1% of VW, which together with Porsche's 74.1% stake meant that 94.2% of VW was in "secure" hands. Critically, the "free float" i.e. the amount of shares available to trade publicly, was now only 5.8%. All short-sellers of VW, typically hedge funds, suddenly realised they were facing unlimited losses - an underlying assumption of short-selling is that you can buy back the shares at some stage. With such a small amount (5.8%) of the company as a free float it would be very easy to manipulate the shares. Simply put, there were for all intents and purposes no more VW shares in the market left to buy, and short-sellers were desperate to buy back their shares. They had become forced buyers in a very illiquid market.

With that as background, let's track the subsequent events. As equity markets started taking strain on the back of the global credit and liquidity crisis, VW shares fell sharply in line with other automakers around the world. It closed on Friday, 24 October at 211 some 47.1% off its 16 October peak of 399. But following Porsche's disclosure over the weekend, Monday 27 saw the VW share price rise 146.6% to 520. As more people became aware of the problem, so it took on increasing importance. Tuesday 28 October saw the VW price rise another 81.7% to 945 after having hit a level of 1005 at one stage – refer to Chart 3.2 for all the action.

Chart 3.2: VW share price: 1 Sept to 1 Nov 2008



Source: FT.com

Bear in mind that all this nonsense was occurring at a time that global equity markets were recording the largest weekly and monthly declines in living memory and the financial world was literally falling apart. The cumulative 348.2% gain in the VW, combined with collapsing equity markets elsewhere, left VW, at $376bn, as the largest company in the world by market capitalization, even larger than Exxon Mobil – how ridiculous is that?! In 2005 VW was only Germany's 15th largest company.

But that was not all. Given that markets are so inter-related, VW's rise began to create all sorts of distortions, many of which carried significant financial consequences. *Firstly*, VW is part of the German Dax index as well as a host of other indices. The Dax consists of 30 companies. VW's rise had increased its weighting in the Dax index to 28%! So VW's rise on Monday the 27th had the resultant effect of pushing the Dax into a daily trading range of 10.6%, although it ended 0.9% higher while other markets declined sharply. On Tuesday the Dax ended 11.3% higher, after a mind-boggling daily range of 14.0%, which, again was completely out of line with other European market returns on the day. By my calculations the 81.7% gain in VW on the day lifted the Dax about 15% i.e. the Dax would have closed about 3.7% lower were it not for VW's rise.

Secondly, rumours began to spread about the losses that hedge funds were taking on their positions in VW. First it was the turn of French bank Societe Generale (SocGen), whose share price initially plunged 17.5% but ended the day 12.3% lower despite the company issuing a statement denying they had any VW exposure. Then it was the turn of Goldman Sachs, whose price declined 8.0% before they denied it, and then Morgan Stanley, whose price fell 11.0% on the rumours. All of this at a time of extremely volatility caused by other factors – it couldn't possibly have happened at a worse time.

But the VW story doesn't end there. Deutsche Bourse, the manager of the Dax index, now have plenty of egg on their face. Having said they are "monitoring the situation on an on-going basis" (*Ed:* really? Weren't we all?) the VW saga has seriously damaged the credibility of the German exchange. And in a belated move, on 1 November Deutsche Bourse reduced the weighting of VW in the Dax from 27% to 10%, *which is exactly what they shouldn't have done*! Think about it: the index has borne all the effects of a massive distortion on the way up and has now had that distortion "locked in" by down-weighting VW. Let me explain by way of a specific example: Central Park Global Balanced Fund has an equity hedge in place, one component of which is a short position in the Dax i.e. we have sold some Dax futures contracts to hedge part of the core equity portfolio. Throughout the VW saga, Central Park thus had to endure a loss as the Dax rose (remember the Fund is short of the Dax) due to the large and rising VW weighting. That is all good and well, but one would like to have benefited from the unwinding of the distortion as the VW situation returns to normal i.e. it is reasonable to expect the VW share price to return to earth with a bump at some stage; the Dax would subsequently decline accordingly and Central Park would benefit from its decline as things got back to normal. But with VW's weighting capped at 10% the Dax's decline is also capped. And guess what? That's exactly what happened! On 1 November VW's price fell 21.3%. Had VW's weighting been retained at 28%, its loss would have caused a 6.0% (21.3% x 28.0%) decline in the Dax, but it didn't. The effect was only 2.1% (21.3% x 10.0%), indicating that while it is nice to chat and write about these things, there is a very real cost to bear when the "markets don't work properly." Central Park's shareholders and many others elsewhere bore a direct cost because of Porsche's manipulative tactics, Deutsche Bourse's ill-conceived actions and Bafin, the German financial regulator's failure to act in this instance. And Germany now has a lot of work to do to restore its credibility. The same laws, which encourage these "stealth takeovers," remain in place. It is not the first time a party has abused this situation for their own purpose (the Schaeffler family used the same tactic a few months ago to gain control of Continental) and it will surely not be the last time either.

Of course there are other consequences of the VW saga. For example Porsche has a history of doing this kind of thing, to the extent that many believe it should be reclassified as an investment bank - there are not too many of those around any more! Why? Consider this: in its 2007 financial year Porsche earned $1.27bn from its car manufacturing operations but $4.5bn from trading VW (financial) options, all on the back of turnover of $8.9bn. Given its share trading activities this year, profits from financial activities in the current year are likely to be substantially higher. Lest my comments come across as sour grapes, let me give credit where it's due: Porsche's initial 31% stake in VW cost $7.4bn – that stake alone is now worth $58.4bn. And just on the additional 11% in VW, Porsche's profit could exceed $12.7bn! Another point: given the huge volatility in the VW price during the last week of October, Porsche's 42.6% equity stake first rose by $127bn and then fell by $76bn – hardly the stuff shareholders would like to experience at a time like this.

Given the above, you won't be surprise to hear that Porsche chief Wendelin Wiederking's package last year was about $83m. Indications are that it will increase this year to $100m. I wonder if he is aware of what happened to other CEOs of US investment banks that used to earn similar amounts before the crises that overwhelmed financial markets this year.

And then there was the story of VW's chief production manager who hit the jackpot when he just happened to sell his VW shares in the midst of the saga, earning him a cool additional $1.27m. How coincidental.

I hope this little cameo has shed light on some of the events that led many to believe that the markets have stopped operating efficiently – at least for now. It will also highlight how integrated markets are and how one event can trigger a host of other events, the outcomes of which are hard to predict and not always profitable.

In closing, it seems appropriate to wrap up the VW saga with a chart of Porsche's share price over the past year. Excluding dividends –Porsche has a recent history of large special dividends – the share price is down about 60% in the year to October. Given all of the above, it isn't quite what you'd expect is it?

Chart 3.3: Porsche share price over the past year

Source: FT.com