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Market Update

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Market update post AIG rescue

Summary of latest events:

- **American International Group (AIG)**, has been bailed out by the US government by accepting an \$85 billion Federal loan in return for a 79.9% government stake
- **Barclays Bank** has announced that it has agreed to acquire Lehman Brothers North American investment banking and capital markets businesses for a cash consideration of \$250 million as well as Lehman's New York Head Office and other properties for a combined consideration of \$1.75 billion.
- **The US Federal Reserve** keeps benchmark rates on hold

American International Group, AIG, became the latest financial firm to take centre stage in the ongoing turmoil in global financial markets. The firm had been feared as close to collapse as recent credit downgrades were triggering collateral calls or the termination of investment agreements which the company could not fund. AIG accepted an \$85bn federal loan in return for a 79.9% stake being taken by the government at terms reflecting a hefty premium; 8.5% above LIBOR. The firm will now endeavour to sell assets in an "orderly basis."

The Federal Reserve stated that a "disorderly failure of AIG could add to already significant levels of financial market fragility." In other words, the systemic risk of allowing AIG to go under was simply too big to take, unlike Lehman Brothers, which received no such lifeline.

AIG sees one systemic risk removed. Nationalisation of the company does not really provide encouragement for equity holders and, under the terms of the agreement, shows that the government has the right of veto over dividend payments to common and preferred shareholders. From a bondholder perspective, the inclusion of the Fed as a majority shareholder is positive in that bankruptcy can now be avoided. However,

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the \$85bn loan is secured over the total asset of the company, which means bondholders will be subordinated – ie. will be pushed further down the queue in their claim on AIG's assets. Junior subordinated bondholders are also still at risk as coupon payments could be cancelled.

The move by US authorities is however, without doubt, another step in the right direction. This action, combined with the Treasury support for Fannie Mae and Freddie Mac will serve to alleviate some of the systemic concerns which investors have feared. It was interesting also that the Federal Reserve resisted pressure to cut interest rates, indicating their belief that it is the access to liquidity rather than the cost, which is the real problem. Indeed, the statement accompanying the FOMC decision was somewhat less dovish than most had expected, with little change in commentary over inflationary concerns and a balanced assessment over growth and inflation risks. The conclusion, in terms of future rate action in the US, must be that, barring a further sharp slowdown in the economy, US rate cuts are unlikely. Incremental support for financial sector problems will be less driven by the provision of easy and cheap money and more by targeted lending and government intervention.

Recent moves affirm our view that we are now firmly in the phase where market and government driven activity will drive consolidation within the financial sector. It is worth noting that almost every banking crisis has required a government orchestrated fiscal bailout in order to allow markets to find a bottom. Recent examples of such action were in the creation of the Resolution Trust Corporation in the US in the early 1990s, the Swedish government's underwriting of their national banking system in the early 1990s and the coordinated response to the Asian crisis (through the IMF) in 1997. It remains to be seen whether the action on AIG and the nationalisation of Fannie and Freddie also represent such a watershed event.

From here, however, we can expect further disappearance of banking and financial names as assets are sold and businesses obtained. Indeed, the fallout from the collapse of Lehman Brothers has led to Barclays agreeing to acquire the North American investment banking business for \$1.75bn and recent hour have seen fevered speculation that, in the UK, Lloyds is in takeover talks with HBOS, recently the subject of speculation over the sustainability of its business. Despite such moves, we may well still see blanket guarantees for depositors to preserve confidence and the establishment of government backed asset management corporations to enable banks to sell down and unwind assets in an orderly fashion.

For investors, the only near term certainty is further volatility. Equity markets and credit assets appear oversold but it is somewhat premature to call an absolute bottom in risk assets as we do not believe that investors have either fully capitulated or factored in all of the likely deterioration in fundamentals. From our perspective, while equities offer good value at current levels, we do not believe that investors are yet being compensated sufficiently for the risk which still remains, and the further failures and write-downs which will continue to emerge. That said, a meaningful short term recovery, or bear market rally, could well be in the

offing as it seems that authorities (in the US at least) are, perhaps, coming to terms with the role that they will have to play in resolving the credit crisis.

Paul Niven

Head of Asset Allocation

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