KAPSTREAM CAPITAL

The Crash of '08

We are living through one of the most severe financial crises in modern history. Never, since the Crash of 1929, have so many people been affected by a banking/financial system failure. From the 'fat cats' on Wall Street to the pensioners on Main Street, nearly everyone has felt the wrath inflicted by the markets. The greed that led to this debacle has morphed into a market dominated by fear. While we all hope it would end soon, unfortunately what we wish for and what we get can be quite different.

In the past month, we have witnessed some of the largest financial institutions vanish into thin air. These are not your fly-by-night institutions, but established and reputable firms which have been prominent in the industry for many, many years. Below is a summary of what happened to some of these organizations over the past month.

Global Disappearing Act

Date	Country	Who	Bailout (Bin USD)	Comments
Sep-07	US	Freddie Mac/Fannie Mae	200	Largest US home lenders
Sep-14	US	BOA takeover of Merrill	–	Merrill Lynch founded in 1914
Sep-15	US	Lehman goes bankrupt	–	Nearly 160 years old
Sep-17	US	US Government takes on AIG	85	Largest insurance company in the US
Sep-25	US	JPM takes over WAMU	–	Largest bank failure in US history
Sep-29	Belgium	Fortis	16	Large Belgium Bank
Sep-29	US	Wells take over Wachovia	12	Wachovia's history dates back to 1879
Sep-29	Germany	Hypo	35	Largest real estate lender in Germany
Sep-29	Iceland	Giltner	1	Third largest Icelandic bank
Sep-29	UK	Bradford & Bingley	18	Large UK based financial services company
Sep-29	Belgium	Dexia	6.5	AAA Benalux lender
Oct-07	Germany	Hypo Real Estate	35	Largest real estate lender in Germany
Oct-07	Iceland	Landsbanki	1	Second largest Icelandic bank

The markets have reacted as one might expect. The equity markets have tumbled, credit spreads have sky-rocketed and liquidity has dried up. In the US alone, the government has cut the Fed funds rate, liberalised the discounted window, injected mass amounts of liquidity, instituted swap lines with other central banks, agreed to buy commercial paper directly from corporations, financed the unwind of Lehman through the PCDF, and instituted a US$700 billion economic stabilization package. All in the last month! Surprisingly, these actions have only gained limited traction.

Where are we in the process?

1. A series of banks have failed, while others (investment banks) have merged with deposit taking institutions. The days of pure investment banks are over.

2. Large asset write-downs, whether related to housing or leveraging, are continuing at a brisk pace.

3. Europe and the UK are implementing wide reaching policies to deal with systemic issues and to avoid recessions (too little, too late?).
4. Numerous countries, such as Ireland, Germany, Greece and Iceland, have provided blanket guarantees of bank deposits.
5. The US has also implemented a series of measures, including:
   a. A US$700 billion economic stabilization package to buy distressed debt (TARP). The rescue package is necessary, but may not be sufficient.
   b. A temporary increase in the US Federal Deposit insurance from $100k to US$250k, in an attempt to instil confidence among depositors and prevent a run on the banks.
   c. A facility to purchase commercial paper from corporate issuers.
   d. Ongoing liquidity injections and various funding programs to keep the market functioning.
   e. Taking equity stakes in companies such as Freddie Mac, Fannie Mae, and AIG.
6. Australia cut rates a full percentage point, followed quickly by a coordinated 50 basis point cut from the US, Europe, UK, Canada, Switzerland and Sweden. China even chimed in with a rate cut (27 basis points).
7. Economic activity in most major economies is deteriorating dramatically.
8. The housing and credit bubbles have burst, creating an environment where recovery will be painful and long.
9. De-leveraging, which has caused volatility to soar and the credit markets to freeze up.

What now?

1. We will see more consolidation within the banking industry as institutions merge into large, sustainable organisations with diverse funding bases.
2. Insurance companies and pension funds will need to write down assets they own or adopt hold-to-maturity strategies.
3. Counterparty risk will continue to increase until a greater trust and a free flow of funds between banks occurs.
4. Regulation and nationalisation of institutions will take precedence over free market policies, a drastic reversal for most western countries. This is a fundamental, philosophical blow to capitalism.

What next?

1. The commercial paper market in the US needs to gain some traction. If short term funding is not available to banks and corporations, the economy will grind to a halt.
2. Libor (London Interbank borrowing) spreads are at extremes and need to be controlled. Government guarantees on inter-bank lending are a real possibility.
3. Carry trades continue to suffer. The Australian dollar has fallen over 32% since July. We are slightly below fair value (68 cents/dollar).
4. To maintain confidence, Australia must either guarantee deposits or implement a US-like FDIC.
5. The Fed has become the 'Branjelina' of orphaned financial assets/institutions (via the TARP). They must move quickly to put this plan into action.
6. Central Banks need to continue to cut rates in order to restore confidence.

7. The US economy is in dire shape. The recent ISM and payrolls data printed 43 and –159K respectively.
8. Europe, UK, and Japan are also all facing severe recessionary environment.
9. Repairing balance sheets and de-leveraging in this environment will take time. It is like passing this huge kidney stone, it going to hurt! So do not expect risk assets to start coming back in a hurry.

The un-answered questions?

1. At what price will the central banks buy the high risk assets?
   a. If they buy the assets at current market prices, the institutions selling them benefit, but the central bank is left holding the bag. They will be forced to hold the assets to maturity and hope to be paid back (another real estate bubble?)
   b. If they buy the assets at discounted prices (most likely their true value), the institutions selling them will incur additional write downs, wreaking further havoc on balance sheets and possibly threatening the solvency of more institutions.
   c. If they buy the assets somewhere in between, then both of the statements above have to be resolved in some fashion.
2. What about real economic growth?
   a. The current crisis started in the financial markets, but clearly has moved to Main Street.
   b. Do things have to get worse before they get better? Will the credit crunch lead to small business failures, and eventually to higher unemployment?
   c. Will low rates and high government spending result in higher (or hyper) inflation, leading to a prolonged period of stagflation (no growth with high inflation)?
3. When does confidence return to markets?
   a. At what stage do banks and companies start trusting each other and resume lending?
   b. When will depositors/investors begin trusting banks again as opposed to searching for a mattress to stash their cash under?
4. Is there more to come?
   a. Have the institutions around the world disclosed all their problems, or are there more to come?
   b. When will we see a return to stability and growth?

These questions will be answered in due time. Yes, there are a lot of problems out there. Very scary ones. Over the past few months we have written or discussed them with many of you. With all the negative news thrown at us each day, remember that things will work out. Markets/people will adjust as they always have.

Kapstream Capital Pty Ltd ABN 19 122 076 117 Level 15, 255 Pitt Street, Sydney NSW 2000 Phone: +61 2 9994 7000 www.kapstream.com

7983/1008