The Size of the Shock

With the benefit of hindsight, it now seems clear that the decision by the Federal Reserve and the U.S. Treasury to let Lehman Brothers go bankrupt on September 15 was a policy blunder of historic proportions, dictated by "moral hazard" zealots in the U.S. administration.

The extraordinary seizing up of global money markets and bond markets in the wake of the Lehman shock can be measured in many ways. The financial media are now reporting daily on arcane measures of financial system breakdown, such as the U.S. Treasury/Eurodollar spread or the gap between the London inter-bank offered rate (LIBOR) and the rate on government securities.

With LIBOR rates acting as reference rates on an estimated US$300 trillion of financial contracts, its sharp upward move is having a huge contractionary effect on the global economy. Many contracts affecting average consumers – such as adjustable rate mortgages – are triggered off the LIBOR rate, which is why it is beginning to be a matter of serious concern to millions of people who had not even heard of the term. ("Is that a pill?" asked one shopper when asked about LIBOR.)

Bloomberg Financial Conditions Index: 1992 - 2008 Weekly Standard Deviations from Norm of 1992 - June 2008

Source: Bloomberg and Trilogy Global Advisors

Chart 1: Bloomberg's financial conditions index (FCI) plunged into uncharted negative territory following Lehman's bankruptcy, reflecting acute stress in global financial markets.

What Financial Conditions Say About Economic Growth

One way of summarizing the shock across all markets is to look at Bloomberg's Financial Conditions Index (FCI), which is a weighted average of stress indicators in U.S. money markets, credit markets and stock markets. The index is intended to be a leading economic indicator that summarizes how tight financial conditions are likely to affect the economy over the next few quarters.

As we show in Chart 1, the FCI plummeted in the days and weeks following the Lehman shock. In three days after the shock, the index experienced the equivalent of a 10-standard deviation weekly move. Suppose one considers the FCI to be the economic equivalent of a cardiologist's EKG, with money and credit flows representing the lifeblood of the economy. Using that analogy, the movement of the FCI shows that the economy experienced the equivalent of a massive heart attack following the Lehman shock. Unfortunately, the shock continued to intensify through early October.

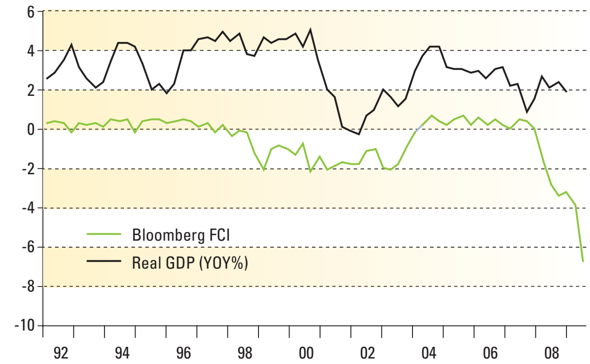
Although the FCI is an imperfect leading indicator of the economy, some rough and ready statistical analysis suggests the following. If the indicator stays at its current level for 90 days or so – which is a big if – we could expect to see the U.S. economy begin to contract at a 10% annual rate within a quarter or so. That's how severe the current deflation shock appears. It also helps explain why policymakers like Fed Chairman Bernanke and Treasury Secretary Paulson appeared ashen-faced in recent public appearances – and why they have every incentive to try to engineer a timely V-shaped recovery in financial conditions.

Chart 2 shows the historical relationship between the FCI and U.S. real GDP growth on a year-on-year basis. The relationship is clear: When financial conditions deteriorate, economic growth tends to falter over the next several quarters. That said, common sense dictates that we should amend our rough and ready statistical analysis in the following way. Although most economists believe that monetary conditions affect the economy with long and variable lags, the lag effect currently may be minimal. Wall Street's panic is now being transmitted almost immediately to Main Street as banks tighten lending to consumers and businesses and as consumers respond to media hysteria and to the plummeting values of their retirement accounts and homes.

Accordingly, it would not be at all surprising to see a sharply negative fourth quarter GDP report unless financial conditions ease dramatically in the very near future. Moreover, since most corporations determine their capital spending and hiring budgets for the following year during the fourth quarter, the huge uncertainty about the economic outlook is likely to hit capital spending and hiring plans well into the next year. Therefore, a moderately severe recession in the United States now looks to be a forgone conclusion, almost irrespective of what policymakers do to stabilize market conditions in coming days and weeks.

Bloomberg does not publish similar financial conditions indexes for other major nations, but we strongly suspect that such measures for Europe, Japan and many other industrial nations would tell a similar story to that seen in the U.S. Credit spreads for Japan's banks have generally shown much less stress than we have seen in the U.S. and Europe, but clearly the outlook for Japan's exports has been adversely affected by the global crisis. Meanwhile, pronounced turmoil

Shocking: Bloomberg's Financial Conditions Leads U.S. Real GDP Growth by Two Quarters



Source: Bloomberg and Trilogy Global Advisors

Chart 2: If not reversed soon, the unprecedented drop in Bloomberg's Financial Conditions Index points to a sharp drop in U.S. GDP growth in the near future.

in emerging market stock markets suggests that major downward revisions to growth forecasts for those nations will be forthcoming quickly, particularly for those with a high degree of dependence on resource industries or exports to the U.S. and Europe.

IMF Highlights Downside Risks

Economists at the International Monetary Fund (IMF) have made a commendable attempt to assess the global outlook in the wake of recent shocks. In their October 2008 World Economic Outlook, the IMF economists come as close as bureaucratic niceties permit to saying that the world economy has slipped into recession. As shown in Chart 3, their base case now has the world growing at 3% in 2009, with the "fan chart" illustrating substantial downside risks. The IMF report loosely defines a global recession as world GDP growth dipping below 3%.

Interestingly, the IMF authors go out of their way to suggest that downside risks to the outlook are substantially greater than the fan chart indicates. They document that at other economic turning points, IMF forecasts have over-predicted the following year's growth rate by nearly 1.5% on average.

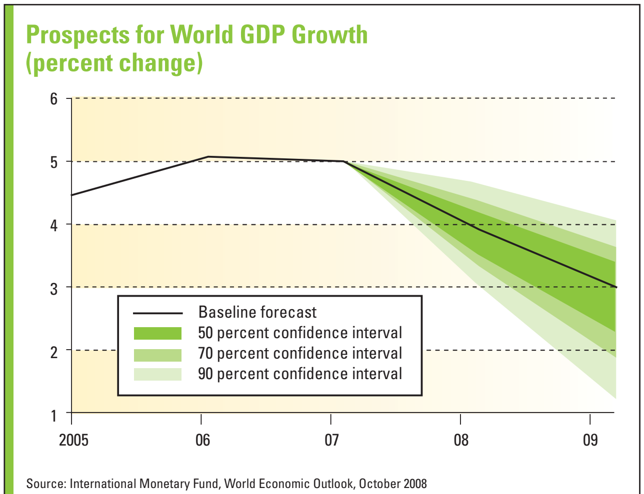


Chart 3: The IMF's recent outlook for the world economy suggests that world growth in 2009 may be the weakest since the global recessions of 1982 and 1991.

They also show how their own financial stress indicator is pointing to global recession, and helpfully note that it has had no false alarms. The authors are also candid that "behavioral biases" have contributed in the past to forecasts that have been substantially too optimistic around business cycle turning points. They show a variety of simulations of the impact of a financial shock on world growth, inflation, and interest rates – with all pointing to sharply lower growth, inflation and interest rates.

We would add that one probable source of what the IMF team delicately calls "behavioral biases" is its reluctance to upset certain governments. A case in point may be China, whose officials continue to call for only a modest deceleration in growth. Even in the wake of the huge financial shocks of recent weeks, the IMF is using an average annual growth forecast of 9.3% for China in 2009. This strikes us as excessively optimistic, along with many of the IMF's other forecasts for emerging market nations, which are still projecting real growth averaging more than 6% for both 2008 and 2009.

Reading between the lines, we suspect that the IMF authors would probably endorse the more sober assessment made very recently by Oxford University economist John Muellbauer:

"We are now on the cusp of the most significant turning point for inflation in the last 20 years, so many of the standard models are likely to go badly wrong.

"The economics of this are straightforward. Global output is probably falling faster than at any rate since the war, except perhaps for 1974-75. Under these circumstances, large excess capacity develops and commodity prices fall. Some still believe that emerging markets will provide a stabilizing influence on the world economy, but in fact, the opposite is true. Countries such as China are highly geared to exports and above all investment, which there exceeds consumer spending. Apart from infrastructure and investment in health care and education, investment is geared to growth, so if growth falls from 11% to 5%, the reduction in investment is likely to be dramatic and more than the percentage reduction in U.S. consumer spending.

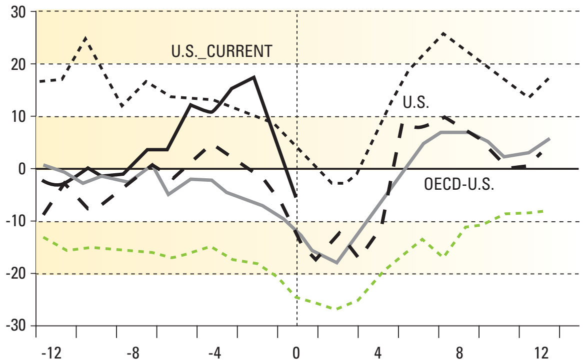
"As over-capacity develops, investment in goods production may fall even further, with serious implications for GDP. It seems unlikely that governments in emerging markets can compensate swiftly enough to boost domestic consumption. Hence, the demand for commodities, which have been driven by emerging market growth, will fall sharply. Eventually, however, lower commodity prices and lower inflation act like a huge tax cut for households and will allow interest rates to fall further, and therefore stabilize economic activity."

Market Cycles vs. Economic Cycles

There is an old line about the relationship between financial markets and economic forecasts that says: "Forecasts do not drive markets, markets drive economic forecasts." So, while the new round of sober economic outlooks are reacting largely to recent market shocks, it is important to keep in mind that markets are perfectly capable of developing new dynamics that may be decidedly out of step with media commentary and current economic and corporate news. In other words, just as bear markets often begin when business conditions are booming and economic reports and media

Equity Markets Typically Bottom Two to Three Quarters after the Economy Peaks

(Percent Change from a Year Earlier)



Source: Stijin Claessens, et al, "What Happens During Recessions, Crunches and Busts?" IMF Working Paper, August 2008

Chart 4: This chart combines data from 122 recessions in the last 47 years in the OECD countries to show the movement of equity prices during a recession. Zero on the horizontal axis represents the one quarter after the economy peaks and a recession begins. The dark solid line represents equity prices during the current U.S. slowdown, and assumes the business cycle peaked at the end of the first quarter of 2008. The heavy dotted line represents the median movement of equity prices during U.S. recessions. The solid gray line represents the median movement of equity prices in recessions in all OECD nations except the U.S., with the light dotted lines representing the upper and lower quartiles of these recessions.

commentary are uniformly positive, bull markets tend to begin when the reverse is true.

To illustrate the potential divergence between news flow and market behavior, we show in Chart 4 the results of a recent IMF study of 122 recessions in the OECD nations in the 1960-2007 period. The chart assumes that the U.S. recession started in the first quarter of 2008 and shows how equity prices have moved in other U.S. recessions in the past (the red dotted line) and in other non-U.S. advanced industrial nations (the light solid line). The light dotted lines show the range of equity market movements from top quartile to bottom quartile in other OECD markets relative to those nations' own business cycle peaks. The good news is that equity markets have typically bottomed two to three quarters after the economy hits a peak. That would arguably point to the bottom of this bear market sometime in the current quarter from an extremely low level that would fall through the bottom of the chart.

This viewpoint would be bolstered if it can be shown that market sentiment is extraordinarily depressed and that policymakers were ready to throw everything, including the kitchen sink, into generating a recovery in financial conditions. We will leave it to others to document the wide range of "investor capitulation" indicators, noting that one of our favourites, the CBOE Volatility Index (VIX), reached an extreme of 70% on October 10. While the economic policy response to the current crisis is still in a state of flux, we believe we are very close to the "kitchen sink" phase. We are particularly encouraged that the U.K.'s approach of using government resources to rapidly recapitalize banks and temporarily guarantee interbank transactions may be close to gaining widespread international endorsement.

Thanks to the financial shock of the last few weeks, the global recession train has probably left the station, with the U.S. in the lead, Europe and Japan in the middle, and the emerging markets in the caboose. Amid the tremendous uncertainty, we are asking our analysts to focus on finding companies that are likely to be winners over the next three to five years, recognizing that those may be very different from the winners of the last five years, which were companies that benefited from the broad-based global boom and rampant commodity inflation. We are also identifying companies that will be leveraged to the economic recovery that will eventually follow the current recession, but which have solid balance sheets to cope with daunting economic conditions that seem likely over the next six to 12 months.

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