in depth in focus **in front**

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Quarterly review

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Research, Analysis and Strategy Group (RASG)

Thomas Della Casa | Mark Rechsteiner | Ayako Lehmann

The team can be contacted at:
MICH-RASG@maninvestments.com

Q1 2009 – special topic: Creative destruction - what's left and what's next?

- Hedge funds broke the downward spiral of Q3 and Q4 2008 and generated a small gain over the quarter, outperforming equities and government bonds
- Convertible bond arbitrage was the best performing strategy while managed futures had an overdue correction
- Banks need to dispose of toxic legacy assets before the economy can truly recover
- We expect sluggish growth over the next few years while the best economic scenario would be reflation
- As markets remain volatile, we recommend exposure to trading-oriented hedge fund strategies

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Performance review Q1 2009

Sentiment was extremely poor until the beginning of March

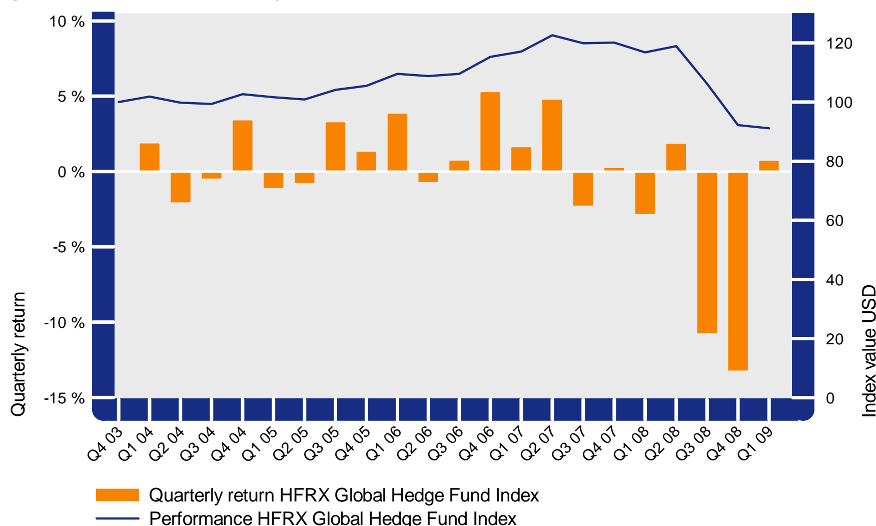
Economic statistics from around the globe in the first quarter reflected the impact of last year's financial crisis. The GDP of export oriented economies deteriorated rapidly and it became evident that growth figures for nearly all countries had to be revised downward once more. All advanced economies are now in a recession and many emerging markets are experiencing a hard landing. As a result, stock markets continued to drift lower and most indices reached multi-year lows by the first week of March. The extremely negative sentiment shifted when Citigroup and other financial institutions delivered positive updates on Q1 earnings which were later confirmed when many banks reported surprisingly good figures. That helped spur a powerful rally in the last three weeks of March but equity indices in the US and Europe still ended Q1 with double digit losses.[1] The rally in emerging markets was even stronger and emerging market equities finished the quarter basically flat. Various government programmes were announced which we cover in more detail in the special topic section. They were initially not well received but investors appear to have begun to warm to intervention measures towards the end of March as more detail has emerged.

Hedge funds made modest profits during Q1

Hedge funds managed to break the downward spiral from H2 2008 and were roughly flat over the quarter. The HFRX Global Hedge Fund Index gained 0.68%.[2] The best styles were event driven and relative value while global macro and managed futures lagged. Convertible bond arbitrage was the top performer with gains of 9.43%.[3] The strategy benefited from normalisation of the convertible bond market after a disastrous Q4 2008. Many hedge funds are now less constrained by the de-leveraging process and are able to increase their risk level and positions again. Generally, we see a lot of tactical trading with rather short-term views and tight stops: 'Make it, and take it' seems to be the name of the game.[4] Also positive is the fact that many of the funds that gated or suspended redemptions in Q4 have now been able to lift gates and in most cases reduce their illiquid positions significantly. Despite these positive developments, many hedge funds are still rather defensive and take risks only selectively. Liquidity management and counterparty risk remain the top priorities.

[1] S&P 500: -11.67% / DJ Euro Stoxx 600: -11.04%
[2] Hedge Fund Research, Inc.
[3] HFRX Convertible Arbitrage Index
[4] 'Make it and take it' refers to trading profits. Currently, most managers have only a short-term view as the longer term outlook is extremely vague. Examples include tactical trades around monetary policy action, interest rates moves, currencies etc.

Figure 1: HFRX Global Hedge Fund Index



Source: Hedge Fund Research, Inc. Time period analysed: April 2004 to March 2009.

Equity hedge managers clearly added value

Equity hedge managers clearly added value during Q1. While benchmark indices recorded double digit drops (MSCI World Index, in LC -10.62%), long/short managers were slightly positive. The HFRX Equity Hedge Index gained 0.76%.[5] Over the course of the quarter, managers kept their net (about 17%) and gross (about 87%) exposure roughly unchanged. [6] At the beginning of the year, short positions in financials paid off hugely as many banks such as RBS or Lloyds tanked over fears of full-scale nationalisations. These positions were mostly closed out by late February / early March. On the long side, most managers focused on consumer staples and other defensive sectors which made money in January and February. Fundamental, bottom up managers dragged on performance as many were hurt by the relative outperformance of cyclical stocks in March.

Relative value was powered by convertibles

Relative value funds generally posted modest profits during Q1. Liquidity in many markets improved considerably, but still pales in comparison to levels seen before 2008. Convertible bond arbitrage was the best performing strategy. The HFRX Convertible Arbitrage Index was up 9.43%.[7] Convertible bond arbitrageurs benefited handsomely from a normalisation of the relative value dislocations between specific convertibles and the corresponding equity and credit instruments. The absence of forced selling, issuer buybacks and large purchases of cross-over buyers lifted the asset class. YTD new issuance is low by historical measures but is expected to gain pace as companies take advantage of the attractive terms.[8] The asset class is still cheap but not nearly as cheap as it was late last year.

Credit RV managers posted mixed results. On the positive side, CDS basis trades finally moved in the right direction with cash bonds outperforming CDS. However, these moves were not sustained and reversed in some cases. Fixed income RV traders were

[5] Hedge Fund Research, Inc.
[6] RMF underlying equity hedge managers
[7] Hedge Fund Research, Inc.
[8] Many companies can raise hybrid capital at a low coupon and sell expensive volatility embedded in the option

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mostly positive as significant volatility in the level of rates, slope of yield curves and various spread relationships continued to offer good opportunities. The volatility in fixed income markets can largely be attributed to the gyrations in the pricing of risky assets, uncertainty over the various government programmes as well as heavy government new issuance and buybacks.

Volatility trades were costly to implement

Volatility focused managers had a tough time as long convexity trades were costly to implement and the time decay a drag on performance. In many cases, they have shifted away from bulky long vega exposures to focus more on long/short premia trades. The more directionally oriented managers continued to focus on trades in the front ends of government bond markets to trade around the volatility that arises due to government interventions. Market neutral equity struggled as there was a lack of differentiation between good quality and bad quality stocks. Multi strategy managers were mostly profitable, particularly those with high allocations to convertibles.

Special situations and merger arbitrageurs benefited from the closure of several M&A deals, such as Roche/Genentech and Dow Chemical/Rohm&Hass. Both deals offered a very attractive spread as they neared closing.[9] Short positions in European financials, such as Lloyds and RBS paid off hugely early in the quarter as the share prices of both banks dropped for weeks.

Distressed lagged the strength in the credit markets

Distressed securities managers recorded heavy losses, which was somewhat disappointing considering the relative strength of the credit markets. The HFRX Distressed Securities Index fell -5.2% while the CS High Yield Index gained 5.81% and the leveraged loan index rose even more[10] as large inflows into high yield mutual funds brought relief for the battered credit markets. One reason why distressed managers did not capitalise on this recovery was a clear split between on-the-run and off-the-run names.[11] Most of the recent strength in the credit market was concentrated in the on-the-run liquid names. Off-the-run illiquid names did not trade up nearly as well. Moreover, hedging positions detracted from performance. Default activity, as expected, picked up significantly in Q1 as 40 companies have defaulted for a record-high USD 75.1 billion.[12] This amount already vastly exceeds the full year 2008 default volume of USD 49.2 billion.

[9] Both deals have now closed
[10] The CS Leveraged Loan Index gained 7.17% during Q1
[11] On-the-run refers to the more liquid part of the non-investment grade credit market whereas off-the-run names are highly illiquid and there is still a selling overhang
[12] JPMorgan Default monitor March 2009: figure includes actual US defaults and grace-period default up to March 31, 2009

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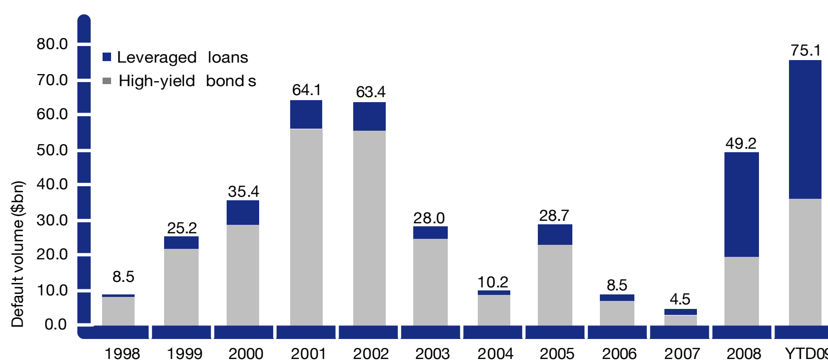
Figure 2: YTD 2009 default volume in the US has already hit a record USD 75.1 billion



Source: JPMorgan, S&P LCD. Note: includes grace-period defaults.

Central banks moving towards quantitative easing

Global macro managers had mixed fortunes. Some benefited from divergence trades within European sovereigns (long Germany, short Southern Europe, Ireland and Austria) or short biases on Eastern European FX and credit. In fixed income, managers generally had a yield curve steepening bias on. The Fed followed in the footsteps of the Bank of England, the Swiss National Bank and the Bank of Japan, which have also announced quantitative easing (QE[13]) measures. The Fed's QE is the most aggressive, with potential purchases of up to USD 300 billion in long term Treasuries. The ECB is not (yet) in QE mode and still applies classic monetary policy by lowering interest rates. Policy rates are now at 1.25% (as at 2 April 2009). QE will be difficult for the ECB to implement as it is unclear which country's bonds it would buy. QE is generally thought of as positive for government bonds, especially long duration ones, and negative for the currency as interest rates are zero. While QE was initially negative for the USD, this changed when others introduced QE measures.

MBS and agency spreads narrowed

In the UK, gilts initially rallied strongly following the BoE QE announcement but a failed auction of 40 year gilts and uncertainty about the scale of QE led to a sharp correction. In the US, there was a big move in long-term Treasuries when the Fed announced more details on its QE measures. The Fed's move was seen as very aggressive and led to a huge rally in long bonds. MBS and agency spreads narrowed as a consequence. Global macro managers were, however, mostly positioned in the front end of the yield curve with a steepening bias and thus could only participate to a limited extent in the bond rally. Many macro managers believe that QE initiatives will lead to flatter yield curves and declining volatility in rates. However, the more long-term effect could lead to inflation and debt monetisation (discussed in more detail in our special topic section). This could increase the demand for inflation-linked products.

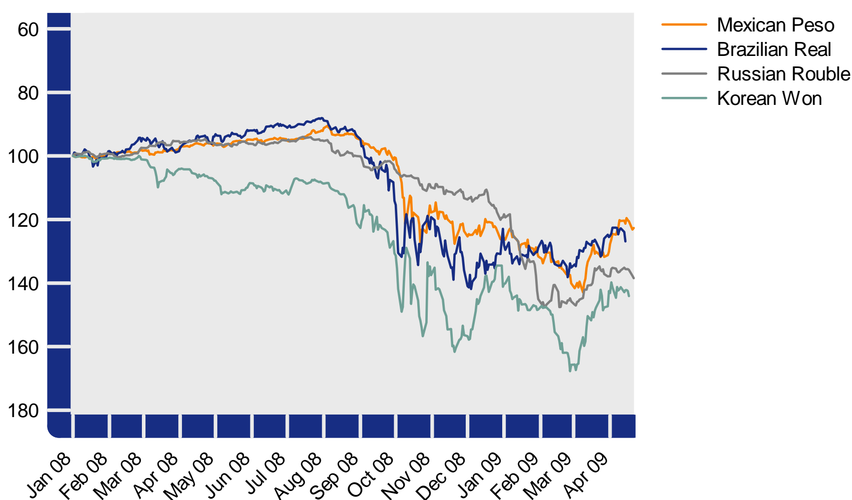
Differentiation between EM was a strong theme

Popular trades in emerging markets included short currencies and stocks in economies dependent on foreign capital and overweight economies with strong external positions. All EM asset classes (equity, fixed income, FX) benefited from the strong rally during the last three weeks of March. In fixed income and currencies, managers benefited from spread tightening and a relative outperformance of Asia and Latin America compared to

[13] Quantitative easing refers to the central bank 'printing of new money', in order to increase the supply of money. 'Quantitative' refers to the money supply; 'easing' essentially means increasing. Quantitative easing was used notably by the Bank of Japan to fight deflation in the early 2000s. Quantitative easing can basically be understood as a method of 'printing money' although today the new money is generally created electronically rather than physically printed.

Eastern Europe. In addition to the overall improved market tone, the IMF's new financing resources significantly reduced EM systemic risk[14] and the negative momentum for EM FX has reversed notably, as seen in the next figure.

Figure 3: EM currencies stabilised against USD



Source: Bloomberg. Period analysed: January 2008 to March 2009.

Commodity hedge funds made money in natural gas

Commodity focused hedge funds did well during Q1, further demonstrating their added value in comparison with long-only indices. While major commodity indices were down[15], most commodity hedge funds made money. A great deal of alpha came from the natural gas market. Falling industry demand, high inventories and signs consumers were reining in domestic consumption to keep heating bills down hit natural gas prices hard. Nearby natural gas futures fell -33% over the quarter to reach the lowest level since 2002 but prices further out the maturity curve were much more resilient which meant that bear spreads worked exceptionally well. Crude oil continued to fall in January and February but recovered strongly in March. The IEA[16] reduced its demand forecast for 2009 to 83.4mb/d, 2.7% lower than the demand in 2008. This decline will mark the first 2-year decline since 1982/83.

Agriculture and precious metals outperformed base metals and energy. Gold once again briefly kissed USD 1000/oz, but quickly retreated as risk aversion eased. Strong fundamentals (production problems in West Africa and resilient demand) continued to support higher cocoa prices and most agriculture-focused managers were long cocoa. The recovery in the base metals is somewhat surprising given the economic picture but significant supply cuts coupled with strong re-stocking demand from China added a more bullish tone over the last few weeks. Copper gained 31% in Q1, the largest quarterly increase since Q2 2006. A large part of this gain can be attributed to China's open market purchases ahead of its proposed rise in infrastructure investments as part of the economic stimulus package.

[14] IMF policies are discussed in the special topic section
[15] Reuters/Jeffries CRB: -3.98%, SP GSCI -10.64% during Q1
[16] International Energy Agency

Figure 4: China infrastructure investment, change YoY

Source: China economics and strategy teams, ©Datastream International Limited, Credit Suisse.

Managed futures suffered trend reversals

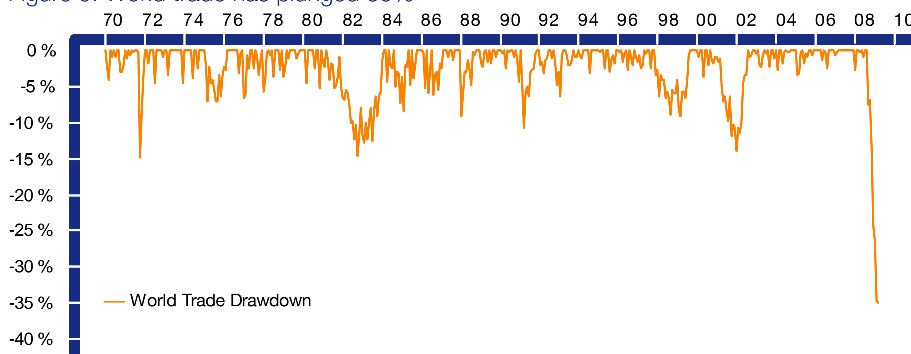
Long established trends such as long government bonds, long CHF and JPY, short equities and short commodities all came to a (temporary) end during the quarter. The CS/Tremont Managed Futures Index lost -1.81%. Currency trading was the biggest drag on performance for managed futures. Particularly challenging was the Swiss National Bank's intervention to weaken the franc by announcing FX intervention and QE. Government bond trading also generated losses as the established uptrend in long-term govies abruptly ended when the new supply was not easily absorbed by the market. While QE supports higher prices for government bonds, fears over less demand from the private sector and also from China and other emerging markets led to strong price movements with CTAs being stopped out. Generally, CTAs are still positioned for a recessionary scenario, i.e. short equity, long bonds, short commodities and long USD. However, it is important to note that these positions have become increasingly diversified with much lower exposure to specific positions.

Special topic: Creative destruction - what's left and what's next?

World trade collapsed

The current recession is special in that it affects the whole world at exactly the same time, i.e. there is no place to hide. Hopes that emerging countries such as China or Latin America would be able to keep the world economy going while industrialised countries are in a recession have been dashed. Instead, world trade is shrinking at the fastest pace since the Second World War and with no quick recovery in sight it seems likely that deflationary forces will persist for some time.

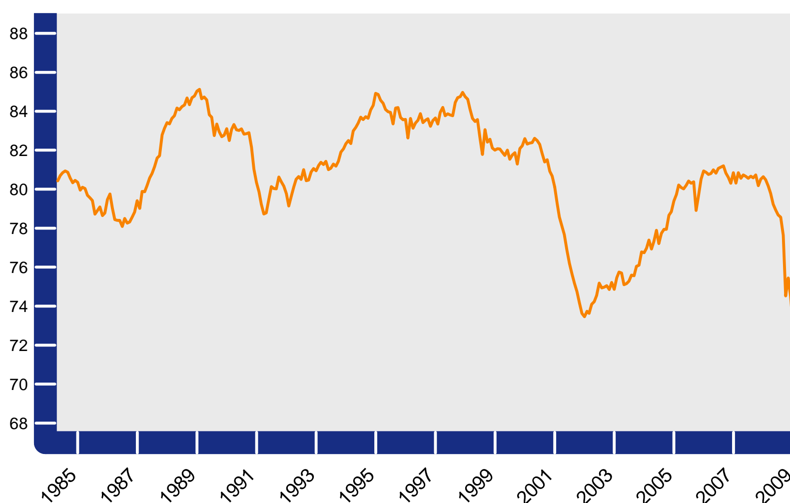
Figure 5: World trade has plunged 35%



Source: Bridgewater. Time period analysed: 1970 to 13 April 2009.

With demand continuing to fall, companies are facing declining revenues as well as shrinking margins and have started to make adjustments by cutting production. As a result, capacity utilisation around the world has decreased significantly resulting in serious excess capacity.

Figure 6: Capacity utilisation has fallen off a cliff



Source: Bloomberg. Refers to US. Time period analysed: 01 April 1984 to 22 April 2009.

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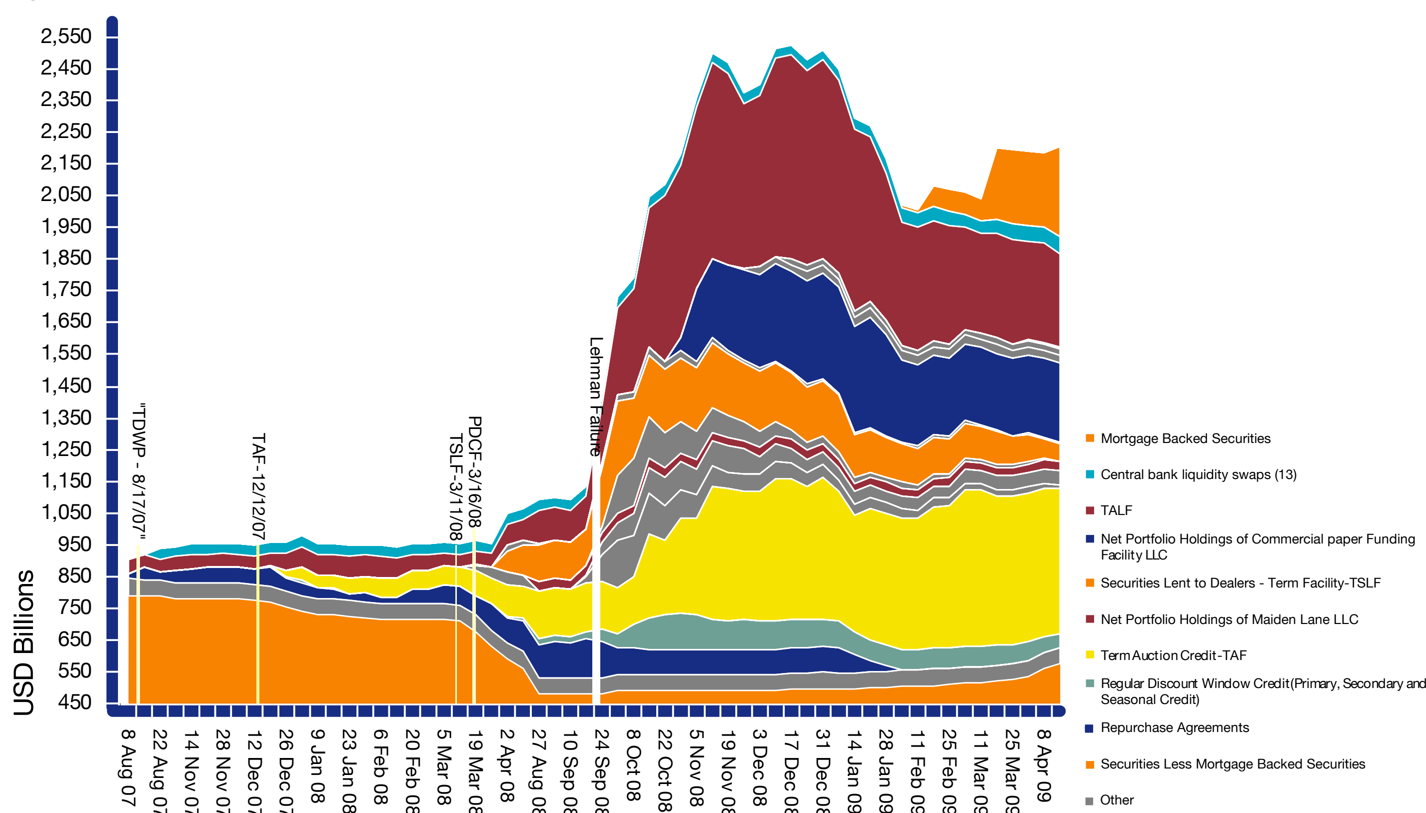
Governments are using monetary and fiscal policies…

…decreasing rates and increasing budget deficits

Central banks and governments around the world have been very active in providing economic support to get the global economy going again using a combination of monetary and fiscal policy. Traditional monetary policies have largely been exhausted with most central banks having reduced their interest rates to close to zero (zero interest rate policy).[17] The next step in (non-traditional) monetary policy is quantitative easing (QE). This includes buying long-term government bonds, expanding loans to financial institutions, purchasing private securities and buying mortgage or asset-backed securities. This growth in assets has been financed with increased liabilities such as commercial-bank reserves, swaps with central banks and other ways of printing money. As a result, the budget deficit of the world's richest countries is expected, on average, to increase to close to 9% of GDP; a figure six times higher than before the crisis started[18].

Figure 7: Fed balance sheet exploded



Source: Federal Reserve Board of Governors Statistical Release H.4.1. Note: Data are weekly averages for all but the Foreign Central Bank TAF which are as of the last day of the week. TDWP = Term Discount Window Programme. Maiden Lane = first holding company bearing the name that was created when JPMorgan Chase took over Bear Stearns in early 2008. It holds the asset portfolio that JPMorgan found too risky to assume in whole, thus the Federal Reserve Bank of New York extended a USD 30 billion credit line to the limited liability company to facilitate the unwinding of these assets.

[17] US 0-0.25%, UK 0.5%, Eurozone 1.25%, Japan 0.1%, Switzerland 0.5%
[18] Source: The Economist, 25 April 2009.

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Credit losses will continue to mount

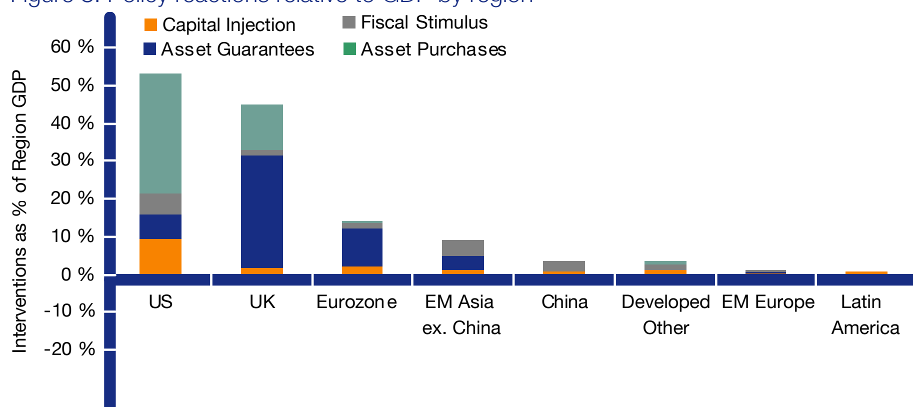
While only a small portion of the huge amount of 'printed' money has flowed through into the markets it has still helped banks to write down some, though not all, of their toxic debts. According to the latest estimates from the IMF[19], another USD 3.1 trillion of write downs, on top of USD 1 trillion taken thus, could be necessary on some USD 58 trillion in assets originated in the US, Europe and Japan. The ultimate size of the write downs will depend on the length and severity of the recession. It is hard to imagine that house prices will stabilise and job markets improve during the vicious circle[20] we are currently in. This hurts banks beyond their original mortgage problems as credit card debt, auto loans, student loans, commercial mortgages etc are also impaired. In order for the global economy to recover from the current crisis, it is absolutely essential that the financial system is fully restructured and its deadweight removed, otherwise lingering fear will continue and systematically important institutions might collapse, triggering further market disruptions and perpetuating the downward cycle.

Fiscal stimulus packages can help but come at a cost

While monetary policies are driven by central banks, governments can support their economies directly through fiscal stimulus. Over the last few months, several countries have initiated such measures, with the largest coming from the US, China and Japan. Such packages include tax breaks, various forms of subsidies to industries (such as clean energy) and infrastructure projects. Currently, the G20 stimulus packages amount to 1.4% of global GDP.[21] The disadvantage of stimulus programmes for infrastructure projects is the fact that their impact on the economy only comes with a delay of several months, if not years. In the US, for example, it is estimated that the heaviest impact of the 787 billion package[22] will be felt in 2010.

The below figure summarises the monetary and fiscal policy actions taken so far by different regions around the world. It shows that the US and UK haven been most active until now.

Figure 8: Policy reactions relative to GDP by region



Source: Bridgewater Daily Observations, 2 March 09.

[19] As at 21 April 2009.
[20] The vicious circle refers to a complex set of events that reinforce themselves through a feedback loop. Sometimes the term 'adverse feedback loop' is also used.
[21] IMF
[22] American Recovery and Reinvestment Act of 2009

The IMF has re-gained its importance as lender of last resort

At the recent G20 summit in London, it was decided that the International Monetary Fund (IMF)[23] should have more resources and play a broader role in the world economy. The IMF's resources are to be increased by USD 500 billion to USD 750 billion. The IMF has also overhauled its lending framework to make it easier for countries to apply for and receive loans and reduced the potential stigma of doing so. The main changes include replacing the old short-term liquidity facility (SLF) with the new flexible credit line (FCL). While the SLF was a loan requested once a country was in distress, the new FCL should be seen as an insurance policy. Countries with a sound economy can apply for the FCL when they are not in distress, but these loans can be fully disbursed when the need arises and will not require compliance with policy targets as in traditional IMF-supported programmes. In other words, the FCL is set to improve liquidity and prevent emergencies and not just provide support for economies in crisis as has been the case before. Three countries have already applied: Mexico (USD 47 billion), Poland (USD 20.5) and Columbia (USD 10.4 billion).

…and EM countries continuing to increase their influence in the organisation

What is more, the IMF will also get another USD 250m in Special Drawing Rights (SDR) to allow countries suffering from a balance-of-payments crisis to increase their FX reserves. The new SDRs will be allocated as assets to IMF members' central bank balances at the fund, based on existing quotas. As SDRs are not liabilities, this move is not the same as central bank printing money, i.e. it is not the same as quantitative easing.[24] We expect the IMF to be more active in the next few years as the recession will last for a while. By lending money to crisis-stricken countries, the IMF will also take influence on these countries, which could potentially lead to political conflicts. Furthermore, several EM countries will ask to get a bigger influence within the IMF going forward. This will change the role and influence of the IMF for the future.

Lessons learned from past financial crises

The current financial crisis has several characteristics in common with previous crises. We have picked three financial crises we believe have a close bearing on today's economy: Continental Illinois in the 1980s, the Swedish crisis in the early 1990s and Japan's lost decade starting in the 1990s which lasted well into the new century. Continental Illinois National Bank and Trust Company (Continental) was a major bailout in the financial industry and was when the sobriquet 'too big to fail' was first introduced.

Figure 9: Continental Illinois

	Continental (1981/1982)
Origin of crisis	• Continental used to be a conservative bank in the US • Mid 1970s – started growth strategy, which focused on commercial lending • By 1981 – Continental was the largest commercial and industrial lender in the US • As most indicators such as return on equity, equity level and return on average assets were at acceptable levels, few observers realised that the bank might have inherent problems. • Analysts at the time overlooked the fact that the loans-to –assets ratio had increased dramatically from 1977 to 1981, i.e. that Continental was exposed to high default risk
Crisis	• Late 1981 – problems started to surface: • Penn Square Bank in Oklahoma, from which Continental had purchased a monumental USD 1billion in bad loans, failed

[23]The IIMF is an international organization that oversees the global financial system. It offers financial and technical assistance to its members, making it a global lender of last resort.
[24] The allocation of new SDR has two benefits. First, it increases the notional amount of FX reserves countries hold and second, it allows members countries to exchange these new SDRs with other members for hard currency. Only when SDRs get exchanged into real currencies, new money is created. Hence, the SDR expansion is not a global liquidity boost per se, but rather a global liquidity facility.

	• Mexico defaulted in August 1982 • Continental lost credibility in domestic money markets, and with only a small retail banking business, it only had small amounts of core deposits • Continental had to roll over large volumes of deposits, as it had favoured issuing shorter-term, more volatile but less expensive instruments rather than longer-term ones that were both stable and more expensive.
Policy response	• At that time, Continental was considered „too big to fail" by regulatory agencies • US Federal Deposit Insurance Corporation (FDIC) infused USD 4.5 billion to rescue the bank • Shareholders were wiped out, bondholders were protected • Bailout of Continental was largest bank failure in American history – until Washington Mutual was seized in 2008
Resolution	• Continental was renamed Continental Bank; was later acquired by Bank America in 1994, now part of Bank of America.

Source: FDIC History of the Eighties – Lessons for the Future, Vol. I, December 1997.

Figure 10: Swedish versus Japanese financial crisis

	Sweden (1991-1993)	Japan (1990 – 2004)
Origin of crisis	• Swedish financial sector characterised by lending ceilings, restrictions to investing in government bonds and mortgage institutions, careful oversight by Riksbank. • Early/mid 1980 Sweden started deregulating its financial sector • Result: banking sector started taking excessive risks • Tax code was not reformed, i.e. allowed full interest deductibility and thus strengthened incentives to borrow. • Public incentives support demand for residential real estate, especially for less creditworthy buyers	• Source of banking losses stemmed from sharp increase and drastic subsequent decline in real estate/stock prices. • Towards nd 1980s, JPY appreciated substantially • To sustain growth, BOJ flooded market with liquidity to reduce interest rates/ boost investment • Excess liquidity prompted bubble in stock market/real estater
Crisis	• Faltering growth • Increasing unemployment • Large number of private sector loans became non-performing • Banks curtailed credit extension to build up loan loss reserves • 1991 – property prices imploded, Swedish banking system became insolvent	• Late 1980s – BOJ tightened monetary policy. As a result, stocks/real estate fell. • Banks in Japan are allowed to hold equities as part of their capital base. The bursting stock bubble caused the value of unrealised capital gains to plummet, reduced capital reserves of many banks. • Declining real estate led to the value of collateral underlying bank loans to fall below principal, NPL increased.
Policy response	• First response: Capital injections and capital guarantees for troubled banks. • 1992 – government issued blanket insurance for four years to creditors of all country's 114 banks. • Participating banks had to recognise losses, bad assets were transferred to two independent state-owned asset management companies at book value. • Government recapitalised these banks and took direct ownership in them. • Asset management companies were adequately capitalised in relation to expected losses.	• Asset price collapse/credit crunch led to a severe recession • First response: greater deposit protection, provision of emergency liquidity, facilitating/encouraging merger of failed institutions • First capital injection: 1996 • 1997: banking sector recognised to be in full systemic crisis after bankruptcy of major banks. • Towards end of 1997: accounting changes were approved, by which banks could chose either market of book valuations of their assets. • Asset management companies were established to encourage banking sector consolidation (1992/96/96). • 1998: two biggest financial institutions went bankrupt and were nationalised, shareholders were wiped out. • Government capitalisations in 1998/1999/2001/2004.

Resolution	• By 1997, troubled assets liquidated, at faster pace and lower cost to Swedish taxpayers than initially projected • 4% of GDP spent to rescue ailing banks • Final cost estimated to be less than 2% of GDP • Asset management companies recovered economic value left in NPL by taking equity stakes in borrowers to maintain/restore values and taking over defaulting firms until they could be liquidated.	• Value of bad debt written off amounted to nearly 20% of GDP. • Japan recovered by benefitting from increasing export. • Banking sector eventually recovered by 2004. • Two nationalised banks were sold to private investors.

Source: OECD, Economic Outlook, March 2009.

Despite the different natures of these financial crises it is interesting to see that they have several things in common. First of all, crises tend to develop based on inflated real estate prices and lax financial regulation. Second, it is essential that authorities recognise the severity of banking problems early in order to introduce adequate measures such as creating independent asset management companies, to which toxic assets can be transferred, thus separating the healthy bank from its toxic part. This was not the case in Japan. It took the Japanese central bank (BOJ) six years to unlock the frozen credit market in 1997 and even then the amounts were too small. Central banks and governments around the world have reacted much faster in the current financial crisis than the Japanese did during the lost decade and seem to be willing to raise/print as much funding as is needed to resolve the crisis. Furthermore, the case of Sweden shows that it is important to give asset management companies responsible for toxic assets a certain financial independence in order to shield their decision makers from political pressures. To conclude, it can be said that the US reacted fairly swiftly to the current crisis (although they could have prevented Lehman Brothers from going bankrupt). But today's main problem, which is something that did not exist in previous crises, is the valuation of toxic assets, as without a price, the final amount that needs to be written off remains unclear.

The following section looks at some industrialised economies and emerging markets countries in more detail.

US

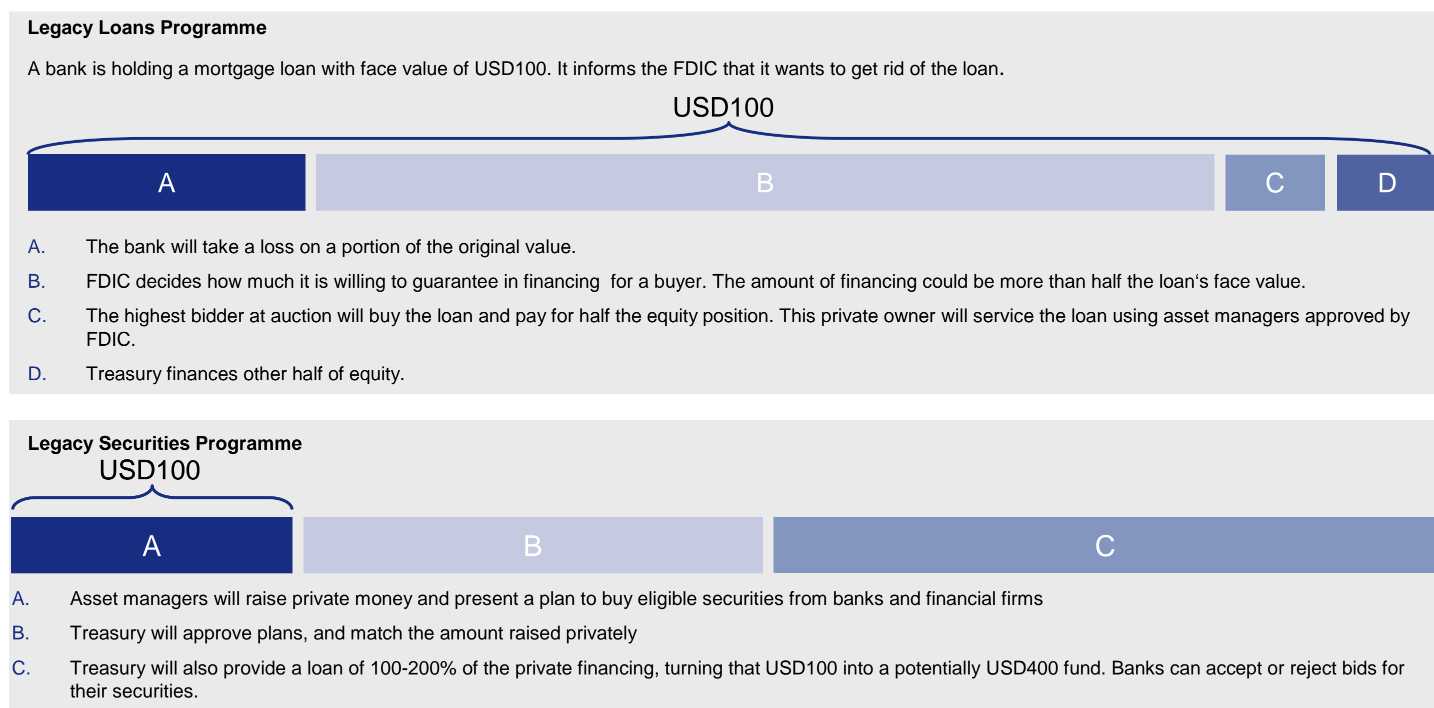
Monetary policy is largely exhausted

Since the beginning of the credit crisis in Q3 2007, the US has been very active in combating the crisis. After interest rates were reduced from 5.25% to a range close to 0% (zero interest rate policy), the Federal Reserve has started to use quantitative easing by buying US Treasuries, mortgage-backed securities, and other debt instruments with the intention of bringing longer-term interest rates and credit spreads down. They started with TARP (Troubled Asset Relief Program) which was followed by TALF (Term asset-backed securities loan facility). These measures are explained in figure 12. The biggest problem, however, remained. How to clean up the banks?

PPIP is now the alternative to the bad bank

While the idea of a national bad bank was discussed, it soon became clear that it would be very complicated to implement. Perhaps the biggest challenge of all was to find the correct pricing for these toxic debt instruments. US Treasury Secretary Timothy Geithner announced the Public-Private Investment Plan (PPIP) on 23 March 2009 in detail. As the main reason for banks not to sell their toxic assets has been the fact that they were afraid of having to sell them at too low a price, and taxpayers on the other hand were afraid that they would end up having to pay too high a price in an environment of no market activity for these type of securities, the PPIP plan tries to find some common ground.

Figure 11: Public-private investment programme – how it works



Source: US Treasury Department, Wall Street Journal.

Figure 12: Overview of most relevant US government plans (in chronological order):

Name of US government programme	Main purpose	Challenges	Date of announce-ment
TARP (Troubled Assets Relief Programme)	• To purchase/insure up to USD 700 billion of troubled assets • "Troubled assets" are defined as (a) residential or commercial mortgages and any securities, obligations, or other securities that are based on or related to such mortgages, issued on or before 14 March 2008 and (b) any other financial instrument that the Secretary determines to purchase of which is necessary to promote financial market stability. • Revision 14.10.08: Treasury to buy senior preferred stock/warrant in 9 largest US banks. • Revision 12.11.08: reviving securitisation market for consumer credit • Revision 19.12.08: TARP to be used to avert financial crisis, i.e. it allowed to support the US auto industry.	• Valuation of toxic assets difficult • Programme was revised several times as the financial crisis deepened. • Banks passing the stress test are interested to return TARP money to the government asap in order to free themselves from government restrictions regarding executive compensation.	28-Sep-08
TALF (Term Asset-Backed Securities Loan Facility)	• Support issuance of ABS collateralised by student loans, auto loans, credit card loans, loans guaranteed by Small Business Administration. • Fed NY lends up to USD 1 trillion on non-recourse basis to holders of certain AAA-rated ABS.	• Follow-up buyers after Fed need to be found • limited impact in marketplace • loss of confidence in AAA-rated tranches	25-Nov-08

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Financial stability plan	• Bank stress test for banks in the US with more than USD 100 billion assets (19 banks). Results will be reported at the end of April 2009. According to preliminary results, all 19 banks passed the test. • To identify bad assets on bank balance sheets, using financial models to project futures loan values and loss rates under different economic scenarios in order to determine their ability to with stand a severe and lengthy recession. • Capital assistance to banks as determined by stress tests, PPIP, housing market support. • Orderly work-out of large, complex banking institutions.	• Banks failing stress test should go straight to bankruptcy as it is not worth investing more money into these institutions. • Economy worsened since Treasury first announced the tests in February. Market participants expect baseline scenario might not be rigorous enough.	10-Feb-09
Quantitative easing	• Treasury buying back longer term USTs now that short-term interest rate cannot be lowered any more (currently at 0-0.25% range). As of 21 April, the Fed has purchased USD 59.7 billion,	• Yields will be driven lower with more quantitative easing. • Printing money is the only option left to the Fed.	18-Mar-09
Public-Private Investment Plan (PPIP)	• To buy toxic assets from banks' balance sheets • Using USD 75-100 billion in TARP capital, PPIP will generate USD 500 billion in purchasing power to buy legacy assets with potential to expand to USD 1 trillion over time, thereby maximising the impact of each taxpayer dollar. • Consists of two parts, the legacy loans programme and the legacy securities programme • Under both, Treasury will match private sector capital 1:1 to provide equity for investment funds to purchase assets	• Finding investors from the private sector will be difficult, as several hedge funds who were initially interested no longer are • It remains to be seen whether banks are willing to sell their toxic assets at depressed prices • Despite trying to include both public and private money, tax payers will bear most of the risk associated with this programme.	23-Mar-09
PPIP – Legacy Loans Programme	• Buy residential loans from banks' balance sheets • Funds will be able to leverage up to six times equity with the FDIC guaranteeing their debt secured on purchased assets. • Price discovery through some form of auction process, whereby everyone who wants to participate in the bidding can avail themselves, subject to some basic registration	• It remains to be seen how many private investors will participate. • Several banks already refused to participate in particular as sellers, as they fear government changing rules halfway through the programme.	23-Mar-09

PPIP – Legacy Securities Programme	• Buy legacy assets, defined as mortgage-backed securities such as RMBS (originally rated AAA), CMBS and ABS (rated AAA)
	• Via TALF programme, government will provide non-recourse loans for up to 100% of fund's equity.
	• Funds come equally from TARP, TALF, and private investors.
	• US government selects 5 fund managers based on several criteria:
	  o Fund managers must have minimum of USD 10 billion eligible assets under management
	  o Fund manager must have five years of experience in applicable asset class
	  o They will have discretion over asset selection and control trading and disposition
		• It remains to be seen how many private investors will participate.
		• Positive feedback from hedge fund managers so far is fairly weak.
			23-Mar-09

Source: US Treasury Department, various investment bank analysis, MI Research.

Hedge fund interest in PPIP has been muted so far

Some hedge funds and private equity companies expressed interest in participating in the Legacy Securities PPIP, but more and more hedge funds have decided not to do so after the Treasury Department announced that certain conditions have to be met by potential fund managers interested in participating in PPIP:

- only companies that already manage a minimum of USD 10 billion in toxic securities can apply. This rule was later relaxed by the US Treasury, allowing also smaller fund managers. Furthermore, more than five fund managers could be appointed in the end.
- these securities must be comprised of commercial and residential mortgage-backed securities that are “secured directly by the actual mortgage loans, leases or other assets and not other securities”
- Headquarters in US. This rule, too, was weakened in early April, allowing also foreign fund managers.
- asset managers such as hedge funds who have indirect exposure to these toxic assets such as through CDO squared, i.e. CDO secured by other CDOs, do not qualify for PPIP.

Many questions regarding PPIP remain

As a result, only a handful of asset managers are eligible for this programme, including BlackRock (will participate), PIMCO (will participate), Goldman Sachs (not interested), JPMorgan (not interested), Citigroup (not interested), Legg Mason (not known) and Bridgewater (initially showed interest, but decided not to participate, as they fear that the US government might change its rules midway through the programme and that they would be blamed for benefiting from tax payers’ money). Perhaps the biggest flaw of the PPIP in its current form is the lack of tools/incentives for banks to participate, i.e. sell their toxic assets. If banks do not participate PPIP will not achieve its main purpose: to clean up the banks’ balance sheets. This does not bode well for the PPIP and we believe that the US Treasury will need to adjust the PPIP to the market situation if they really want to include private investors into their plan and make PPIP a success. If PPIP does not take off, toxic assets will remain on banks’ balance sheets and only lead to bigger losses in the future. Stress testing currently underway may serve as catalyst for participation as those banks that fail the test will need to sell assets and raise more capital. Furthermore, PPIP has been criticised for containing a loophole: banks could use PPIP to buy toxic assets, thereby adding to their stockpile of bad assets with cheap taxpayers’ funds.

New issuance of USTs will be enormous…

On another note, the problem with liquidity infusion from the Fed to various banks is that it did not differentiate well enough between banks that are worth saving, i.e. banks that will be able to survive, and those that are not, resulting in so called “zombie-banks” by putting non-viable entities on life support. And yet it is clear that without the enormous government intervention, conditions would be much worse today in the US. According to Bridgewater estimates, the combination of government rescue shortfalls, spending programmes and financial assistance will produce a total UST borrowing of UST 2 trillion in 2009. With total outstanding supply of UST at the end of Q308 at USD 5.8 trillion, the addition of the issuance would amount to a 35% increase in UST supply in a one year period.

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…and the Fed is keen to keep a lid on yields

Normally, such a large increase in supply would put pressure on UST prices and push up yields. However, under the quantitative easing regime, the Fed is aiming to keep yields low across all maturities. Hence, it is safe to assume that the Fed would step in if demand for new UST were insufficient. China, which has been a large buyer of UST in recent years is still buying but has recently expressed concerns about the safety of its USD assets. It may well be that demand from China (and other countries) will slow. Despite this, China's holdings of US debt are still growing in absolute terms.[25] This is mainly due to China's trade surplus and its purchases of USD to prevent the Yuan from rising.[26]

As the table below shows, the US government has been very active in combating the current crisis, with most of the points in the checklist already ticked off.

Figure 13

	Checklist for combating credit crisis	Current status
1.	Aggressive Fed easing accompanied by an open-ended commitment to ease further if necessary	✓
2.	Coordinated easing by major central banks	✓
3.	A steeper yield curve	✓
4.	Non-conventional policy support	✓
5.	Central banks buy private sector assets and monetize	✓
6.	Fiscal stimulus	✓
7.	A major fiscal bailout of financial institutions (recapitalisation)	✓
8.	Official guarantee for liabilities of entire banking system (i.e. blanket guarantee)	✓
9.	Removal of toxic waste from bank balance sheets	?
10.	Increased transparency and recognition of losses in financial sector	✗
11.	A moderation in decline in US house prices	✗

Source: BCA Research, 20 April 2009.

[25] According to Standard Chartered, China bought 22% of newly issued USTs during February 2009
[26] Since the beginning of the financial crisis, the Chinese Yuan has been flat against the USD

Accounting rule changes have been controversial

On 2 April 2009 the US Financial Accounting Standards Board (FASB) announced that it would relax fair-value rules. Several banks had complained that mark-to-market rules do not work when markets are inactive, i.e. there is no price in inactive markets. The change to more flexible accounting rules will give bankers more leeway to use their judgement in valuing assets and reduce the amount of write-downs they take on impaired investments, including MBS. The new rule says that once an asset is other than temporarily impaired, only losses related to the underlying creditworthiness would affect earnings and regulatory capital. Hence losses attributed to market conditions would be disclosed and accounted for elsewhere. Depending on the situation of the market, more weight should be placed on transactions when a market is operating in an orderly fashion and less when the market is less active. This is an extremely vague definition from the FASB and obviously gives bankers far too much room to polish up their financial statements[27]. On the other hand, critics argue that a high percentage of the toxic assets have already been written down, so the impact of the FASB rule change will be minimal.

Some banks benefited from accounting rule changes in Q1…

…and want to return TARP funds

One of the first banks to benefit from this changed accounting rule was Goldman Sachs, which reported a USD 1.81 billion profit in Q1 09, surprising all analysts. But other big banks such as Wells Fargo, Citigroup and JPMorgan also reported positive Q109 results. It remains to be seen whether these positive results are sustainable or whether they were simply the result of less stringent accounting rules. While these rule changes were fairly unexpected, we believe that they may be changed back to marked-to-market once the economic situation improves in line with the current tendency to increase transparency. Interestingly enough, some banks such as Goldman Sachs, Citigroup, Morgan Stanley and JPMorgan Chase & Co. have started to announce that they are planning to pay back the funds they received from the TARP programme as soon as the results of the stress test are known and they get the regulator's approval to return TARP money, thereby trying to unleash themselves from strict government controls and shed government limits on executive pay.

Households and businesses are also de-leveraging

The massive government intervention to stabilise the financial system seems to have succeeded in stopping the freefall in credit markets. For the first time since the Great Depression, households and businesses were (net) paying down their debt. While credit growth prior to the crisis peaked at about 17%, this figure came down sharply to currently very weak levels of 1-2% of GDP a year[28]. This slow rate of credit creation means that households and business cannot rely on new credit to augment their incomes; hence they have to either boost their spending by earning more or save less. But neither are real options in the current market environment as incomes keep falling and liquidity concerns means households and businesses will save more to secure their debt rollover concerns.

Other countries are also taking strong measures to fight the crisis.

[27] Patrick Finnegan, director of financial reporting policy for the CFA institute, argued that "financial statements are not there to reflect management's assumptions".
[28] Source: Bridgewater.

Eurozone

The current recession has divided the European economy, with the West facing different kinds of problems from the East, and Southern Europe facing other challenges.

Western Europe is suffering

While the eurozone experienced a less severe banking crisis than the US and the UK, European countries are also facing a severe recession and European financial institutions also required to get government support. According to Fed research, this is because 40% of US originated securitisations are held abroad, i.e. USD 4.3 trillion out of USD 10.8 trillion[29], with 90% of foreign exposure falling on European banks (including the eurozone, UK and Switzerland). Furthermore, European banks were more heavily exposed to Eastern Europe and Latin America, increasing the write-down. According to the latest estimates, bad debt at German banks amount to 12% of German GDP (USD 265-480 billion) and Germany is considering a bad bank concept, though that would not be a centralised bank, but rather a means of separately identifying and insuring banks' illiquid assets.

Germany, as the worlds' export champion, is hit hard

Germany, Europe's biggest economy, has also been hit hard by the global slump and its GDP is expected to shrink 5.6% in 2009, with no recovery in 2010. This is not surprising as export accounts for almost 47% of German GDP, only slightly less than in Japan which has been hit equally hard by the global economic contraction. So far, Germany has come up with EUR 80 billion in stimulus measures, including EUR 5 billion for the doubtful car scrapping scheme, which will push the deficit to 3.7% in 2009 (up from 0.1% in 2008). Furthermore, with foreign new industrial orders falling more sharply than domestic new orders, the Eurozone is importing weakness from abroad in addition to its own aggregate demand contraction.

Southern Europe is not competitive enough

While the European countries in the West are busy supporting/bailing out their financial institutions, their counterparts in the East are suffering from tumbling exchange rates, gaping current account deficits, fearsome foreign-currency borrowings and nasty recessions (see details in the EM section later on). Countries in Southern Europe are suffering from the fact that they cannot lower their currency now that they are part of the EUR. Results reported by the European Commission show that those countries with the largest current account imbalances such as Greece, Spain, and Portugal, are estimated to be overvalued by about 12-13%. In order to rebalance their economies, these countries would have to deflate in real terms by either higher productivity (not possible) or consumption restraint. As a result, credit spreads for the individual countries increased.

On top of that, each country has its own problems. Spain suffers from a collapse in the housing/ construction industries resulting in unemployment surging to over 17% in Q109, the highest among EU member countries. Greece currently suffers from high levels of public debt, loss of competitiveness and ballooning deficit outlook, resulting in some analysts warning that Greece could default on its debt obligations. Italy has not been able to reposition itself in the global economy after the export business in industrial areas such as textiles, machinery and furniture has moved away from Italy to the cheaper Chinese production.

[29] Source: RGE monitor, Global Economic Outlook, Q1 2009 Update.

As a result, the financial strength within the Eurozone is very different from one country to another (see next figure).

Figure 14: Balance sheet stretching capability of AAA rated governments

Aaa countries		Magnitude of debt challenges		
		Considerable	Sizeable	Limited
Adjustment capacity	Considerable	US		
	Sizeable	UK	Germany France Switzerland Austria	Australia Canada Denmark Finland Luxembourg Netherlands Norway Sweden Singapore
	Limited	Ireland	Spain	New Zealand

Resilient Aaa countries — Vulnerable Aaa countries — Resistent Aaa countries

Source: Moody's, CS, EMU sovereign credit risk, 3 March 2009.

Furthermore, there seems to be growing fears that stimulus packages initiated in one country will obviously not just benefit that country, but also neighbouring countries. This has led to further tension within Europe, with countries such as the Netherlands publicly talking about their fear.

Figure 15: Stimulus packages do not remain within one country's borders

Source: The Economist, 21 March 2009.

The ECB is in a difficult position as it cannot easily implement non-traditional monetary measures such as quantitative easing, as each European country can decide on its own government interventions. In fact, the Treaty forbids the ECB and national central banks from purchasing eurozone government debt in the primary market or providing any direct credit. As a result, member countries in trouble can either request help from the IMF or the ECB could purchase government debt in the secondary market.

UK

The UK has excessive consumer debt and public finances will be messy…

The UK, although geographically in Europe, is dealing with its own problems as excesses in real estate and consumer debt were more pronounced than anywhere else in Europe. Furthermore, one obvious frailty was that the country showed an over-reliance during the boom years on a now-stricken financial sector, relying heavily on the City of London. The British economy continues to face severe headwinds with real estate contractions gaining momentum, unemployment rising rapidly (6.7%), and a large budget deficit. According to budget projections presented on 22 April, the British government will be borrowing a breathtaking GBP 175 billion (USD 254 billion), representing 12.4% of GDP this year alone. As a result, UK public finances are on some measures the worst of any rich country. It therefore does not come as a surprise that the government has decided to increase tax from currently 40% to 50% on earners above GBP 150,000 from 2010. And yet the national debt burden will double to almost 80% of GDP by 2013-14.

…but the lower pound currently helps a bit

On a positive note, the UK was the first country to implement QE measures, later followed by the US, increasing the supply of money and paving the way for a weaker currency. This aggressive measure is desperately needed if the UK wants to offset the risk of a debt/deflation spiral. And with the sterling falling by -27% from July 2007 to March 2009, it has made British exports more profitable. Furthermore, a falling pound is guarding Britain against deflation, as it would push up the real value of the debt of this over-borrowed economy.

Japan

Although Japanese banks were hardly exposed to toxic assets, and although Japan did not experience a housing bubble like in the 1980s, the Japanese economy has been hit hard and is currently in the midst of a deep recession. Machine tool orders, exports and industrial production all collapsed by 84%, 49% and 38% YoY respectively. This is mainly due to the fact that the Japanese economy was heavily exposed to exports, with roughly 55% of total exports weighted towards capital goods. These plunged roughly 40% from their peak due to declining demand from the US and Europe. Furthermore, Japan's high-value products, such as cars and consumer electronics, are the first things people stop buying when the economy sours. Another reason was the super-cheap yen, which encouraged Japanese exporters to expand capacity in the belief that the yen would stay low and global demand remain strong. As a result of lower demand, consumer confidence and spending plunged on the back of market deterioration in the job market with unemployment rate rising to over 6%.

The Japanese floating workforce has been hit particularly hard in the current downturn. Japan's social security system was not adapted when companies there changed from lifetime employment to more flexible employment similar to the West. While regular workers enjoy the benefits such as housing, bonuses, training and (to a certain extent) lifetime employment, non-regular workers, i.e. floating workers (the Japanese call them

fleeters) earn as little as 40%[30] of the pay for the same work, and do not receive training, pensions or unemployment insurance. In the past 20 years, the number of these fleeters has grown to a scary one-third of all workers, thus bearing the potential for upcoming social unrest.

Compared to the lost decade, however, the Japanese government has been much more active in combating the current crisis this time round, with total fiscal stimulus to date amounting to JPY 25 trillion, after they unveiled their third stimulus package on 10 April worth JPY 15.4 billion, i.e. representing 3% of GDP. With the IMF and OECD both expecting Japanese GDP to fall by 6.2 – 6.5% in 2009, thereby wiping out all the gains from the previous five years of recovery, it remains to be seen whether these stimulus packages announced will be enough to combat the current crisis. The current crisis has reversed Japan's seemingly strong recovery of 2003-07, resulting in the Japanese economy having gone nowhere for the past 16 years.

Emerging countries

EM countries have better balance sheets than during past downturns…

Many emerging market governments have learnt valuable lessons from past events, such as the Latin American debt crisis in the 1980s or the Asian financial crisis in the 1990s. On aggregate, emerging markets have better balance sheets and fewer currency mis-matches than during past downturns. During the boom years, many countries took advantage of the abundant liquidity and generally reduced and/or refinanced their dollar-denominated debt in favour of local currency bonds. Most EM central banks also accumulated large amounts of FX reserves to defend against currency attacks.

…but are heavily impacted by the collapsing world demand

However, it is important to keep in mind that most EM economies are either commodity and/or export driven and consequently they are deeply impacted by the collapse in world demand. In fact, in some cases, they are suffering even more than developed countries due to the fact that they are in cyclical industries (such as consumer electronics) and their economies have a lower share of services, which are generally more stable. Figures from the last few weeks suggest that the contraction in EM industrial production (IP) may have bottomed out in January. However, with the exception of China, forward looking IP numbers remain low and point towards contraction, albeit at a gradually slower pace. On a positive note, EM inflation is rapidly declining as oil and grain prices are down sharply in year-on-year terms. In some countries, however, the fall in inflation is quite modest as prices for tradable goods are pushed up by weaker domestic currencies.

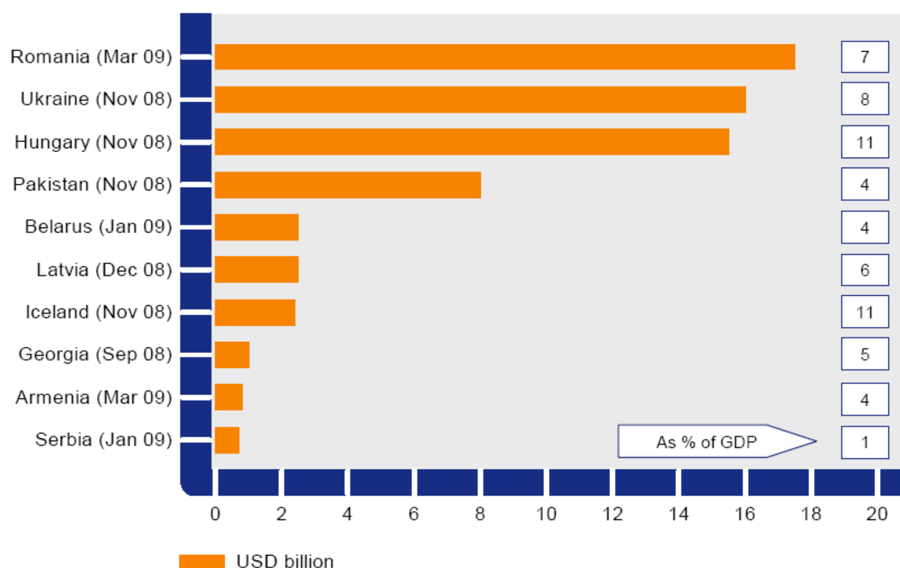
EM differentiation is now key as some are suffering much more than others

One aspect that we want to highlight is increasing differentiation within emerging markets. While Q4 of 2008 was characterised by a general flight out of EM assets (stocks, bonds, EM currencies), this year we see a great deal of differentiation based on economic and political fundamentals. Clearly, Eastern Europe has been hit hardest due to a credit-fuelled consumer boom, large debt-financed current account deficits, property bubbles and large external re-financing needs. In many cases, emerging

[30] Source: The Economist.

Europe has been hit by a classic EM currency and debt crisis comparable to the Asian tigers in the 1990s. Currently, eight out of the ten largest recipients of IMF[31] loans are Eastern European countries.

Figure 16: Top ten IMF loan recipients billion of USD (balance outstanding)



Source: IMF.

Asia and LatAm are in better shape than Eastern Europe

In contrast to Eastern Europe, emerging Asia and Latin America are in better shape. Latin America only had a moderate credit-fuelled consumption and property boom. Its two largest economies, Brazil and Mexico, learned their lessons in the 1990s when both countries needed debt bailouts.[32] Since then, both economies have significantly lowered their external debt levels and most of their sovereign debt is now internally financed. In addition, they benefited from the commodity boom over the last few years and were able to accumulate large FX reserves. In Asia, nearly all countries have low debt levels and are in much better shape than 10 years ago during the Asian crisis. As a consequence, most of emerging Asia does not have a balance sheet problem. However, the region has experienced a hard landing and a broad growth recovery will only happen when the global recovery begins. The next few paragraphs describe the largest emerging markets' current situation:

Eastern Europe

Russia was heavily affected by declining energy prices, capital flight, a tumbling rouble and a stock market crash. The rouble fell by about a quarter (against the two-currency basket to which it was pegged)[33] but has stabilised over the last two months. Most Russian financial risk indicators, such as sovereign bond spreads, have improved nicely

[31]

[32] The 1994 crisis in Mexico, widely known as the Mexican peso crisis, began with the sudden devaluation of the Mexican peso in December 1994. The crisis is also known as the Tequila crisis / Brazil received a USD 41.5 billion IMF bailout package in November 1998

[33] The rouble's fall started in September 2008 and stopped in January 2009. The Russian central bank intervened heavily, burning through hundreds of billions of USD

since the end of January and the central bank has not been forced to continue to burn through its reserves to support the rouble. Thus, gross external reserves have remained broadly stable, in a range of USD 380-390 billion. After the severe output declines since September 2008, the latest producer confidence indicators point to a relative improvement in the prospects for manufacturing output. Also, oil prices have stabilised between USD 40 and 50 per barrel, a level which Russia can live with. On the negative side, inflation is projected to stay elevated at between 10-15%. We expect Russia to suffer a recession, but not need help from the IMF.

Turkey has been reluctant to ask for IMF help

Turkey has always been a country heavily impacted by global risk appetite. Its last financial crisis only dates a few years back[34]. This time, however, Turkey has proved to be surprisingly resilient. While the country is in a recession and suffers from the downturn in Western Europe, its main trading partner, its banking system and households are in relatively good shape due to low leverage and modest credit growth in recent years. However, Turkey has large external financing needs with scheduled external debt amortisations of USD 50 billion (8.4% of GDP) during 2009. Hence, it is probable that Turkey will seek help from the IMF. It is currently unclear if Turkey will qualify for the FCL. So far, Turkey has been reluctant to ask for a conventional IMF loan due to its constraints on government spending. However, an agreement seems likely over the course of the next few weeks.

Some Eastern European countries will have to apply painful medicine

Eastern Europe ex Russia and Turkey is probably in the most dire situation with most countries are hit by classic debt/currency crisis. Many have already received IMF help (see figure 16) or are in line to do so. These countries will not be able to avoid unpopular austerity policies and debt restructuring. Examples include Ukraine, Rumania, Bulgaria, Hungary and the Baltic states (Estonia, Latvia, and Lithuania). In many ways, these countries' vulnerabilities are reminiscent of the Asian crisis in 1997/98.

Emerging Asia

China remains the world's major liquidity provider

The Chinese economy will continue to face headwinds due to the collapse in external demand. However, China remains the worlds' major liquidity provider and the stimulus package, mostly directed at infrastructure, is already underway. Copper imports, e.g., were up strongly YoY in March due to new stockpiling. It seems clear that government-sponsored infrastructure projects are the main driver behind this recovery. The external picture is bleak, though, as exports contracted by 21% YoY in February. China is doing much better than the rest of the world, but it has virtually no social safety nets. Hence, private consumption is likely to remain subdued as unemployment rises and social problems arise. Manufacturing workers are unlikely to see significant wage rises this year, after real wage increases of 10-15% YoY in recent years. Added to that, unemployment among migrant workers has risen. Overall, China's growth should remain positive, in the mid-single digits, which will be enough to make China the most important growth driver of the global economy this year.

[34] In late 2000 and early 2001 a growing trade deficit and weaknesses in the banking sector plunged Turkey into a severe financial and economic crisis

Together with China, India is one of only a handful of large economies to show positive growth in 2009, perhaps around 5% (IMF latest estimate). Private consumption is closely linked to agriculture and is generally not leveraged. Also, India is not as interlinked with the global economy and the domestic market is much more important. India is one of only a few Asian countries that has traditionally run a current account deficit. Over the last few months, this deficit has deteriorated sharply due to resilient domestic demand. This could pose a problem if foreign direct investments (FDI) dries up. However, this seems unlikely as India is one of the key EM consumer markets of tomorrow and FDI is generally long-term.

South East Asian economies are highly cyclical but have solid balance sheets

South East Asian countries were most heavily impacted by the Asian crisis a decade ago. This time around, these countries are in much better shape and have accumulated large FX reserves. Central banks have ample ammunition to defend against currency attacks (such as in 1997) and should have no problem servicing their external debt. However, some corporate borrowers could be in trouble re-financing their USD debt. Also, keep in mind that most of the South East Asian economies are highly cyclical and export-oriented and are now suffering heavily from the collapse in global demand. Moreover, a risk that cannot be ruled out is competitive currency devaluation within Asia. This would most certainly trigger negative reactions from trading partners outside the region and lead to more protectionism. In our view, this would hurt the region much more and only bring limited upside for the export sectors. We think that Asian policy makers will avoid this at all costs.

In the GCC (Middle East), lower hydrocarbon prices will have an impact as oil exports are the main funding source for GCC budgets. Moreover, the credit crunch has heavily affected the real estate and tourism boom in places such as Dubai. However, a correction of the overheated economies is probably healthy in the longer term.

Asian central banks have been more active than other regions

Nearly all the major emerging market central banks have lowered their policy rates in recent months in an effort to address the severe shock to their economies.[35] However, as figure 17 shows, the magnitude and timing of the policy moves have varied greatly across countries and regions. Looking at the policy moves since 1 Sept 2008 (when EM first felt the crisis) Asia has clearly been the most active region by both timing and magnitude. Latin America, which historically could not run counter-cyclical policies due to high debt levels, has responded much later and has some catching up to do.

[35] The notable exceptions are Russia and Hungary, which are both faced with stubborn inflation due to FX depreciation

Figure 17: Monetary response in emerging markets

Country	Policy rate on 1 September 2008 (pre-crisis)	Current policy rate (as at 20 April 2009)	Magnitude of rate cuts in (bps)	Magnitude of rate cuts in %
Hungary	8.50	9.50	-100	-11.8
Poland	6.00	3.75	225	37.5
Egypt	11.00	10.00	100	9.1
Russia	11.00	13.00	-200	-18.2
Turkey	16.75	9.75	700	41.8
Ukraine	12.00	12.00	0	0
Total EMEA[36]	9.44	7.75	169	24.2
China	7.47	5.31	216	28.9
India	6.00	3.50	250	41.7
Indonesia	9.00	7.50	150	16.7
Korea	5.25	2.00	325	61.9
Taiwan	3.63	1.25	238	65.5
Total Asia	5.57	3.41	216	43.7
Brazil	13.00	11.25	175	13.5
Mexico	8.25	6.00	225	27.3
Columbia	10.00	7.00	300	30.0
Total LatAm	9.05	6.30	275	32.3

Source: Bank of America / Merrill Lynch. As at 20 April 2009.

Brazil is in good shape…

…while Mexico has applied for the IMF flexible credit line

The strong economic growth during the global boom enabled Latin American governments to strengthen their fiscal positions and reduce external debt to less than 25% of GDP[37]. Inflation has been successfully reigned in over the last few years and trade flows have been balanced with about equal imports and exports. Brazil, the economic heavyweight of the region, is no stranger to crisis. In fact, the most of the 1980s and 1990s was marked by hyperinflation, currency devaluations and debt restructurings. Hence, it may be somewhat surprising that the country of the Amazon is now considered a poster child. While the economy has been hit by slumping commodity prices and capital outflows, its banking system is fundamentally sound and sovereign debt is at manageable levels. As a relatively closed economy (only 15% of GDP are export related) Brazil benefits from its huge domestic market (190 million consumers) and increasing industry diversification. The central bank has over USD 200 billion in FX reserves and only 14% of GDP is in external debt. Hence, Brazil will not need any IMF resources. In fact, it may even lend money to the IMF. Mexico, by contrast, will be one of the hardest hit economies in the region due to its high exposure to oil prices and close ties to US consumers. Mexico has been the first country to use

[36] EMEA = Emerging Europe, Middle East and Africa
[37] In the 1980s, external debt was over 50% of GDP

Man Investments

the IMF's new Flexible Credit Line (see comment on page xx). Both, Brazil and Mexico, are investment grade debtors and will likely remain so in 2009. The rest of Latin America is quite diverse with some countries in relatively good shape (Chile, Peru) and others not (Ecuador, Venezuela).

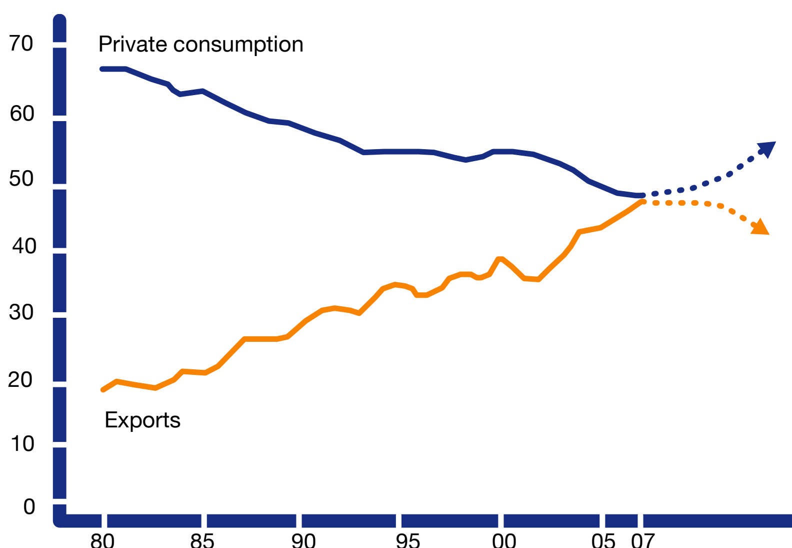
EM risk factors have improved significantly since February

With global manufacturing activity rebounding slightly and the recent strong efforts to boost liquidity for emerging markets, risk sentiment for EM has improved slightly. In most countries, currencies, FX reserves and private sector outflows have stabilised or even reversed over the last two months. In fact, there have even been some inflows into EM equity markets and the MSCI Emerging Market Index has outperformed the MSCI World by a wide margin.[38] However, significant downside risk remains. Should leading indicators take another nosedive we would most certainly see another leg down in most EM. However, the worst can probably be avoided with the IMF's new resources and tools. Asia remains best positioned and Eastern Europe is the most vulnerable region.

This crisis will be a tipping point for the unwinding of global imbalances

This crisis will be looked at, several years from now, as a tipping point for the unwinding of global imbalances. Consumer-driven countries with previously high trade deficits (e.g. US) will have more balanced current accounts and higher savings. On the other hand, export-driven economies (most Asian economies) with high trade surpluses will have boosted domestic consumption and lowered their reliance on exports. They will also have large domestic service industries as the main growth driver. No doubt, this will be a multi-year event and not happen overnight but the crisis is likely to accelerate this change. As seen on figure 18, emerging Asia's growth over the last decades has been export-led. Private consumption has also increased, but slower than overall GDP and its share of GDP decreased.

Figure 18: Emerging Asia, as % of GDP



Source: The Economist, 29 January 2009.

[38] MSCI World Index Q1 2009: -10.62 vs. MSCI Emerging Market Index +0.95%.

American consumers can no longer be the world's growth engine

However, this adjustment will largely depend on China's stance on its currency and willingness to spend more domestically, including extending social safety nets such as health care, social security etc. It is not a daring prediction that American (and other credit-driven) consumers can no longer be the engine of global growth. In contrast, most Asian households (and companies) have modest debt and ample room to boost job growth, and hence incomes and domestic consumption.

Global economy going forward

We are still on thin ice

After the terrible storm in the financial markets around the globe nearly ended in a fatal breakdown in the middle of the second half of last year we believe that any sign of relief, whether from inside the financial centre or from individual sectors, will trigger relief or bear market rallies. These rebounds tend to be more vigorous than plain vanilla bull markets and are often proportionate to the huge drops that preceded them. Currently, we can not rule out substantial gains over a few quarters and these will probably be strongest in markets such as Asia which were less impacted by banking problems. A reality check, however, would put things into a different light showing that current improvements are certainly just a slight variance of reality. Statements of policy makers and central bankers about their success inf solving the financial crisis must be taken with a large portion of caution. As described in this paper the price for fixing the financial sector's problems is huge and the public debt burden as a result of it will be staggering.

Monetary policy has not done the trick this time

The current downturn is highly synchronised and associated with a deep financial crisis. This is a rare combination in the post war period and made the situation unusually severe. In the past monetary policy had not been very effective in dealing with recessions associated with financial crises. By contrast, fiscal stimuli by countries with moderate debt levels had proved to be helpful in fighting such downturns while countries with debt levels of 60% or higher of GDP will probably not benefit from fiscal stimuli.

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Figure 19: Gross government debt as % of GDP

Source: BCA Research, 20 April 2009.

Consumers in such countries will have to cut spending for two reasons. One, tax payers will have to anticipate tax increases and two, the private sector will need to restructure its debt position and start increasing savings. On top of that the financial sector needs to be totally repaired, i.e. balance sheets restructuring, before a recovery is possible.

Figure 20: Different economic scenarios

Scenarios	Reflation/ recovery	Stag-deflation/ recession	Stagflation/ recession	Depression
Real GDP growth	Positive	Negative or sluggish	Negative or sluggish	Very negative
Price level	Up	Down	Up	Strongly up or down
Countries/ Regions (2009E)	Asia (ex Japan)	U.S., Canada, Japan, Spain or Sweden,	U.K., Norway, Italy, Eastern Europe	Zimbabwe
Shape of upturn	V- or U-shaped (mild recession like 1990) or W-shaped (severe recession like 1981)			No upturn, as L-shaped (like 1930s)
Timing	Best case in H2 09; normal case by 2010 or 2011	Currently (started Q3 07)	Possible if commodity supply is constrained	Known in the next six months

Source: Research, Analysis and Strategy Group Man Investments.

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We expect sluggish growth with relative global price stability over the next 2-3 years

Our analysis shows that the most probable outcome for now is very sluggish growth for the foreseeable future, even over the next two to three years, with relative price stability on a global scale. Regions with stronger deflationary tendencies like the US or Japan will compensate for those with higher inflation like Latin America or Eastern Europe. At the moment we cannot completely exclude a prolonged period of deflation tagged to stagnation in some important economic regions. Stagflation describes a very negative setting in which lower prices do not trigger much interest by the consumers. In such an environment governments will try to turn the deflationary psychology into an inflationary psychology for instance by introducing inflation targets.

Inflation has left the station but will not be an issue until the economy recovers materially

Despite the current deflationary tendencies we think that inflation has left the station. Any improvement in global economic activity will quickly revive fears of inflation. We believe that commodity prices will see a rebound in demand first and also become apparent in higher long term bond yields. If they start to rise too swiftly the increased cost of debt could undermine any economic recovery. Hyperinflation like in the 1970s is unlikely if central banks remain independent and do not shy away from restrictive monetary policy. Energy prices can recover quickly during the early stages of an economic upturn. In 1999 and 2002 the oil price rallied between 35 and 80% within six months after the last production cuts. So this could add to the inflationary pressure from excessive government debt and its monetisation. For the time being though, the deleveraging of the private sector together with contained wages will limit any inflationary pressures..

We advise keeping exposure to trading oriented strategies for now

We reckon that it is too early to make large bets on reflation and it is still possible to see stocks retest their recent lows. Also, some assets might have already overplayed the reflation theme especially some of the industrial metals. Being early may be painful as is being wrong. Today, it looks like some investors are continuing to hang on to their reflation trades, like long industrial metals, long cyclical stocks, short gold, long Australian Dollar, short Swiss Franc. This might still be profitable in the very short run but the odds of a continued domination of deflation trades are still relatively high. For hedge fund investors, we advise keeping exposure to trading orientated strategies. Volatility is likely to stay elevated offering profit opportunities for trading and momentum based strategies in the short term like 'trader' long-short equity, discretionary global macro managers and managed futures. In the mid term asset prices will try to catch up with reality, offering good opportunities in the longer term for macro-oriented long-short equity, emerging market and commodity, as well as fundamental distressed and credit managers.

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Conclusion

Currently, the global economy is in the middle of a synchronised contraction. Advanced economies will experience a severe recession with export oriented economies such as Germany and Japan suffering the most. Emerging markets will still show positive growth but slow sharply. Aggressive monetary and fiscal policy action has helped to stabilise the economy. However, there is little further room for monetary policy action and measures thus far have been largely insufficient while fiscal policy is slow to take effect. At the same time, banks are still facing mounting credit losses and need to dispose of toxic legacy assets before the economy can truly recover. We think that this now the most important issue on the 'to do' list. While we believe the private sector could play a valuable role in this regard, the Public-Private-Investment-Program in its current form is inadequate to spur sufficient interest.

The IMF has been given increased resources and a mandate to provide more flexible credit facilities. This has helped to reduce systemic emerging market risk and helped to differentiate between EM economies. We now see increasing dispersion in risk premia among EM countries. We conclude that most emerging economies are in better shape than during past downturns, i.e. during the Asian crisis a decade ago. We highlight the unwinding of global imbalances and predict a more balanced world in future with deficit countries having to cut back and surplus economies having to increase domestic consumption.

The best economic scenario would be reflation, i.e. a return to modest inflation while the other outcomes such as stag-deflation or stagflation would all be detrimental. Even in the best case, however, we expect sluggish growth over the next few years as credit-dependent consumers have to downsize. We think it is too early to worry about inflation now but it could become a serious issue down the road.

Overall, while we believe there are some positive signs for a global economic recovery we expect that markets will remain volatile for some time with several years of below trend growth and the potential for a number of false-dawns (or bear market rallies) punctuated by market shocks. In this environment, we recommend exposure to trading oriented strategies, such as global macro or managed futures, as both styles benefit from frequently changing sentiment around policy actions or fear/greed cycles. In addition, we also see opportunities in long/short equity, commodity and distressed.

Important information

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