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## WEEKLY RESEARCH NOTES

## The beginning of the end of the beginning

At the Lord Mayor's Luncheon, following the General Montgomery's victory at the battle of El Alamein in November 1942, Winston Churchill famously remarked: "This is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning." In this current storm afflicting financial markets and the global economy we are probably closer to the beginning of the end of the beginning.

The only thing surprising about the longevity of this period of market turbulence was the resounding confidence of many that it would prove short-lived. Lest we forget, the S&P500 surged to record highs in the second week of October, two months (and one Fed rate cut) after the storm broke full force in August with the seizure in the interbank markets. However, institutional investors were wiser. Since September the investment regime has been Riot Point. This four month run is a record.

The Regime Map is a pictorial representation of complex data that maps cross-border equity flows and investor behaviour. Though the model only has 10-years of back history, this unprecedented run of Riot Point regimes is telling. This is no short-lived risk aversion squall. The Russian default and collapse of Long Term Capital Management was the catalyst for two months of Riot Point in 1998. The previous record three-month period of Riot Point occurred in February, March and April 2001 as the US dipped into recession.

Prices now vindicate the cautious stance institutional investors took in September. The S&P500 has officially undergone a correction, more than 10 percent lower than its peak. Broader indices, such as the Russell 2000 in the US and FTSE250 in the UK, are flirting with the 20 percent declines from their peaks that formally define a bear market. Across asset classes signs of risk aversion are writ large: gold drives remorselessly to new records; investors are buying that other classic safe haven, the Swiss franc; the spread of the JP Morgan emerging bond index above US treasuries is now 90 basis points higher than the record low of last summer; developed market junk is once more priced accordingly and even good credits face wider spreads and tougher covenants.

Both the Riot Point regime and prices suggest that investors are positioned for a recession in the US and a global slowdown. Institutional investors are not among the proponents of the theory that somehow the world barely snuffles when the US goes down with a bad case of flu. They continue to sell economically-sensitive emerging Asia. Over the last three months flows into emerging Asia as measured by the Cross-border Equity Flow Indicator are at a new record low.

The same tone is struck by the sector preferences of institutional investors. In the last two months of 2007 flows shifted to a highly defensive pattern, with selling of economically sensitive sectors such as Materials, Industrials and Consumer Discretionary. The sectors being bought were classically defensive: Health Care; Utilities; and Consumer Staples. That pattern has persisted into 2008.

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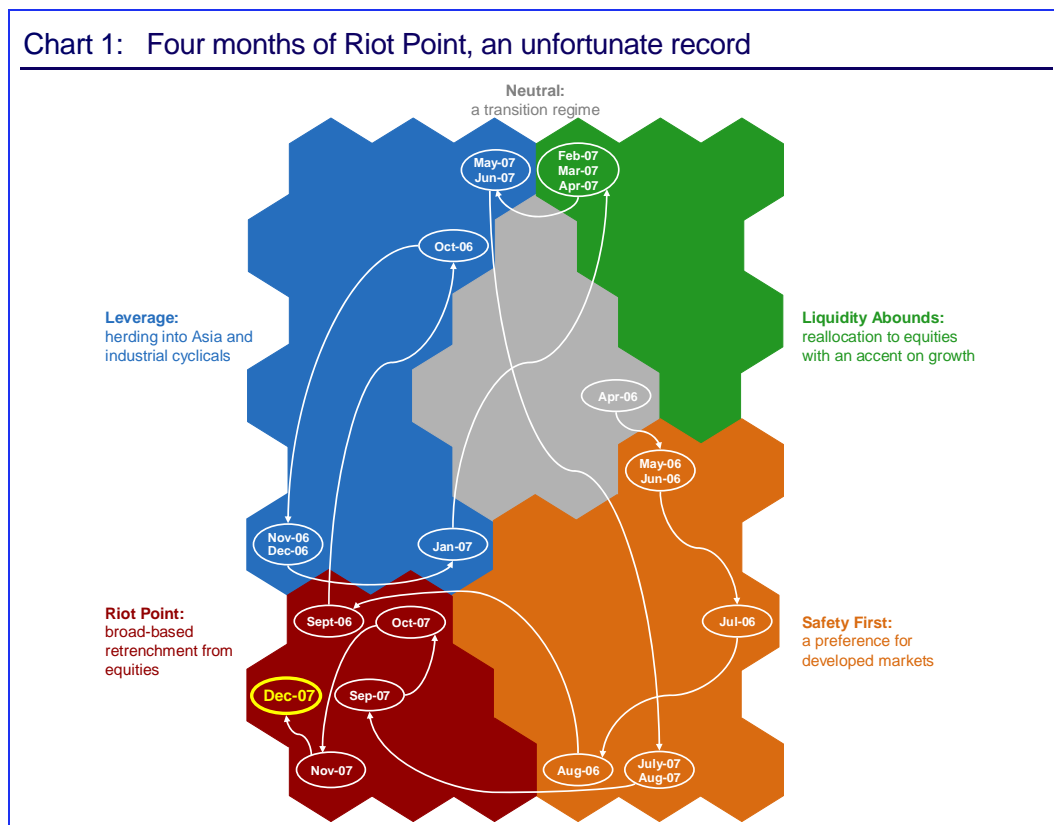
One scintilla of good news, perhaps marking the beginning of the end of the beginning, is that the money markets are normalizing. Despite meeting with studied indifference when announced on December 12th, the coordinated efforts of the Bank of England, European Central Bank, Federal Reserve and Swiss National Bank, has worked. Back then the spread of three-month Euribor, \$ Libor and £ Libor over policy rates averaged 94 basis points. That has fallen to 36 basis points. Though this in part reflects the expectation of further interest rate cuts, it also shows that the sclerotic money markets are being unblocked.

However, this was always only one symptom of a deeper malaise in the financial system: fear over counterparty credit exposure. That was always, to some degree, likely to be self-correcting as the rigours of quarterly reporting forced banks to come clean about their exposures. As

said before, solving the liquidity needs of the banks is not a panacea. This crisis was never likely to be endogenous to the financial system, let alone cul-de-sacs with comfortingly obscure labels such as sub-prime or structured credit. It has infected markets and become an event of broad economic significance.

Still, the beginning of the end of the beginning is something to hold onto, especially in this dark hour. Though he could not know it at the time, Churchill was right. El Alamein did mark a decisive turn in the fortunes of the war. Three months later the Germans surrendered Stalingrad and the Russians begin their push west. Within eight months the Germans tasted their first defeat in Europe, fleeing Sicily. The road ahead may be rocky, but the New Year is no time for doom-mongering. The last word goes to the ever quotable Churchill. "The pessimist sees difficulty in every opportunity. The optimist sees the opportunity in every difficulty."

Chart 1: Four months of Riot Point, an unfortunate record



Source: State Street Global Markets

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