



Thinking Aloud...

"It's all fun and games, till someone loses an eye, then it's just fun you can't see."

James Hetfield

Everyone has his or her own opinion/prediction when it comes to the financial crisis; some are wrong and some are right. In this light, I decided to ask questions and get some answers on the crisis from someone whom I respect and with whom I generally agree: myself.

Q: Navin that's a strange quote to begin this article, what's it got to do with the financial crisis?

A: Well, that quote just about sums up everything. After the bursting of the dot com bubble in 2001, the Federal Reserve lowered the Fed Funds target rate to a low of 1% in the space of about 3 years; it had unintended consequences. Borrowers were motivated to borrow more than they could afford and lenders were motivated to make loans they shouldn't have made. Cheap rates coupled with a lack of adequate lending criteria led to an explosion of credit, particularly focused on the residential real estate market. Property prices as such rose significantly and continuously from 2001 to 2006.

At the same time, financial innovation on Wall Street coupled with a period of deregulation, allowed for thousands of mortgages to be combined together into a CDO (Collateralized Debt Obligation) and then sold off to different investors based on the type of risk they were willing to take. Hedge funds, pension funds, insurance companies and banks all bought these securities, meaning the originator of the loan no longer held the interest in it (as had previously been the case).

Property owners were happy and the Wall Street bankers were happy, as profits and bonuses soared.

Then came 2007-2008.....

Q. Were there any indicators the financial crisis would have evolved to this extent?

A. In hindsight, all the warning signs were there. However, it's human nature to be bullish; we are always optimistic, as such the warning signs appeared opaque.

To put it in perspective, at the end of 2007, the size of the US residential mortgage market was approximately US\$10 trillion, of which approximately US\$2 trillion was classified as sub prime. Furthermore, the approximate size of the US MBS (mortgage backed security) market was US\$4.3 trillion as of the end of 2007.

As the mortgage market collapsed, fueled by declining home prices and increased foreclosures, it would have been evident that a financial tsunami was approaching.

So to answer the question, hindsight aside, I believed that after the Bear Stearns collapse in March 2008 and the subsequent government intervention to prevent the unwinding of the credit market; the market would have normalized in the latter half of 2008.

Q. So, are you admitting that your prediction was wrong?

A. Yes, but I must add that the bursting of the commodity bubble in the latter half of 2008, as illustrated by Table 1, as well as the announcement of Lehman Brothers bankruptcy in September 2008 (which shocked the credit markets), can be classified as extraordinary events. Not only did I get it wrong but many economists, investment bankers and government officials also did not anticipate these events.

Table 1 – Selected Commodity Prices

Commodity	2008 High	Present
Copper (US\$, lb)	407.75	151.50
Gold (US\$, troy ounce)	1004.30	888.00
Oil (US\$, per barrel)	145.29	41.00
Aluminum (US\$, tonnes)	3271.25	1305.25

Q. Ok, moving on what's your outlook for 2009?

A. Well it all depends on confidence, credit and the consumers.

Q. Sorry, confidence?

A. Yes, investor confidence. Looking at the US situation, we see that between June 2007 and November 2008, Americans lost more than a quarter of their net worth. By early November 2008, a broad U.S. stock index, the S&P 500, was down 45% from its 2007 high. Housing prices had dropped 20% from their 2006 peak, with futures markets signaling a further 30-35% potential drop. Total home equity in the United States, which was valued at US\$13 trillion at its peak in 2006, had dropped to US\$8.8 trillion by mid-2008 and was still falling in late 2008. Total retirement assets, Americans' second-largest household asset, dropped by 22%, from US\$10.3 trillion in 2006 to US\$8 trillion in mid-2008. During the same period, savings and investment assets (apart from retirement savings) lost US\$1.2 trillion and pension assets lost US\$1.3 trillion. Taken together, these losses total a staggering US\$8.3 trillion.

Further, the last quarter in 2008 was marked by "extreme" market volatility, as investors switched to a capital preservation mode. This further exaggerated market declines across all asset classes, except US Treasury securities (driving the yield on US T-bills, for example, close to zero), which was the assets of choice for these scared and battered investors.

Without a resurgence in investor confidence, extreme market volatility is likely to continue throughout 2009.

Q. You mentioned credit, how does credit affect the economic prospects?

A. Access to credit for both consumers and corporations is vital to any economy. Consumers use credit to supplement

their spending whilst corporations use credit to meet short-term liquidity commitment (paying wages, suppliers etc) and for long term capital requirement. The estimated size of the US corporate bond market is US\$20 trillion, US credit card market is US\$1 trillion and the US commercial paper market is US\$1.7 trillion in 2006. As such, the financial sector plays a huge role in the support of any economy.

Following the bankruptcy of Lehman Brothers in September 2008, the credit markets in the US and Europe froze (compounded by the “nationalization” of AIG, speculation of potential bankruptcies of Washington Mutual and Wachovia and the default of Iceland's biggest banks) and presently, continues to be strained.

Basically banks were not lending to other banks and this filtered down to a tightening/halting of credit to consumers, corporations and municipals. Further, the rate at which banks lend to each other, i.e. LIBOR (London InterBank Offer Rate), spiked during this period. In addition, car loans and credit card interest rates are often tied to LIBOR while some estimates put as much as US\$150 trillion in loans and derivatives that are tied to LIBOR. Overall, higher interest rates place additional downward pressure on consumption, increasing the risk of a recession. So what began as the sub-prime crisis rapidly evolved into a liquidity crisis.

Q. Do you see an end to the “credit crisis” in the near future?

A. That's a difficult question. The problem is that within the financial sector no one knows who holds defaulting securities or where their valuation may end up. Taking into perspective that to date, financial institutions worldwide have reported losses (write-down and credit losses) of approximately US\$1.05 trillion and with the IMF predicting that worldwide bank losses related to toxic US originated assets will reach US\$2.2 trillion in 2009, it seems that the credit crisis is here for a while longer.

Financial institutions are under severe stress and any “bailout/government loan” granted to the firms are being used to bolster their balance sheets rather than being loaned out to consumers and corporations. The ramifications are huge.

Both consumers and corporations have switched to a capital preservation mode; the ironies being that both are affected by each other's actions – a double whammy effect.

For corporations, preserving liquidity is vital as credit availability remains tight. As such, advantage goes to those firms with the ability to implement a low cost strategy, maintain existing credit lines and actively manage their working capital. As part of their ongoing restructuring, firms are reducing their capital expenditure and slashing jobs. For example, on 26 January, 2009 over 76,000 jobs were slashed in Europe and the US. Overall, in the US, over 2.6 million persons lost their jobs in 2008; with the figure expected to climb in 2009. Firms that are not able to restructure or are cash strapped have no choice but to file for bankruptcy, for example Nortel and Circuit City among the many.

Q. Well I guess the consumers are left holding the short end of the stick?

A. Yes. The consumers (taxpayers) are feeling the effects via unemployment, limited access to credit, decline in property values and declines in investment value. As consumers increase their savings, demand will fall, corporate profits will decrease; the vicious cycle continues.

Further taxpayer funds are being used by the governments to bailout the financial institutions; the same institutions some

may argue initiated this crisis in the first place (via massive leveraging schemes and inadequate credit approval standards).

Q. With Mr. Obama as the US president can we expect a quick end to the US recession?

A. Mr. Obama is in the hot seat, faced with an ever worsening economy. However, he has put together a very powerful team with the knowledge and experience to come up with some viable solutions.

If passed, his US\$800 billion stimulus package should bear fruit in the long run. Challenges he may face include:

- A growing US budget deficit – It is expected that the deficit will be at a minimum of US\$1.20 trillion and can rise to US\$2 trillion in 2009.
- His aim is to create jobs, with the focus being infrastructure projects. This would require a re-tooling of workers, for example, those that have lost their jobs from the financial and retail sectors.
- Time frame to implementation of the package – Optimistically, works can begin in the latter half of 2009.
- Reviving the credit markets/recapitalization of the banks/nationalization of the banks.

Overall, the road to recovery will be long and rocky.

Q. Is the global recession expected to affect Trinidad and Tobago and the wider Caribbean?

A. I don't believe it's a question of if, but when. In Trinidad, we are beginning to feel some effects from the recession, mainly the decrease in oil and gas revenue and the movement towards deficit financing. Oil prices should see US\$30 /barrel or below before it recovers to an average of around US\$45 /barrel. The reason being, the global slowdown in demand especially in the US, China and India should more than outweigh any decrease in the supply or any speculative activity. As such, a slowdown of the energy sector is expected to continue in 2009.

Further, unemployment may increase as government cuts back on expenditure, especially in the construction sector. Additionally, the energy sector may also see a fall-out in employment. Real GDP growth rate is expected to range between 0.5% and 1% in 2009. One positive for the economy, from the global recession would be a decrease in inflation expected to range between 7% and 9%.

The wider Caribbean remains highly vulnerable to changes in the external environment, as there is heavy dependence on tourism, foreign direct investment (FDI) and remittances. The wider Caribbean should experience a slowdown in economic growth but may benefit from falling inflation.

Q. Closing thoughts?

A. The market works in cycles. How long this recession last and what tribulations it brings, is anyone's guess. One thing's for certain, the crisis is truly global in scope and it will take a global effort to subdue it. Possibly there is a silver lining; perhaps this might be the beginning of a "true global community".

FINANCIAL & ECONOMIC INDICATORS

As at 12 February, 2009

<u>Exchange Rate/US\$</u>	<u>Closing Value</u>	<u>Previous Week</u>
Yen	90.94	91.23
Euro	1.29	1.28
Jamaica	88.39	86.55
Guyana	206	205.70

<u>Commodity Prices</u>	<u>Closing Value</u>	<u>Previous Week</u>
Crude oil (US\$/bbl)	33.98	41.17
Natural Gas (US\$/mmbtu)	4.67	4.84
Gold (US\$/Troy Ounce)	946.75	914.55

Eurobond Indices (As at 12-February-09)

Lehman Brothers Global Aggregate Index (Return % YTD)	-2.86
JP Morgan EMBI+ (Basis points)	667
JP Morgan Central America and Caribbean Index (CACI) (YTD return %)	4.10

<u>Policy Interest Rates (%)</u>	<u>Closing Value</u>	<u>Previous Week</u>
United States	0-0.25	0-0.25
Euro Zone	2.00	2.00
Japan	0.10	0.10
Brazil	12.75	12.75
Trinidad	8.75	8.75
Jamaica	13.50	13.50
Barbados	3.00	3.00

<u>Market Interest Rates (%)</u>	<u>Closing Value</u>	<u>Previous Week</u>
US 90-day T-Bill	0.29	0.27
US 10-Yr Treasury	2.79	2.91
3-month UK Libor	2.07	2.14
Japan 90-day T-Bill	0.38	0.38
Brazil 90-day T-Bill	12.49	12.05
TT 90-day T-Bill	6.32	6.32
Jamaica 90-day T-Bill	22.33	22.33
Barbados 90-day T-Bill	4.33	4.33

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

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