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Emerging Markets Weekly

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Can I have a Credit Crunch solution for $700 billion please?

What a rollercoaster ride the past few weeks have been as the market toyed with the idea of a massive US$700 billion bailout. Volatility, as indicated by the VIX Index, has posted new all time highs as the equity markets whipsawed points back and forth within a single trading day – definitely not a market for the faint-hearted! However, while the bailout, TARP (Troubled Asset Relief Program) or EESA (Emergency Economic Stabilization Act of 2008), whichever name suits your fancy, was the subject of intense discussion for many nights and an important question looms. Will this long awaited passage prove worthwhile in justifying the primary decision makers' salaries at the end of the year or will this be another flop?

The structure of the financial sector has undoubtedly experienced some mind blowing changes over the last few weeks as major players in the industry underwent acquisitions or just went bankrupt. For example, Fannie Mae and Freddie Mac were taken over by the US Treasury, Bank of America bought Merrill Lynch, and Bear Stearns was acquired by JP Morgan. An 80% stake in AIG was given to the Fed while Lehman Brothers filed for bankruptcy. The last large independent Investment Banks remaining in the industry are Morgan Stanley and Goldman Sachs and even they have opted to become regulated bank holding companies.

As troubles mounted and with no clear end in sight, the US Treasury thought it necessary and perhaps more realistic to create a US$700 billion lump sum plan to ease liquidity pressures in the market, hence the reason behind the TARP.

Initially the plan proposed US$800 billion but it was cut to US$700 billion. The original idea came to the forefront on September 19th however, there were some concerns by members of both parties in Congress, leading to the rejection on the 29th. The Act was then ratified and finally passed in the senate on October 2nd and then by the House and signed off by the President on October 3rd. This was probably the most painstaking two and a half weeks for the US stock and treasury markets within recent times. Charts one and two aptly illustrate the journey over the past few weeks.

Chart 1

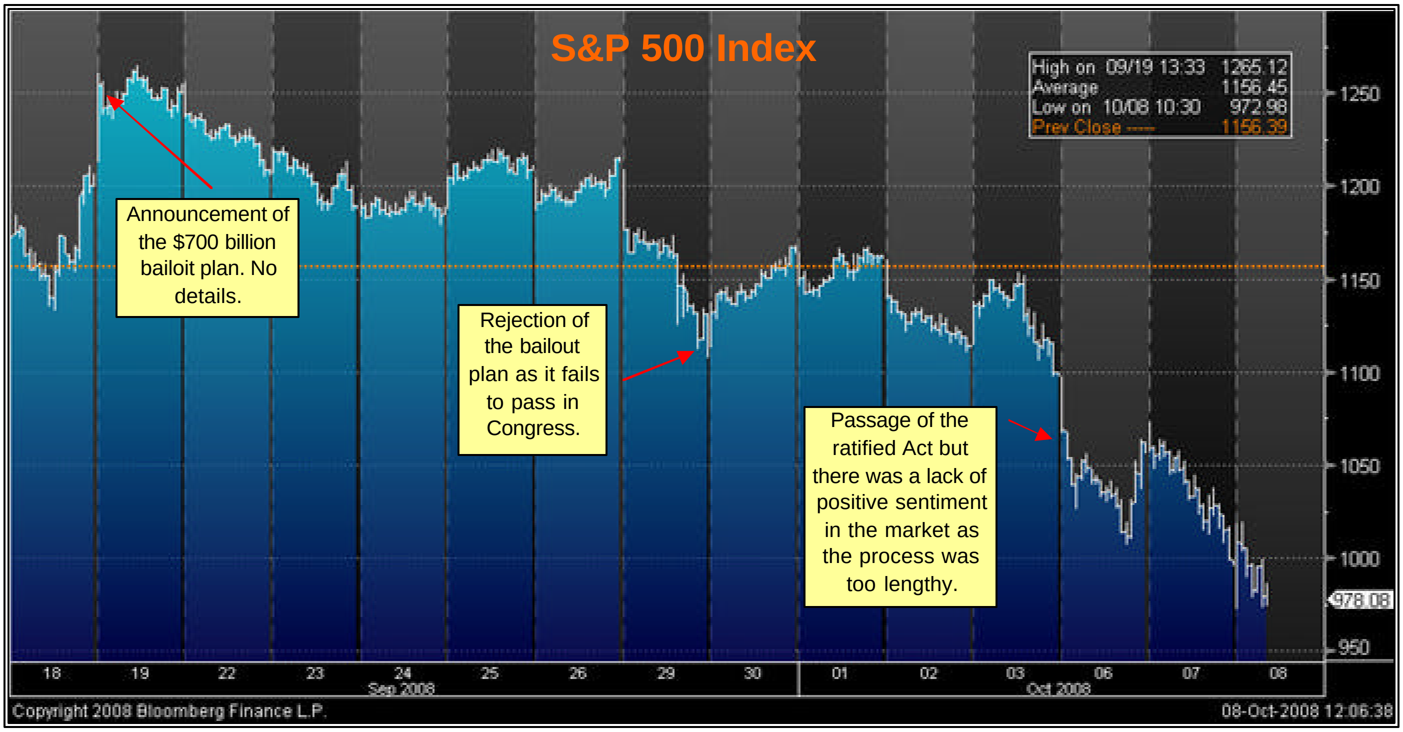
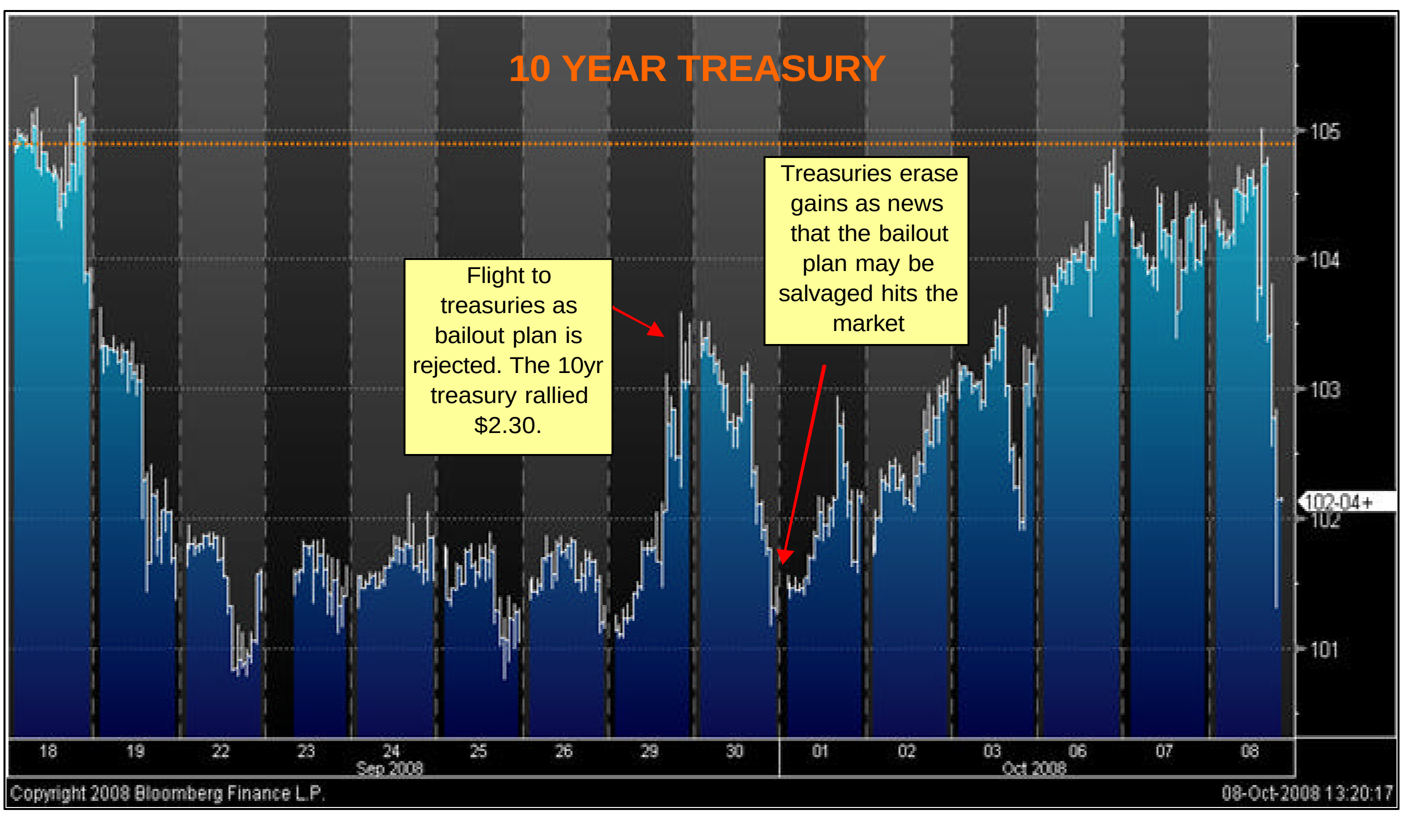


Chart 2



As written in its legislation, the main purpose of the ESSA is to, "…provide authority to the Treasury Secretary to restore liquidity and stability to the US financial system and to ensure the economic well-being of Americans." More specifically, it involves the purchase of troubled assets from financial institutions. In so doing, the Treasury would remove assets that have created balance sheet problems consequently improving the ability to raise new capital. Some of the highlights of the Act as are follows:

- Authority to use the funds – Though the Treasury has access to a total of $700 billion, only $250 billion will be immediately available. The next $100 billion will be available upon written consent from the President and Congress. The remaining $350 billion also requires the approval of the President and Congress but has a 15-day period in which Congress can disapprove.
- Scope of assets to be purchased – The plan allows for the purchase of residential and commercial mortgages and any such related instrument issued on or before March 14th 2008. Other financial instruments may be acquired by the Treasury after correspondence with the Fed chairman.
- Authority to suspend marked-to-market Accounting – Only if the issuer or transaction warrants it necessary or appropriate for public interest and the protection of investors.
- Oversight – A board called the Financial Stability Oversight Board is to be established to review the actions taken.
- Temporary increase in FDIC – The coverage limit for insured deposits will be increased to US$250,000 from US$100,000 for the period until December 2009.
- Limits on Executive compensation – When the Treasury directly purchases and acquires a stake in a firm, companies will lose certain tax benefits and executives must return unearned bonuses in addition to having any possibility of a golden parachute prohibited.
- Purchase prices of assets – On the question of purchase price, the Secretary will make purchases at the lowest price that he deems to be consistent with the purpose of the Act.
- Timing before use of funds - The Treasury has decided that it will take at least a couple of weeks after enactment before it actually begins purchases.

The discussion of timing and the fact that there is a two week lag between the enactment and the purchases bring me to the discussion on whether this plan will ultimately work. In the current situation, a time lag does not seem to be the best approach by the Treasury as liquidity in the market is almost if not completely frozen. Granted, the Treasury needs time to analyze and determine which corporates and assets should have priority over others. However, given the current circumstance, the market actually needs to see something being done, that is, more action alongside legislation.

On a more technical note, the size of the bailout is a topic that is also up for debate. It is estimated that the potential value of troubled assets in the financial industry is US$1-$3 trillion. However, the bailout covers only US$700 billion, which leaves US$300-$2,300 billion still unaccounted for.

However, for those of us who believe our past is an indication of our future (and I'm not sure this is the best approach to life but it may very well apply here), history suggests that bank bailouts have resulted in positive returns at least three months after the bailout has been implemented and that's a good sign!

The plan is a step in the right direction and will help ease liquidity issues. In the eyes of the American taxpayer, it probably does not seem like the most productive use of their funds but for what its worth, the Act mentions the eventual recoupment of funds from entities benefiting from the program. The time lag is rather unfortunate as it stalls the recovery process and on the issue of size, the plan only accounts for so much of the ailments in the industry.

So far, apart from providing funding directly to the firms mentioned above, the Fed has established currency arrangements with foreign central banks and assisted money market mutual funds that have faced heavy redemptions. Their most recent efforts have been to make an unexpected inter-meeting rate cut concurrently with other central banks such as the European Central Bank (which had been stubbornly hawkish on inflation within recent months), Bank of England, Bank of Canada and Sweden's Riksbank. Also, the creation of a special fund to purchase US commercial paper was made in an effort to support the needs of corporations. As of now, these measures have done little to restore confidence and this recovery process is likely to be a long and drawn out process. The Fed and the US Treasury will have to continue putting additional measures in place. Consistent efforts on their part could provide the confidence needed in the market and put an end to the sharp decline in the stock market.

FINANCIAL & ECONOMIC INDICATORS

As at 9 October, 2008

Exchange Rate/US$	Closing Value	Previous Week
Yen	99.82	105.33
Euro	1.36	1.38
Jamaica	72.96	72.95
Guyana	204.90	204.40

Commodity Prices	Closing Value	Previous Week
Crude oil (US$/bbl)	86.59	93.97
Natural Gas (US$/mmbtu)	6.69	7.59
Gold (US$/Troy Ounce)	913.25	836.40

Eurobond Indices (Return % YTD, as of 9-October-08)	
Lehman Brothers Global Aggregate Index	-0.99
JP Morgan EMBI+ (percentage change)	118.40
CMMB Eurobond Index	n/d

Policy Interest Rates (%)	Closing Value	Previous Week
United States	0.25	0.25
Euro Zone	3.75	4.25
Japan	0.54	0.65
Brazil	13.75	13.75
Trinidad	8.50	8.50
Jamaica	13.50	13.50
Barbados	4.50	4.50

Market Interest Rates (%)	Closing Value	Previous Week
US 90-day T-Bill	0.52	0.60
US 10-Yr Treasury	3.79	3.63
3-month UK Libor	6.28	6.28
Japan 90-day T-Bill	0.53	0.53
Brazil 90-day T-Bill	14.00	13.90
TT 90-day T-Bill	7.17	7.17
Jamaica 90-day T-Bill	16.69	14.26
Barbados 90-day T-Bill	3.48	3.48

Sources: Bloomberg, CMMB, Central Bank of Trinidad and Tobago, Bank of Jamaica, Central Bank of Barbados, www.lehman.com