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Market Comments

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The domino effects of the mid-September Lehman Brothers bankruptcy continued with a vengeance in October, as the crisis spread to European banks, commodity markets and currency markets. The result was not only a massive further selloff in global equities, but also a shocking decline in current economic activity and expectations for global growth in 2009 and beyond. The truly global nature of the current financial crisis became painfully evident in October as it was increasingly clear that many emerging market economies would not be immune to the recessionary forces that were gripping the United States, Europe and Japan. Although the IMF in early October issued a brave forecast for 3% global growth in 2009, the authors made it clear that almost all of the risk to that forecast was to the downside and that growth at half that pace would not be surprising. Since then, global growth in the 1%-to-2% range for 2009 is rapidly becoming a consensus view. If realized, such an anemic economic outcome would be profoundly disinflationary and would represent the most severe global slowdown since 1982.

The pathology of the current crisis is rooted in what financial historians call a “collapse of intermediation,” whereby financial institutions are so concerned about counterparty risk that interbank lending has plummeted and resulted in a severe tightening of credit conditions for non-bank borrowers as well. One of the most dramatic illustrations of that process has been a 90% drop in the Baltic Dry Freight index, reflecting the fact that international shipping activity has withered as letters of credit for financing trade have become scarce. The drop in trade has contributed to sharp declines in commodity prices and commodity-related currencies including the Australian dollar, the Canadian dollar, the Brazilian real, and the South African rand. The dim outlook for global growth and commodity prices has triggered financial instability even in emerging market nations like Russia with trade surpluses and large foreign exchange reserves, because a significant amount of domestic debt had been issued based on the assumption of permanently higher commodity prices.

Exceptional times have triggered exceptional policy responses as well, with various countries around the world having announced nearly \$3 trillion in financial system relief measures including capital injections into banks and the creation of programs such as the U.S. Troubled Asset Relief Program (TARP) to take distressed assets off of the balance sheets of financial institutions. Aggressive coordinated easing by central banks around the world has also been seen in response to the crisis, with more easing likely in coming weeks and months. Government guarantees of banks deposits and money market funds have helped avoid bank

runs, but led to unintended consequences as well. These include upward pressure on long-term interest rates as market participants worry about rising government budget deficits, and downward pressure on many emerging market currencies as investors sought safe havens in developed nations that had guaranteed bank deposits. By the end of October, the barrage of policy measures appeared to be having some success in bringing down interbank lending rates, triggering a relief rally in stocks and some commodity prices and commodity-related currencies.

That said, indicators of financial stress remain elevated and market participants are justifiably concerned about whether the sharp economic slowdown that is underway will trigger additional financial strains or what Fed officials delicately call “adverse feedback loops.” The most important silver lining to the dark clouds that have enveloped global markets is that policymakers have clearly reached the “kitchen sink” mode, whereby they are ready to throw everything including the proverbial kitchen sink at restoring global growth and financial stability. Another silver lining is that global stock markets are arguably discounting a 40%-to-50% drop in earnings as they trade at around 10 times estimated 12-month forward earnings, although the forward estimates are admittedly not worth much at times like this. If history is any guide, equity markets frequently find a bottom many months ahead of actual economic recovery and amid horrible news flow. Our focus at this time is to look through the fog and identify companies that will be winners in their global sectors over the next three to five years, but which have solid balance sheets that will permit them to survive the challenging economic conditions that seem likely in 2009.