Philequity Corner (October 13, 2008)
By Valentino Sy

Nowhere to Hide

There was no escaping from the onslaught that financial markets suffered last week. Global equities markets were in free fall, commodity markets have tanked, credit markets were virtually frozen and credit spreads have surged through the roof.

The Dow Jones Industrial Average (DJIA) capped the worst week in its 112-year history with its most volatile day ever, as new round of central bank measures were overwhelmed with wave upon wave of selling and investors scampering for safety.

Last week's 18.2 percent decline and Friday's 1,018.77-point swing were the biggest since the DJIA was created in 1896. The VIX volatility index, a.k.a. the fear index, rose to 69.95, by far its highest level since it was introduced in 1993.

DJIA & VIX Daily Chart

Source: www.stockcharts.com

Financial tsunami

What started out as ripples from the US sub-prime market has now turned into a full-blown financial tsunami. And it was at its most vicious last week, destroying everything along its path (see table below).

	Performance Last week	52-week
US dollar, trade-weighted	4.2%	6.9%
Gold	3.2%	14.3%
US investment-grade bonds	-5.2%	-11.9%
REIT stocks	-9.3%	-32.0%
Commodity futures	-10.6%	-19.7%
US corporate junk bonds	-10.9%	-24.9%
Emerging-market bonds	-13.8%	-17.8%
Nasdaq Composite index	-15.3%	-41.2%
Russell 2000 (small stocks)	-15.6%	-37.9%
Crude oil	-17.2%	-7.2%
Dow Jones Industrial Average	-18.2%	-40.0%
S&P 500 stock index	-18.2%	-42.4%
Global stocks	-19.8%	-46.3%
Emerging-market stocks	-20.2%	-53.6%
European stocks	-21.5%	-47.5%

Source: The Wall Street Journal

European stocks absorbed the brunt, falling -21.5 percent, as the deepening crisis prompted European governments to pledge bailouts for troubled banks. In addition, the small country of Iceland became the first sovereign nation to fall victim to the credit squeeze.

Meanwhile, emerging market stocks declined 20.2 percent, forcing countries such as Russia, Brazil, Ukraine and Indonesia to halt trading in their exchanges as the global banking crisis escalated worldwide.

Emerging market bonds (if one can find a buyer) tumbled 13.8 percent, its worst week in 10 years, as investor flee riskier assets. Meanwhile, US investment-grade bonds, which are considered safer than stocks, had their biggest declines ever last week.

Commodity futures plummeted 10.2 percent and oil plunged 17.2 percent on worries the global economy will enter recession. By the end of the week, only cash and gold survived the tsunami's rampage.

Lehman failure - a major blunder

We believe that allowing Lehman Brothers to fail last month was the Fed's biggest mistake. It damaged the equilibrium of the global financial system by spreading distrust among banks. As proof of this, the London Interbank Offered Rate (LIBOR) have skyrocketed which means that banks are so afraid to lend to each other. Even investors and fund managers don't know whom to trust and where to put their money. Meanwhile, companies are finding it hard to raise money as the commercial paper market is virtually at a standstill.

Pulling all stops to rescue the markets

Policymakers are now scrambling to take additional action to unfreeze the credit markets amid growing recognition that the $850 billion bailout plan enacted two weeks ago will not be sufficient given the scale and the breadth of the crisis.

In a bid to avoid another Lehman, the European Union finance ministers on Tuesday agreed to raise the minimum level of insurance on bank deposits (euro50,000) across the 27-nation block and pledged to recapitalize any bank that faces failure. In fact, Ireland, Germany, Denmark and Greece issued blanket guarantees on deposits to prevent a run on their banks. Others are also set to adopt similar moves.

Likewise on Tuesday, the US Fed announced it was buying US commercial paper in light of the sharp deterioration in the commercial paper market.

On Wednesday, the US Fed, the ECB, the Bank of England, and the central banks of Canada, Sweden and Switzerland lowered key rates by half a percentage point – unprecedented coordinated cuts since the 9/11 attacks. This followed the Reserve Bank of Australia's full percentage cut the preceding day.

On Thursday, the US Treasury said it is considering direct capital infusion to the banks similar to the UK bailout – in contrast to the original plan of just buying the banks' distressed assets. Shoring up bank balance sheets is seen as the fastest way to re-establish confidence in the banking system and restore the flow of credit.

On Friday, the Group of 7 major nations agreed to continue working together and to mobilize all possible policy measures to resolve the financial crisis.

Learning from the 1997 Asian Crisis

The US and most advanced economies are in a similar situation as Asia was in 1997 to 1998 as discussed in our previous article, *The US can learn from the Asian Financial Crisis* (see the January 21, 2008 issue of **The Philippine Star**). During those years, everything in Asia looked so gloomy just like now. Equities markets plunged by 60 – 80 percent. Asset prices collapsed. Banks and corporations went bankrupt. Banks were unwilling to lend and the economy went into recession.

We have to learn from the past. We know that the markets will continue to experience bouts of volatility and market turmoil, even as bailouts, reforms and economic stimulus are being undertaken by policymakers. But we also know that despite all the doom and gloom, Asian markets recovered. In fact, they made new highs after the crisis.

And while we don't know how long how this current crisis will last or how deep the damage will be, we know that, in time, the economy and the markets will recover. They always do.