



**“Equity markets experienced declines not seen since October 1987 as volatility touched record highs amid rising investor anxiety. As Alan Greenspan spoke of a ‘credit tsunami’ threatening jobs and growth, governments around the world acted individually and in concert to thaw credit markets, and provide support for rapidly decelerating economic growth prospects.”**

**Niall O’Leary, Head of Credit Portfolio Management**

## Markets pare losses with end of month rally...

- A final-week rally on the world’s stock markets helped contain total losses in October, although overall returns remained deep in negative territory for the month. In a period of significant financial market upheaval, emerging markets tended to come off worse, amid recognition that the credit crisis and the global economic downturn would have negative consequences beyond US and European borders.
- Intervention by authorities dominated, with governments injecting capital into some banks, nationalising others and providing liquidity, while official interest rates were lowered in many countries. Some countries pushed interest rates higher in an attempt to relieve selling pressure on currencies.

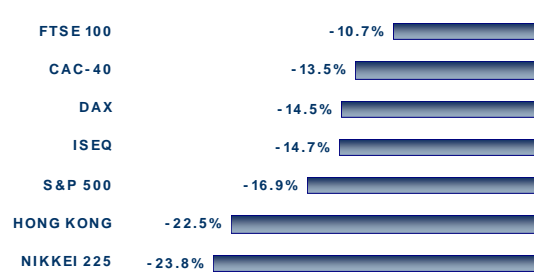
## Governments bail out troubled banks...

Negative double-digit stock market returns were commonplace this month. The financial sector distress of late September continued through the first half of October as authorities grappled to contain bank funding difficulties. As a result of a proposal to improve the balance sheets of UK banks, the British government could own up to 60% of Royal Bank of Scotland in return for a £20 billion injection, and up to 40% of the proposed Lloyds TSB/HBOS entity.

In the US, legislators finally passed a revised Troubled Assets Relief Program championed by Treasury Secretary Hank Paulson. The first tranche (US\$125 billion) was used to purchase stock from the country’s nine biggest banks. In Ireland, the Dáil passed a bill to guarantee bank deposits and debt, and this appeared to put a floor under bank share prices. Variations of these plans were in evidence around the globe and by month-end the financials sector (and the wider market) had recovered from its lows, aided by a substantial loosening of monetary policy on the part of many central banks.

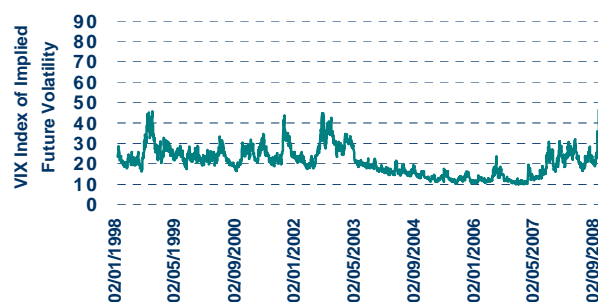
Given the activity of the past month, there is little surprise to find banks near the bottom of the performance table. However, commodity prices slumped in October taking mining company shares, in particular, sharply lower as well. Copper and nickel prices fell 36% and 24%, respectively, while oil fell by a nearly a third to close at US\$67 per barrel.

## Equity market returns – October 2008



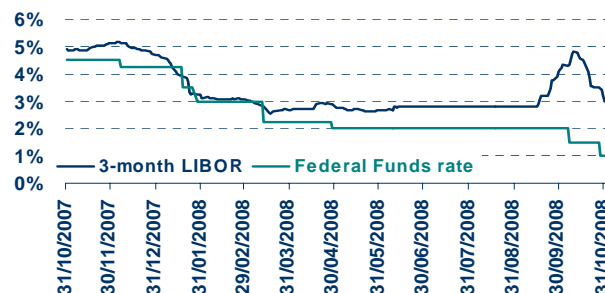
Source: Bloomberg. Capital returns in local currency.

## Record volatility for equities...



Source: Bloomberg.

## Inter-bank lending rates come off high...



Source: Bloomberg.

## Central banks take coordinated action...

As progress was made on bank rescue packages, attention began to shift towards the wider implications of the ongoing crisis. In a coordinated move on October 8th, central banks in the US, UK, Eurozone, Canada and Sweden cut their respective official interest rates by a half-percentage point. Among the others that followed suit: India cut its rate from 9% to 8%; and New Zealand reduced its rate by a full percentage point, despite inflation in excess of 5%. Sweden and the US each cut rates by a further 50 basis points later in the month.

Iceland lowered its key interest rate from 15.5% to 12% after effectively nationalising its banking industry. However, the subsequent sharp fall in its currency posed fresh problems and it increased rates to 18% as part of its agreement with the International Monetary Fund to borrow US\$2.1 billion. Hungary increased its interest rate from 8.5% to 11.5% as the forint weakened.

Amid expectations of further rate cuts, European bond yield curves steepened further as two-year German bund yields fell to 2.54% at month-end, extending the difference with 10-year bunds to 136 basis points, the biggest such gap in nearly four years.



## 10-year bond yields

	31-Dec-07	30-Sept-08	31-Oct-08
<b>US</b>	4.03	3.83	3.97
<b>UK</b>	4.51	4.45	4.52
<b>Germany</b>	4.31	4.02	3.90
<b>Japan</b>	1.51	1.47	1.48

Source: Bloomberg.

## BIAM Outlook

- The sustained nature of the financial sector distress and emerging macro data point to a more prolonged economic downturn than previously envisaged. While the interest rate cuts in October did not immediately imbue markets with a sense of calm, these were necessary responses to the economic deterioration. Notwithstanding the Bank of England's dramatic cut in early November (4.5% to 3%) and the European Central Bank's 50 basis point cut the same day, we believe that further such action should be forthcoming. It is worth noting that credit markets have responded positively to the various government and central bank initiatives, and Libor rates – which had spiked sharply in late September and early October – have fallen consistently since then. The spreads between Libor and official rates remain elevated, by historical comparison, but the progression has been positive.
- Both bottom-up stock analysis and top-down macroeconomic scrutiny indicate compelling value in equities. Several valuation metrics – including price-to-earnings and price-to-book multiples – indicate unambiguous buying opportunities, unless one feels that the next few years are likely to be very different from the last twenty. We do not believe that we are facing conditions similar to those prevailing in the 1930s and we do not see a secular change in the equity risk premium (i.e. where equity investors demand an even higher compensation for the risk of holding stocks versus risk-free assets such as sovereign debt). In short, equities have discounted a lot of very poor news. They remain very cheap relative to their own history and other asset classes. Nevertheless, markets may well remain very volatile in the coming weeks and months.