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Market Update

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Explosive rally after week of turmoil as authorities take action

Summary of latest events:

- **Major Central Banks** joined forces on Thursday to pump massive liquidity into the system with the US Federal Reserve making an extra \$180 billion available to other major central banks
- **The UK Financial Services Authority (FSA) and US Securities & Exchange Commission (SEC)** have introduced temporary bans on short positions in selected financial stocks – other authorities may follow suit
- **US authorities** are reported to be considering plans to establish a government agency to buy bank assets

The end of a tumultuous week sees equity markets post some of the strongest gains in six years over hopes that the US authorities will announce a permanent solution to the current banking woes. In addition to possible plans to set up a US government agency to buy bank assets, the FSA and SEC have temporarily banned short selling of selected lists of financial stocks.

Last night, in the US, it was reported that Treasury Secretary Paulson and Chairman of the US Federal Reserve, Bernanke, are proposing a Resolution Trust Corporation style lifeboat for US financial institutions. The plan likely involves the movement of illiquid assets from US financials into a state backed institution. Full details of the plan are yet to be forthcoming, and legislation will be required in order to progress the vehicle, so detailed comment is supposition at present.

Nonetheless, as we previously stated this week, government intervention is a necessary condition for the end of the credit crisis to come into sight. Indeed, there are numerous precedents of government action enabling a line to be drawn under banking crises through history, such as the formation of the RTC in the

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late 1980s in the US and the Resolution Finance Corporation from the Great Depression era. Other examples of authorities intervening after market failure exist in the Swedish experience of the 1990s and the Asian crisis, where the IMF played a key role.

The pending creation of a new RTC type vehicle will aim to remove toxic assets from listed financials, helping to reduce counterparty risks, and should alleviate stress in the inter-bank markets, increase capital positions, and bring some order to the de-leveraging process. Numerous questions do, however, remain given that there are legitimate concerns over just how much of the ring fenced bad debt will actually have any meaningful value.

The explosive rally which is now taking place in equity markets is being driven, to a great extent, by short covering, as investors are forced to close out positions due to change in the regulatory and fundamental backdrop. Precedent from the early 1990s suggests that we may well have seen a significant turning point and that this could now be 'the beginning of the end.' Despite comparisons with the Savings & Loans crisis, when the market subsequently rebounded sharply one should not forget the pain which will likely still sweep the real economy from here. A roadmap out of the crisis now appears much clearer, following a well worn path of government intervention and capital injections but the de-leveraging process which is underway has some way to run. The bear market has been halted, but many challenges and pitfalls lie ahead.

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