

News that the US Treasury is working intensively on creating a huge public entity to buy the most toxic assets in the US financial system set off a strong recovery in global stock markets on Friday. The authorities' series of massive interventions over the last two weeks, and in the case of Lehman Brothers non-intervention, have been done on a case-by-case basis with very different outcomes each time and markets had got very uncertain on where the next problems emerge. The decision to create this entity amounts to addressing the current crisis at a systemic level so also defining the problem as essentially a systemic one, so not to do with this or that individual bank or other financial company. The model for the entity will be the Resolution Trust Corporation (RTC) which was used to solve the savings and loan crisis of the eighties.

Global markets breathed a collective sigh of relief on Friday, with some euphoria mixed in after the down days of earlier in the week. In the US, the S&P 500 Index was up over 3% by mid-morning, led by a rise in financials of 6.8%. The US market had already started to rally strongly right at the end of the previous day's trading session as news of the government's decision circulated ahead of the formal announcement. The Securities and Exchange Commission temporarily halted, until October, the short selling of 799 stocks. This followed the UK government's decision to temporarily prohibit the short selling of all financial sector stocks. Waves of short selling by hedge funds have been blamed for the fierce and destabilising downward pressure on bank stocks, particularly over the last two weeks. The FTSE 100 Index was up a massive 8.2% by late Friday afternoon with banking stocks up on average well over 10%, buoyed by the prohibition on short selling them. In Europe the FTSE Eurofirst Index rose almost as much, by 7.6%. Chinese stocks had led an Asia-Pacific rally on Friday before the US news, buoyed by Chinese government moves to support the stock market. Below Tom Fahey, Senior Portfolio Manager, Global Fixed Income Strategies, Standish Mellon Asset Management in Boston, gives his thoughts on global macroeconomic and comments on the government move to hasten the creation of an RTC-like structure:

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"To stabilise the macroeconomic situation not just markets, the US government has to stabilise the US financial sector and this it is now focusing on doing by prioritising the creation of an RTC-style structure to buy the most toxic assets of the financial sector. Ben Bernanke and Hank Paulson have been doing a very good job over recent weeks but making policy in real time is an incredibly difficult thing. The market now needs breathing room and this is what the creation of this entity – to address the problems at a systemic level – should give it. It also explains the strong sense of relief in, and recovery of, markets today. Bail-outs do not come free however – witness the penalty rate of interest of 850 basis points above LIBOR that the government will be getting on its US\$89 billion short-term loan to AIG – so expect that those financial companies that have to sell assets to the future entity will be paying a high price for so doing. These companies may be ultimately footing the cost primarily, rather than the public purse. That said, it is important to note that, despite the share price falls in the US financial sector over the two last weeks, the US financial sector BKX Index actually bottomed some time ago, on 15 July."

"The giant step to create this entity will not return us to a path of global growth in the near term. I believe that we are facing a period of at least three to four quarters of negative world GDP growth and that the working through of the 'credit crunch' will take another two years. 2009 corporate earnings expectations will have to be pared back, unemployment in Western economies is rising, global inventories are at historic highs: the global economy is in for a tough time, and the UK and Europe are most certainly not immune. The consensus that emerging markets have decoupled from Western economies is set to come under more pressure. It is clear however that emerging markets are in a much better position than in their period of crisis in the early nineties to withstand external shocks coming from the Western financial system or Western

economies: crucially, unlike then, they now have on aggregate huge foreign exchange surpluses and positive current account balances. I expect global interest rates to come down substantially in the next months: US rates could well, in six months time, be as low as 1% with UK and European rates possibly falling to 3%."

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