

## Bailouts 'R US(A)

Thank god for man-made dates like "year-end" and "quarter-end", when we think that we can put all the bad things behind us and look forward to a new beginning.

So ended the 1st quarter of 2008, where many a person in financial markets is glad their worst nightmare is over. The Dow, S&P and NASDAQ finished the quarter down 7.5%, 9.9% and 14% respectively, while the ASX 200 fell a whopping 15.5% ... so much for decoupling!

The US Federal Reserve continued to provide liquidity by various means (TAF, TFSF, and any another acronym they could create) continuing the theme of pumping in billions of dollars (and euros and yen by the ECB and BOJ) to stabilise the markets. Most investment banks estimated the losses from sub prime/credit derivative melt downs to be around US\$400 – 500 billion until the IMF topped them all with a warning of up to US\$ 945 billion! Is this ever going to end?

The Fed also continued its aggressive stance on monetary policy by slashing rates an additional 75 bps on March 18th, bringing rate cuts in this quarter alone to 125 bps and cumulative to 300 bps since August 2007. The market now expects another 25 to 50 bps of rate cuts in the coming months. A full 100 bps of easing is priced in for the UK and somewhere between 40 bps and 60 bps for both Europe and Canada. If there is no growth, where is inflation going to come from? In this environment, who is going to open their wallets (sorry, someone else's wallet – remember we live in an economy where the word leverage is used even by most 13 year olds!)?

On March 14th, we had the largest victim yet of the sub-prime crisis. Bear Stearns, which survived the depression, succumbed. JP Morgan (with the Fed's backing) bailed out Bear Stearns with a purchase price that was less than the book value of the building where Bear was located. Is this the bottom in spreads, equity market, investors wondered? So much for moral hazard and vigilance by central banks to fight inflation.

Most balanced funds have posted negative returns for the first quarter. Global bond fund indices have performed well, as should be expected in an economic slow down. The widely used Lehman Global Aggregated in USD terms is up 3.81% YTD and 11.34% for one year ending 03/31/08. Unfortunately an Australian investor who had all their fixed income exposure in local currency did not fare as well, as the UBS composite bond index has returned a meagre 2.20% for the quarter, and only 4.1% for the 12 months ended 03/31/08.

Again cash continued to outperform most asset classes in Australia. The no-nonsense RBA raised rates once again to 7.25% and is providing a gift to superannuation funds and savers in Australia. Australian investors are getting paid a risk-free rate of 7.25% to sit on the sidelines and watch this drama unfold. Except for our neighbours across "the ditch", no other G7 country is this generous to its investors. The same option in the US, Europe and UK is 1.5%, 3.5%, and 4% respectively.

In recent weeks, credit and credit spreads have made a short term comeback. There are a few rumblings in the local markets regarding Australian mortgage backed securities (provided by lenders to low doc, highly leveraged borrowers). Is Australia coming to the party, albeit a little late?

I wish we at Kapstream knew the answers and could reassure our investors that we can see the light at the end of the tunnel. We see a light, but it is still relatively dim. This crisis is about de-leveraging and unwinding the excesses of years of borrowing by consumers (financed by leveraged lenders). So we can all breathe a short sigh of relief while the world feels like a safer place, but we are not prepared to sound the all-clear. The next hump to get over is the real economy and the corporate sector. Only time will tell. We just are not yet ready to call it a day!

Stay tuned.