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Newsflash

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Produced in association with RMB Asset Management International Limited (trading as RMB Asset Management), authorised and regulated by the Financial Services Authority (UK).

As March closed, bringing to an end a torrid first quarter, investors might reflect on the unique series of events that they have witnessed in the last three months. Some names such as Pelaton and Jérôme Kerviel may not have been widely known last year, but their import in 2008 was material. One very well known moniker, Bear Stearns, also hit the headlines as rumours regarding its liquidity led to the bank becoming almost insolvent. Thankfully, the Fed's decisive action in concert with JP Morgan may have been sufficient to contain markets that had also been shaken by a slew of poor economic data. We will delve deeper into the Bear Stearns debacle in the Focus section later on, but its share price graph is worthy of note on the first page (*see Fig 1*). In light of these events it is unsurprising that global equity markets experienced negative performance in March and indeed throughout the first quarter. What is notable is the large nature of the declines in January which dominate the 3 month return. Thankfully January did not quite set the tone for the rest of the quarter.

Fig 1: Bear Stearns Common Stock
Source: Bloomberg

Global equities spent the first half of March adding to their losses, falling in the order of 8% in Europe, 4% in the US and 13% in Japan. The turning point was the Fed's action to prevent the whole scale collapse of Bear Stearns, after which the equity markets staged a reasonable rally. The major markets still finished in negative territory for the month in local currency terms as the rescue's positive influence failed to provide enough buoyancy. It is tempting to view the Bear Stearns troubles as a turning point, especially as market crises in the past have often been defined by large corporate failures. Examples of this include ENRON and WorldCom earlier this century, LTCM in the late 90s and Drexel Burnham Lambert earlier that decade. Whether this is the case here will become clear with time. What is certain is that the Fed believed that the repercussions of the collapse of Bear would have been too great a risk. Arguably the implication of this action is that the Fed will not allow any major investment bank to fail going forward. The March returns for the regional indices were soft. Japan led the markets down, returning -7.6%, while Europe returned -2.7% and the UK -2.1%. The US market was resilient, losing only -0.5% over the same period. Over the quarter, the returns from equities have been poor. British and American equities fell in the order of 10%, while Europe and Japan returned -14.9% and -17.0% respectively.

Emerging Market equities also finished March, and the Quarter, in negative territory. Large index constituents such as China, India and Brazil suffered poor returns as investors reappraised their risk appetite in the shadow of falling developed markets and, later, the collapse of Bear Stearns. In the month China returned -12.2%, India -12.5% and Brazil, performing well in comparison, returning -4.1%. The weight of these indices dragged the MSCI EM Index down, returning -5.3% in the month and -11.0% over the quarter in US Dollar terms, despite many of the local currencies experiencing strength against the dollar. Over the quarter China and India feature again as particularly poor, returning -23.8% and -25.7% respectively. A decreasing number of investors are espousing the decoupling theory as emerging markets have been caught up in the malaise overshadowing developed markets.

The Fixed Income markets continued to provide some respite for investors in March. Global bonds returned 2.2% in US Dollar terms as continued uncertainty and a weakening dollar combined positively. The total rate cuts undertaken by the Federal Reserve in the first quarter of 2008 were 200 basis points, the most aggressive cut in over two decades. This coupled with a continuing flight to safety has resulted in global bonds returning 7.4% in three months. The US yield curve is now steep and normally shaped, with yields below 1.5% for three month paper and rising to nearly 4.5% for 30 year bonds. At present levels, the yields available on government bonds are not appealing and we are investigating diversification opportunities outside the government sector, in sectors of credit which have fallen to historically low valuation levels.

High Yield spreads continued to widen at the start of March, but, like equities, the market turned mid month and spreads closed back in. At the end of March the US high yield spread was c.650 basis points over the government curve. Emerging Markets debt has followed a pronounced widening trend since the middle of 2007. The spread has doubled from historically low levels in 2007 of approximately 150 basis points to 300 basis points currently. The widening of these spreads demonstrates increased investor anxiety regarding the creditworthiness of perceived higher risk borrowers. As a result, investors are demanding greater compensation for the credit risk inherent in these investments. An upshot of this is that companies or governments with low credit ratings will find any new debt that they have to issue now more expensive to service.

In the currency markets there were mixed fortunes for the majors. The commodity currencies such as the New Zealand, Australian and Canadian Dollars all weakened against the greenback, as did the South Korean Won and the Brazilian Real. The Rand returned -3.3% against the US currency and Sterling declined by -0.3%. Amongst the currencies that appreciated against the US Dollar, there was a Scandinavian theme as the Danish, Norwegian and Swedish currencies gained 2.3%, 3.8% and 3.9% respectively. The euro was also strong, appreciating 4.0%. Finally, the low-yielding Yen and

Swiss Franc both appreciated by over 4% against the dollar. The Swiss Franc is often viewed as a safe haven currency during periods of market turbulence and, slowly, interest rate differentials are becoming less disadvantageous for the currency as the rest of the world appears more biased towards rate cuts. The Japanese financial sector still appears relatively unscathed as more consequences of the credit crunch surface. Portfolios with holdings in the euro and Yen will therefore have experienced a tailwind to performance in March.

Global listed property continued to decline with the equity markets. Over the quarter, Asian property performed poorly, and with no strong gains elsewhere to offset it, the Global Property Index finished the quarter down -5.6% in USD terms. In March, US REITs performed well, returning 6.6%. This return was also sufficient for US property returns to be marginally ahead of the other regions over the quarter, providing 2.1%. The UK and European property stocks performed similarly, returning 1.8% and 1.5% respectively in the quarter.

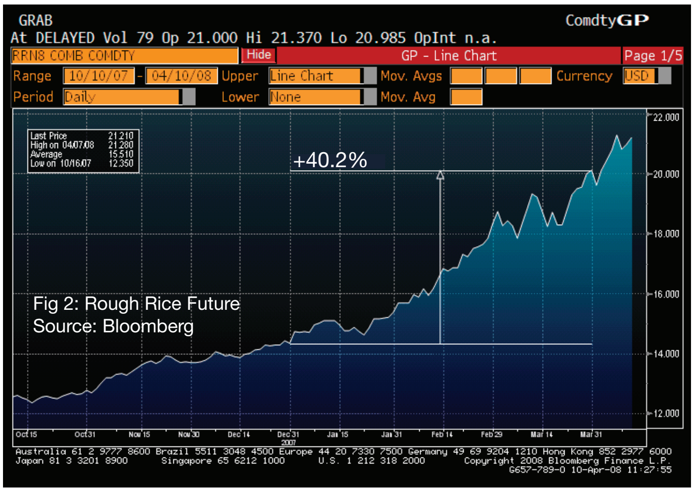

Fig 2: Rough Rice Future
Source: Bloomberg

Commodities performed poorly in March after a number of strong months. The majority of commodity futures posted negative returns, including gold which fell -3.9%, silver returned -13.2%, agricultural commodities fell -13.1% and palladium fared worst, returning -22.3%. Oil managed to provide positive returns of 3.1%. Within the agriculture universe, notable performers in March were largely on the downside with commodities such as oats and coffee returning -14.2% and -23.1% respectively. Rice hit the headlines, returning 12.7% in a month and 40.2% over the quarter (*see Fig 2*). Overall commodities were strong over the quarter, adding to fears of stagflation.

Asset Class Performances

Asset Class Performance (%)	Mar 2008	Q1 2008
US Equities $	-0.5	-9.6
UK Equities £	-2.1	-9.9
Cont. European Equities €	-2.7	-14.9
Japanese Equities Yen	-7.6	-17.0
Global Equities $	-1.0	-9.1
Global Emerging Markets Equities $	-5.3	-11.0
US Bonds $	0.7	4.5
European Bonds €	-0.6	2.3
Japanese Bonds Yen	0.4	1.4
Global Bonds $	2.3	7.4
US REITs (property) $	6.6	2.1
FTSE Real Estate £	-1.4	1.8
FTSE EPRA Real Estate ex UK €	-1.4	1.5
FTSE EPRA Real Estate Asia $	-4.8	-16.4
Euro vs. US Dollar	4.4	8.4
Sterling vs. US Dollar	-0.1	-0.2
Yen vs. US Dollar	4.6	12.2
Rand vs. US Dollar	-4.4	-15.9
Commodities $	-5.4	9.3
Agricultural Commodities $	-13.1	3.1
Oil $	4.8	9.8
Gold $	-3.9	11.7

FOCUS: A Stearns Warning

The decline and fall of Bear Stearns was easily the most prominent market event in March and demonstrates the continued widespread effects of the credit crunch. Bear Stearns is the largest casualty to date of the sub prime crisis and the credit crunch that ensued. Indeed the recent history of Bear is entwined with these phenomena: the collapse of two Bear hedge funds last summer heralded the onset of the crisis. In an echo of John Pierpont Morgan's intervention to calm the Wall Street Panic of 1907, the bank bearing his name, JP Morgan Chase, made an offer of USD2 per share for the US's fifth largest investment bank. This offer was made in concert with the Federal Reserve of New York, who underwrote much of Bear's potential losses.

Fig 3: Bear Stearns Intra-Day Price
Source: Bloomberg

The Fed's intervention was both unprecedented and swift. It appears that the central bank was willing to extend its discount window to an investment bank, as to dither would have been catastrophic for any of Bear's counterparties who had been unable to unwind their positions in time. The rapidity of the rescue also highlights the leaden and ponderous nature of the UK Government, Central Bank and Financial Regulator's combined response to the Northern Rock fiasco. The confident and decisive work by the Fed and JP Morgan prevented the continued withdrawal of funds from Bear Stearns and meant that some value remains in the Bank.

The spectacular lack of liquidity at Bear came about as market participants grew concerned that the Bank would be unable to fulfil its obligations, particularly as a prominent prime broker. This led to the investment markets' equivalent of a run on a bank. Many funds closed any positions which were routed through Bear's prime brokerage; the investment banking equivalent of the queues of investors huddled outside Northern Rock branches. The liquidity of a prime broker is important as the funds that use this facility become economically exposed to the prime broker. As rumours regarding Bear's predicament spread, the number of clients that wished to remain exposed to Bear fell. The simplest way to restrict these risks would be to close the outstanding trades.

On Friday 14 March, as news of the bail-out came to the market, Bear's shares initially jumped before falling to as little as half of their opening value in intra-day trade. Despite this fall, JP Morgan appeared to have picked up quite a bargain when news of their offer of USD2 per share first broke, but overall the market appeared to prefer a guaranteed USD2 to the other likely scenario of nothing, were JPM to walk away. Despite this, barely a week later, the bid was increased fivefold to USD10 per share. Indeed, although most of the market had appeared content with a cheap rescue, Bear Stearns' share price never fell as far as USD2 in anticipation of either a rival bidder or a revised offer from JPM *(see Fig 3)*. The final price of USD10 compares to the USD171.51 peak price of Bear in December last year.

The Federal Reserve, as the result of a special vote, allowed JP Morgan to bring collateral from Bear, including the mortgage book, to the Fed in return for 28 day loans. Bear's predicament demonstrates how tight liquidity, when combined with negative sentiment, can quickly spiral into insolvency. Investment banks tend to use short term funding to cover their longer-term operations. Bear was the fifth largest US investment bank and the most exposed to the credit market, relative to its size. In a February presentation*, Bear Stearns had a balance sheet of USD395 billion, supported by shareholder's equity of only USD11.8 billion. The larger institutions may be more diversified and somewhat less leveraged, yet their business models will also be premised on the use of short term funding to facilitate long term obligations. So, despite an arguably larger cushion, many other banks will have a substantially similar model. Their shareholders will be hoping that their risk controls are indeed more robust or that market intrigue, founded or otherwise, does not focus on their operation.

Despite the appealing nominal value of the stock paid, there is scope to argue that this deal still has the makings of an expensive venture for JPM. The negotiations that led to the takeover identified around USD30 billion of assets on Bear's books that are difficult to value. JP Morgan is only liable for the first billion of these, the rest will fall on the US taxpayer. The revised value of the JPM offer also reduces the likelihood that too many shareholders will object to the deal. Despite this, litigation is in the offing. There are class action suits that have been filed, and additionally many investors may be peeved that Bear publicly assured shareholders that it was in good shape quite soon before the JP Morgan offer. Some of Bear's franchises appear valuable, but its staff have undoubtedly been perusing job postings elsewhere and morale is low. Furthermore JP Morgan has set aside USD6 billion for legal and other costs related to the merger.

The people who stood to lose from the original JPM deal were the Bear Stearns shareholders and employees, the two groups most likely to have had influence on the bank's policy. The rescue of Bear Stearns for USD10 per share fulfilled two functions, namely preventing any possible ripple effect emanating from the collapsing bank, whilst not looking like any sort of 'bail out' for shareholders. This meant that the Fed looked to have acted in a prudent manner to foster stability in markets, whilst not providing any fuel for the proponents of the 'moral hazard' arguments. Whichever way you put it USD10 is a lot more appealing than USD0.

Issues going forward will include whether banks which are deemed sufficiently large would again be effectively bailed out by the government in the event of bankruptcy. Where this is likely, the issue then is whether these institutions should be subject to greater regulation. Moral hazards aside, the Bear issue highlights the fact that once banks get to a certain size they must be cognisant of a certain responsibility that they have to the economy as a whole. There are some positive examples of this, such as the Nordic crises of the 1990s. Here banks were taken into public ownership to the detriment of shareholders, then re-privatised. The government in fact made money and this can be seen as some compensation for the taxpayer for the acceptance of the risk taken on in these banks. In the case of Bear Stearns however, the gain in value of the Bank will benefit JP Morgan shareholders, despite the taxpayer still being exposed to the risk of the Bear assets at present. Presumably the Fed believes that all will benefit from the continued and reasonably smooth operation of the banking sector. The graph below demonstrates the market's perception of the risk of default on Bear paper. The spread has been consistently low until mid 2007. The spike came as market concern grew. The action of the Fed and JP Morgan has clearly calmed nerves, which is probably a valuable result and justifies the risk passed to the taxpayer. The calmness that the action has brought to the markets is certainly welcome.

Fig 3: Bear Stearns 5 yr CDS Spread
Source: Bloomberg

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