

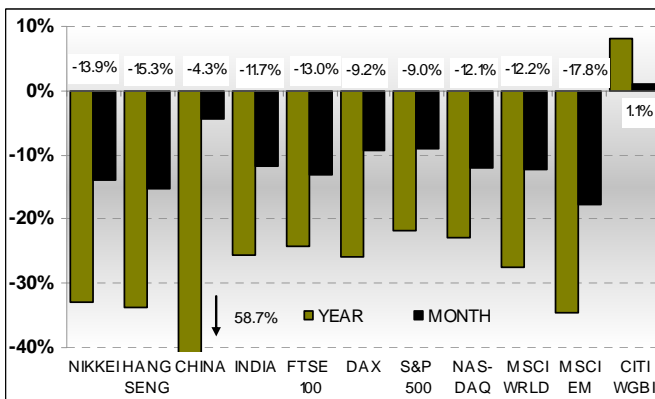


September in perspective – global markets

It is hard to know where to begin describing the market behaviour during September. Markets are moving so fast and there is so much happening in the global financial arena that by the time I have finished writing it will almost certainly be out of date. But let me try and capture some of the salient features of the month to the best of my ability in the interest of retaining a chronicle of these tumultuous and historic times. Forgive me if this edition is a bit long but there is a lot to cover and, given Maestro's commitment to and belief in the value of communicating with its clients, we are keen to relate the "full story" as best possible.

To compare the current markets to the August 1998 crash, when Long Term Capital Management went pear-shaped and induced the emerging market currency crisis, or the Black Monday crash in October 1987 is no exaggeration. That much should be evident from the timeline sketched in the Appendix to this edition. Let me start with the facts before adding comment: the MSCI world index declined 12.2% during September and the MSCI Emerging market index fell 17.8%. Declines were widespread – refer to Chart 1. Japan fell 13.9%, Hong Kong 15.3%, the UK 13.0%, India 11.7% and Russia 26.4%. Bonds fared better, rising 1.1%. Commodities were severely punished: oil declined 11.9%, platinum 32.1% and palladium 34.1%. The S&P GSCI index declined 14.6% and the Baltic Dry index, which represents the shipping rates for certain cargo and which has a strong correlation to commodity prices, declined 52.8%. The latter index is currently 81.0% off its October peak.

Chart 1: Global market returns to 30 September 2008



I sincerely hope that by now you are all familiar with the causes and nature of the current crisis. Simply put, the "oil" used to lubricate the global economy, namely money (we call it "liquidity") has dried up. For a number of reasons banks and other financial institutions are no longer lending to each other; losses related to asset-backed mortgages (and a host of other exotic financial instruments, some of which originated in the US sub-prime crisis), corporate failures, escalating interest rates and inherent distrust are some of the

reasons why the usual "interbank lending" that most of us are blissfully unaware of but that is vitally important to keep the economy "rolling" on a daily basis, has simply dried up. The global economy is seizing up and the resultant fallout is there for all to see.

That, in a nutshell, is a very simplistic description of the current liquidity crisis. I would make the painful point though, that this crisis is a different one from the economic slowdown in general and the US recession in particular. It is important that you understand that *these are two different crises*, although there is a large degree of overlap. Right now the market's focus is on the liquidity crisis, hence the focus on banks, regulators and policy makers. Without resolution to this crisis, there is little reason to focus on the next crisis of the slowing global economy. Once banks and financial institutions start lending to each other again and "the system" starts working again, the world can get "back to business" albeit at a much slower pace.

A historic month of unprecedented drama

I have repeatedly noted in previous correspondence that we are living in unprecedented times. Perhaps some of you thought I was being overly dramatic. I will be the first to admit that the speed and extent of developments have caught us by surprise. Without looking for excuses, it has been the effects of the liquidity crisis that has taken us aback - we were (and still are) focussing on the global economic slowdown. But if current market movements and investment returns are anything to go by, I sense we are not alone in having been caught off guard.

In one dramatic month, the financial landscape as we knew it has changed. The quintessential model of the US-style investment bank has been obliterated. Two have collapsed, one has been sold and the remaining two have become traditional bank holding companies. The gatekeeper of capitalism, the US, has had to nationalise a number of banks and government-sponsored institutions. The third and fourth largest US banks have collapsed, while many are teetering on the verge of collapse. The UK and the EU have nationalised banks and forced mergers between what were regarded only last month as some of the strongest financial institutions in that country. Iceland has been brought to its knees; the Russian market has been in meltdown mode. Trillions of dollars of value has been destroyed on global investment markets – *and all of that in just one month!*

At the end of this edition, I have tried to chronicle some, *but by no means all*, of the major events during the past month. I have done so in part to share some of the drama with you – I encourage you to read it, despite its length – so that we can look back in years to come, in a more investor-friendly environment, and reflect on an historical period of epic proportions.



INTERMEZZO

MAESTRO

Investment Consulting

Investment Letter

8th Edition

October 2008

The Russian rout

One market that has recently suffered unprecedented value destruction has been the Russian equity market. The recent problems began with Russia's bellicose behaviour towards foreign firms operating in key (read oil) industries. A prime example was the altercation between TNK-BP, a large joint venture between BP and a group of Russian oligarchs. Without going into details, suffice is to say that Russia's behaviour, at government and corporate level, was startling to say the least. It certainly didn't do their image amongst foreign investors any good. Foreign capital began to take flight, albeit slowly. Then came the spat between Georgia and Russia. From our vantage point at the tip of Africa it is hard to ascertain the facts behind either side's version of events – the truth probably lies somewhere in the middle – but either way that proved to be the final straw for foreign investors. The trickle of foreign disinvestment turned into a flood. To make matters worse, the sharp decline in the oil price left their economy vulnerable – oil exports play an important role in the Russian economy.

Let me remind you that we are talking about an economy growing at 7.5% per annum, has the third largest foreign exchange reserves in the world (\$582bn), a low level of international debt, a huge resource-fuelled trade surplus and nearly \$200bn stashed away in sovereign wealth funds. It is thus almost incredible to imagine that the Russian equity market declined 26.4% in September (see Appendix 1 for more details) and at the time of writing is down another 33.2% so far in October. This brings its year-to-date decline to 64.7% and it is off 67.5% from its May peak.

Chart 2: Russian equity market: comparison with 1998
RTS index rebased at peak of market



Source: Thomson Datastream

Source: FT.com

Why am I drawing your attention to the Russian problem? Apart from holding some useful lessons about the current geo-political climate and the financial crisis, I suggest that the similarity between Russia and South African is worth noting; more ominously *the Russian case provides a terrifying example of what could happen to the SA equity market*. Russia is an emerging market, heavily dependent

on commodities (oil), its economy is growing at an above average rate and it is reliant on foreign investment and on maintaining an investor-friendly image with foreign investors - something Russian policymakers clearly didn't understand. It emerged in recent years from the political wilderness (the Cold War) but is still trying to find its place in the 21st century's political economy. It definitely has a "voice" and deserves a place at the table of the "Big League" but the jury is still out as to the sustainability and credibility of the "new Russia". Almost all of these characteristics are common of South Africa. We are reliant on commodities (metals) and our political wilderness was that of apartheid, but in the other characteristics mentioned we are similar. The differences lie in SA's relatively small foreign exchange reserves, a large trade deficit (both of which place SA in a less favourable position) and the fact that our economy is not as directly linked to that of Europe and China. I only hope that our political leaders – in particular the future ones – have taken a close look at what happens if you ignore the "rules" of global capital markets in the 21st century. Russia stands as a frightening example of what can happen when foreign investors turn their back on a country. Somehow, I don't think they have, and that worries me.

Chart 3: Russian RTS index since January 2005



Source: FT.com

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 inflation*, having peaked at 8.7% in February, fell to 4.9% in August. During the past month the Chinese authorities turned the policy focus away from containing price rises towards containing the fallout from the current crisis and ensuring it doesn't affect economic growth too much. We continue to watch the situation closely. Exports increased 21.1% in August, down from 26.9% in July, while imports increased by 23.1%, down from 33.7% last month. Fixed asset investment rose by 28.1% in the year to August, from 29.3% in July.



INTERMEZZO

MAESTRO
Investment Consulting

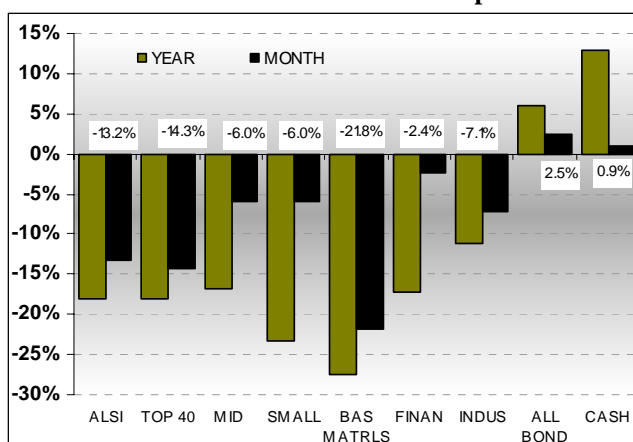
Investment Letter | 8th Edition | October 2008

- US deficit and the dollar:** with the enormous amount of debt the US is wracking up in their effort to contain the financial crisis, it is worth pausing for a moment to consider the effects this will have on the Fiscus. Prior to the Troubled Asset Relief Plan (TARP) the 2009 and 2010 budget deficits were estimated to be in the order of \$500bn and \$525bn respectively. However, making a few assumptions about the rate of TARP rollout, Merrill Lynch projects that the deficits will now rise to \$900bn and \$825bn respectively. Given the existing rollovers of debt for those years, it is likely that the Treasury's total funding need will rise to \$1.5 trillion for each year. What a welcome gift for the incoming President!

September in perspective – local markets

Given the events on the international stage, you don't need me to tell you what happened to the SA equity market. It is worth noting that as concerns about the slowing global economy grew, which would theoretically lead to a slowdown in demand for commodities, so the sellers of resource shares grew more aggressive. The basic materials sector consequently declined 21.8%, just one month after the 19.5% decline in July. The sector fell despite the 7.2% decline in the rand dollar exchange rate, which would ordinarily support resource shares. But then again, there is nothing ordinary about these times! The financial sector fell 2.4% and industrials 7.1%. The mid and small cap indices both ended 6.0% lower. The end result was a loss of 13.2% in the All share index, with the worst declines occurring in the general mining (-26.3%), fixed line telecoms (-24.6%) and platinum (-21.6%) sectors. The best performing sectors were gold (2.9%) and banks (3.4%).

Chart 4: Local market returns to 30 September 2008



Back to basics

Although the events of the past month and into October have rendered any focus on the degree of value in the market rather irrelevant – nobody is paying the slightest notion to any fundamentals right now – we are still

monitoring the degree of profitability of the companies in which we and our clients are invested. We therefore draw your attention to the ongoing excellent results that many of these companies have reported recently. In this regard I refer you to the June Quarterly Reports where we listed examples of what we believed were valuable investment opportunities. (For readers who are not Maestro clients, you can view our comments in the [Maestro Equity Fund June Quarterly Report](#) on our website). The proof of the pudding, as they say, is in the eating. We list therefore, in Table 1, examples of the recent results of companies in which we have invested our clients' funds.

Table 1: The proof of the pudding...

Company	Price (c)	Historic		Growth in		Forward PE Ratio (x)
		PE ratio (x)	Div yield (%)	HEPS (%)	DPS (%)	
ArcelorMittal	9899	7.1	5.4	45.4	46.8	4.0
Aveng	5007	8.5	2.9	72.0	71.0*	7.2
Cashbuild	4606	6.5	5.0	32.0**	32.0	5.4
Digicore	540	8.5	3.5	44.4	46.2	7.2
Jasco ***	248	4.5	6.4	38.9	N/A	4.0

* excludes special dividend

** 46.0% after adjusting for a 52-week period

** interim results

For the record

Table 2 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.

Table 2: Returns of funds under Maestro's care

	Period ended	Month	Year to date	Year
Maestro Equity Fund	Sept	-10.2%	-12.2%	-12.0%
Maestro equity benchmark *	Sept	-10.0%	-13.4%	-14.4%
JSE All Share Index	Sept	-13.2%	-15.5%	-18.0%
Maestro Long Short Equity Fund	Aug	6.2%	-9.2%	-4.6%
JSE All Share Index	Aug	0.3%	-2.6%	-0.8%
JSE Financial and Indus 30 index	Aug	1.7%	-7.3%	-7.7%
Central Park Global Balanced Fund (\$)	Aug	-2.4%	-7.0%	-4.2%
Benchmark**	Aug	-1.3%	-6.0%	-2.9%

* 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

Chart of the month

Although there is a lot of bad news out there right now, at the risk of being extreme we are concerned that investors have not fully appreciated the next and possibly even bigger problem that is silently building up while all the focus is on



MAESTRO

Investment Consulting

INTERMEZZO

Investment Letter

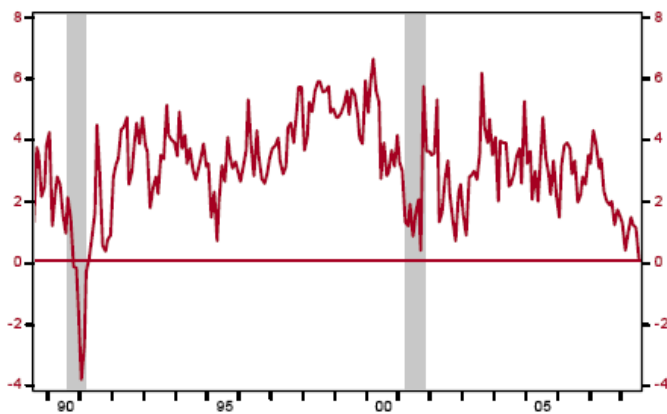
8th Edition

October 2008

global credit markets, the illiquidity and the worst bubble in recent memory, the US housing bubble. This problem, which we have consistently drawn to your attention, is the state of the US consumer. Chart 5 shows that, for the first time in 17 years, the amount of spending by US consumers is declining i.e. the consumer recession is now a reality.

Merrill Lynch put it so succinctly: “not only are we having to cope with the worst credit crisis and real estate deflation in seven decades, we now have to navigate through a period of negative growth in consumer spending.” And in case you need a reminder of the size and significance of this beast, it constitutes 70% of US GDP and 18% of global GDP.

Chart 5: Real personal consumption expenditure (PCE) 6-month percentage change, annualised (%)



Source: Merrill Lynch

Quotable quotes

On Friday, Lehman Brothers was an investment grade bank with \$42bn of liquid assets. On Monday it was bankrupt. Why? *The Lex Column, Financial Times.*

Reflecting on Asia's \$4 trillion foreign exchange reserves and the role it may have played in the current financial crisis, an *anonymous Chinese official* noted: “America drowned itself on Asian liquidity.”

For more than two centuries the US and Europe have exercised an effortless economic, political and cultural hegemony. That era is ending. *Philip Stephens, Financial Times columnist.*

I want to emphasize how little I understand all of the intricate workings of the global financial system. I hope that someone else gets it, because I don't. And I have no idea, really, how this will work out. I certainly wish it hadn't happened. It is just so intricate that all I can conclude, by instinct and by reading the history books, is that it will be longer, harder and more complicated than we expect. *Jeremy Grantham, CIO of Boston institutional investment manager GMO and well-known market historian and analyst.*

In the past 7 days 5 major financial firms have disappeared that had a combined market cap of half a trillion dollars at the start of last year. Thus, anything can still happen ...

Comment in Deutsche Securities Market Bulletin on 17 September after US government steps in to rescue AIG

The market has changed more in the past 10 days than in 70 years. *European Investment Bank executive, 26 September.*

You can now buy the free float of the entire Russia energy sector with the market cap of Coca-Cola and still have change to buy all the Russian banks. *Michael Hartnett, Merrill Lynch global emerging market strategist.*

File 13 – things almost worth remembering

From one of the most senior figures in the private equity industry (Guy Hands, CEO of Terra Firma Capital Partners) comes the startling news that private equity general partners earned \$7bn a year from fees charged on capital committed by investors *before it was even invested.*

The World Gold Council reported that investors' bullion assets rose 31% in the year to September 2008 and nearly doubled in the past two years. Gold-backed exchange traded funds (ETFs) now hold 1 040 tonnes of bullion and rank behind the US, Germany, the IMF, Italy, France and Switzerland as the largest holders of gold.

Exhibit 1: The Golden Calf



Source: Sotheby's

And a final note for File 13: it isn't all bad news. Artist Damien Hirst undertook an experimental sale in bypassing the traditional route through dealers and galleries by going directly to an auction house, in this case Sotheby's. The two day sale of new works by the artist raised more than \$178m. Over 21 000 visitors came to see the sale preview over 11 days, forcing Sotheby's to make extra arrangements for the sale. The star lot was *The Golden Calf*, a 600kg bullock in



MAESTRO

Investment Consulting

INTERMEZZO

Investment Letter

8th Edition

October 2008

formaldehyde with hooves and horns cast in solid 14-carat gold. It sold for a record \$18.3m. Another formaldehyde work, *The Kingdom*, one of the artist's signature shark pieces, was sold for \$17.1m, more than double the initial estimate.

And finally, a few thoughts for contemplation

I'm sure you will appreciate the last few weeks have been rather stressful in the Maestro office – probably no different from the environment in any other investment management firm. We have sought to understand what is happening but have also been besieged with thoughts pertaining to market developments. It has been an emotional rollercoaster, ranging from hope (for a turnaround), to anger (directed at various market participants including ourselves) and disappointment that, with the benefit of hindsight, we had not taken a more conservative approach ahead of the tsunami that hit the global financial system. In fairness though, I don't believe anyone foresaw the intensity and ferocity of the crisis – it has been bewildering in terms of both speed and extent. Our stress is arguably more a function of how seriously we take our responsibilities towards our clients than a belief in our ability to have prevented more damage to the portfolios in our care.

It would be impossible to record all our thoughts and discussions of the past few weeks, but I leave you with *some* of them, in the interests of maintaining the ongoing discourse with our clients and friends in the profession that is so necessary in difficult times like these. We would love to hear from you, specifically thoughts you might have. Here then are some of ours, in no particular order:

- *Systemic risk*: if ever anyone needed an example of systemic risk, this is it. The problem is “the system” at present, in this case the global financial system. The global banking system is not working; money and credit markets are not “clearing” efficiently. In fact some are not clearing at all. The engine has run out of lubricant and is breaking down – this is systemic risk at its worst.
- *Valuation and fundamentals*: let these times also be a reminder to us all that, in times of crisis, investors pay no attention to fundamentals. Markets have seldom been cheaper - the Russian equity market for example is trading on a PE ratio of about 5 times, and the MSCI Emerging market index trades on a forward PE ratio of 6.9 times earnings – the cheapest in its entire history; yes, even cheaper than during the 1998 emerging market crisis, when the nominal earnings on the index was \$10 versus its current \$80. Yet there are no buyers. The value of bricks and mortar, machinery, etc is worth *something*, but investors are valuing many assets at just about nothing, particularly in the case of financial companies. In times of crisis, markets can stay very cheap for a long time.
- *Regulators and policy makers*: there is a tangible sense of anger and disappointment within the investment community, which we share, that regulators and policy makers, specifically those in developed countries (even more so in the US) have failed. They have failed in their duty to protect investors, failed in their role as custodians of the financial environment and failed to identify the risk implicit in an increasingly leveraged system. This is the time for them to have shown leadership and understanding. Yet they have been slow to act and grasp the depth and consequences of the crisis. Why did central banks not cut rates sooner? Why did they not show concerted action earlier? Why did the US regulators not understand what was going on inside the banks that operated under their very noses? Did they fully understand the consequences of a Lehman Brothers failure and the contagion it would unleash on global financial markets? Why did US politicians hold the world to ransom on September 29 as they initially voted against the \$700bn TARP to buy toxic assets from US banks? That event sent a very strong message to the markets that, I believe, was the last straw - investors finally realised that politicians and regulators would not come to their rescue. Significantly every rescue plan or event that has been announced since then has been completely shunned by investors. Even now, at the time of writing, I don't believe policy makers and regulators share the deep concerns of the investment community - the markets are reacting accordingly and investors are voting with their feet. It has been frightening to realise that moral suasion and monetary policy has in effect lost its power to influence. Where to from here?
- *More regulation*: the short answer to the latter question is simply “more regulation.” One can already see the politicians wringing their hands and regulators getting out their legislative hats. We, the financial services profession, must brace ourselves for a massive increase in regulation in the future as regulators and politicians put in place what they believe will prevent a recurrence of the current financial crisis. I don't suppose they will ask of themselves why more regulation is necessary, given that the existing regulation didn't work in the first place. Perhaps a better approach would be to revisit existing regulation and establish why it wasn't properly implemented in the first place or whether it is even appropriate to start off with. If the patient is dying, why kill the patient? Why not change the surgeon? And while you do so, best ensure that he is qualified and knows what he is doing the first place.
- In similar vein, *credit rating agencies* have lost all credibility. Serious questions have been asked about their role and integrity, and they have been found wanting.



INTERMEZZO

MAESTRO

Investment Consulting

Investment Letter

8th Edition

October 2008

- *Global accounting standards*: something which has been less widely commented on but which I think has been a material contributor to the financial crisis, has been the insistence in recent years by the global accounting authorities such as the International Accounting Standards Board (IASB) and their US counterpart, the FASB, on fair value adjustments. We have always been concerned about the vicious spiral that is implicit in this methodology: weak asset prices necessitate downward adjustments to fair value on balance sheets (banks and financial companies in particular), which sow uncertainty and nervousness. This leads to further price weakness, which leads to further downward fair value adjustments and so the spiral develops with ever-increasing ferocity. There is something simply illogical about this methodology and our worst fears have now been realised.
- *Further animosity towards the West and the US in particular*: the current crisis can only lead to greater animosity and inherent distrust towards the West and the US in particular. One can make a substantial case for blaming most of the current crisis on the US and its inherent psyche of excess. For decades the US has been the land of excessive consumption, an aspect that, since Maestro's inception, we have identified as a major systemic risk. The chickens have finally come home to roost, but as a consequence of the global community's inter-connectedness, the inevitable and accelerating collapse of the US Empire has taken the rest of the world with it, if not at the economic level then certainly at the investment market level.
- In similar vein *the ideology of capitalism* as we once knew it, can and will never be the same. The shift in power from West to East can now only accelerate – and that implies a very different future from what we have experienced in the past.
- *The role of hedge funds in the current crisis*: a lot of criticism has been levelled at hedge funds and their activities as a causal factor in the crisis. I suggest much of this criticism is misplaced. Firstly to blame hedge funds and short selling in particular for the meltdown in markets represents a misunderstanding of how markets operate. In addition, the numbers simply do not bear testimony to the criticism: even if the hedge fund industry was, say \$1.5 trillion, which I doubt it is any more, a significantly greater amount than this was wiped off the US market in less than one week in October – how then can it all be blamed on hedge funds? Their role is often exaggerated – the largest pool of investors and hence the most influential in any market, by far, is retirement-related investors i.e. long-only funds. I also note that it has been the regulated banks and investment banks that have been collapsing and going under. While they have suffered along with

everyone else, I suggest that far less hedge funds have imploded and the consequences of such events have been far less pervasive than the failure of banks around the world. This underlines my earlier assertion about the failure of regulators - the very institutions they were supposed to be regulating collapsed while less regulated entities such as hedge funds have fared far better.

Table 3: MSCI Emerging Market September returns (%)

EM countries/regions	Q3	Sep-08	YTD
Philippines	2.0	-6.4	-37.8
Turkey	-0.7	-14.4	-41.4
Chile	-10.5	-10.5	-14.9
Jordan	-13.2	-10.1	-1.7
India	-14.4	-18.5	-50.1
MSCI DM	-15.7	-12.1	-25.6
Israel	-15.7	-8.3	-11.4
Poland	-17.2	-13.5	-28.1
South Africa	-17.6	-15.6	-27.7
Malaysia	-18.7	-9.2	-34.0
Mexico	-19.2	-11.5	-19.8
Hungary	-20.3	-17.7	-29.6
Morocco	-22.1	-14.2	-0.2
Thailand	-23.7	-12.8	-32.0
Asia	-24.0	-16.8	-41.3
South Korea	-24.3	-10.6	-40.0
China	-25.7	-20.9	-46.0
Czech Rep	-26.9	-16.8	-20.1
Indonesia	-27.0	-20.8	-35.6
MSCI EM	-27.6	-17.7	-36.8
Taiwan	-28.1	-19.1	-32.5
Egypt	-28.3	-17.4	-31.4
MSCI EM Small Cap	-28.5	-20.7	-44.8
EMEA	-29.1	-17.6	-34.4
LatAm	-32.9	-19.6	-27.6
Peru	-34.9	-15.3	-31.1
Brazil	-38.2	-23.1	-31.4
Argentina	-44.1	-24.7	-19.8
Russia	-45.3	-23.7	-46.9

Source: Merrill Lynch

Issued by: Maestro Investment Consulting, Box 1289, Cape Town, 8000. Capstone 96 (Pty) Ltd trading as Maestro Investment Consulting is an Authorised Financial Services Provider operating under Licence number 739 granted by the Financial Services Board on 12 November 2004. The information and opinions in this document have been recorded and arrived at in good faith and from sources believed to be reliable, but no representation or warranty is made to their accuracy or correctness. Maestro accepts no liability whatsoever for any direct, indirect or consequential loss arising from the use of this document or its contents. Please do not reproduce wholly or in part, distribute or publish this document without the consent of Maestro.



Appendix 1

A chronicle of chaos

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



INTERMEZZO

MAESTRO

Investment Consulting

Investment Letter

8th Edition

October 2008

- \$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:** after 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 ends 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 ever 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 loses 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



INTERMEZZO

MAESTRO

Investment Consulting

Investment Letter

8th Edition

October 2008

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.
- **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 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 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



INTERMEZZO

MAESTRO

Investment Consulting

Investment Letter

8th Edition

October 2008

\$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 is closed 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:** three-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 (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 first \$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%. Three-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.
- **15 October:** nervousness continues to dominate markets as the focus shifts to the health of the 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. Later that evening the rand plummets 17.1% to R10.66 to the dollar, after touching R10.81. Many other emerging



INTERMEZZO

MAESTRO

Investment Consulting

Investment Letter

8th Edition

October 2008

market currencies are subject to the same pressure as a wave of “risk aversion” sweeps through the markets. The US market declines the most since October 1987 as the S&P500 ends 9.0% lower.

- **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 report that \$27 trillion of market cap has been lost in the past year of equity market declines.

Table 4: The bear market index

Index	30 Sept 08 close	Change from 2007 high
Dow Jones Industrial Average	10,365.45	-26.82%
Standard & Poor's 500 Index	1,106.42	-29.31%
Standard & Poor's 100 Index	515.52	-29.36%
Nasdaq Composite Index	1,983.73	-30.62%
Nasdaq 100 Index	1,496.15	-33.18%
Standard & Poor's Midcap-400 Index	698.21	-23.87%
S&P Small cap Index	351.66	-20.96%
Russell 2000 Index	657.72	-23.14%
Dow Jones Utilities Index	423.63	-23.36%
Dow Jones Wilshire Index	11,322.76	-28.37%
Dow Jones Transportation Average *	4,503.89	-7.92%
Nikkei 225 Index (Japan)	11,743.61	-32.74%
FTSE 100 Index (Britain)	4,818.77	-28.41%
Dax Index (Germany)	5,807.08	-27.78%

* Index peaked on June 5

Source: MSN Money

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.

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.

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.

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).