



Weekly Market Commentary



October 27, 2008

The World Catches a Cold

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Highlights

We believe that the policy actions by the Treasury and Federal Reserve will begin to cure the financial crisis in the United States. However, we are not so optimistic on the measures being taken outside this country to treat the symptoms of the crisis, much less provide the cure.

The economies of Europe lack the tools and resources to address the crisis effectively, and Asian economies are suffering from slowing export growth, driving those economies deeper into recession.

Several steps can be taken to help immunize portfolios against further losses stemming from the worsening overseas outlook, including: minimizing foreign exposure and eliminating exposure to emerging markets, hedging foreign currency exposure, and overweighting small cap stocks, which have the least foreign sales exposure of the domestic equity asset classes.

The old adage “When the United States sneezes the world catches a cold” is proving to be true once again, as foreign markets have suffered from much worse declines than the United States this year. We believe that the policy actions by the Treasury and Federal Reserve will begin to cure the financial crisis in the United States. However, we are not so optimistic on the measures being taken outside of this country to treat the symptoms of the crisis, much less provide the cure. The economies of Europe lack the tools and resources to address the crisis effectively, and Asian economies are suffering from slowing export growth driving those economies deeper into recession. We continue to recommend underweighting foreign developed and emerging markets.

Euro Trash

There are two prescriptions intended to cure the global financial crisis that has threatened to turn into a catastrophe in recent weeks as interbank lending has frozen up. Both the European and American approaches attempt to inject capital into the banks directly through purchases of preferred shares to insure their solvency. However, there is a key difference in how they each address the immediate problem of frozen interbank lending:

- The European plan is mainly composed of each country guaranteeing interbank loans to remove the fear that has all but halted lending between banks.
- In the United States, the Federal Reserve has effectively joined the interbank lending market itself and is acting as if it were one very large and deep-pocketed bank willing to make loans to any bank that can provide collateral of nearly any type.

In our opinion, the European plan is much more likely to fail than the U.S. plan and may take some European economies with it.

As guarantor, the Europeans may be forced to mediate each and every interbank transaction, approving or disapproving the loan and setting the rate. Otherwise, unsupervised, risk-free, guaranteed lending would have disastrous results. Easy to announce, but hard to implement, this plan would have to be micromanaged by a very large team—essentially a whole company—but it is even worse than that since it must be done separately in every European nation, multiplying the delays and bureaucracy. In contrast, the Fed has a much easier job of evaluating only the transactions it undertakes directly, leaving the banks to negotiate terms among themselves.

The exit strategy is also much easier for the U.S. plan. As the health of the interbank lending market improves, rates fall, and sufficient liquidity



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is restored among the banks, the Fed can simply provide less and less interbank funding and allow the banks to take over the market again gradually and naturally. The Europeans must figure out how to gradually stop guaranteeing interbank loans. This is quite a challenge since a partial guarantee isn't really a guarantee at all and only guaranteeing the borrowing of a smaller and smaller number of institutions is discriminatory and disruptive to the financial market.

It may sound as though the American plan is better and the Europeans may eventually adopt it, but they can't. The Fed has the authority to print the money to restore the functioning of the interbank lending market. In Europe, the individual countries have no authority to print money—only the ECB holds that authority. But the ECB is unable to help, since European banks are not regulated at the continental level nor does the ECB have the authority to tax member nations, so it does not have sufficient cash to use even if it could provide direct capital injections (and could overcome the politically contentious issue of which banks in which countries to bail out). When the Maastricht Treaty was signed in 1992, euro zone countries agreed to form linked fiscal policy, a trade zone, and a common currency, but they refused to surrender control over their individual financial and banking sectors. The Europeans just shot down any change to these rules involving a pan-European plan similar to the U.S. solution proposed by France and Italy. Germany and the UK, whose economies have resources that may be sufficient to bail out their own financial systems, would have been expected to bear the burden of most of the plan covering the other countries, and vetoed that idea right away.

The European prescription is further challenged by the integrated relationship between the banks and the companies they lend to. In the United States, the government worked hard to keep a separation between industry and banks as the banking system grew over the past 100 years. On the other hand, tight relationships between banks and businesses were encouraged in Europe. It became common for banks and industry to share board members and create interdependencies that sought to ensure capital was available to build the factories and infrastructure of industrialization without the risk of relying on the availability of investor capital during the boom and bust swings of the 19th century. Through to this day, the majority of European firms' financing comes from banks rather than from the stock and bond markets as in the United States. As a result, the global banking crisis has a far deeper reach into European non-financial businesses.

The country-by-country European approach means that all actions must be developed, funded and managed by a team established in each country—multiplying the delays and bureaucracy of implementing solutions to the crisis by 20+ member nations when time is of the essence. Some countries may lack the resources of talent and capital to resolve their financial problems internally. Some countries are better able to address the problems in their financial and banking systems than others.

- Germany announced a \$95 billion bank capitalization plan, a bailout proposal for real estate giant Hypo of \$68 billion, and up to \$540 billion for interbank loan guarantees.



- France announced a \$54 billion injection plan for banks and up to \$400 billion for interbank loan guarantees.
- The United Kingdom injected \$34 billion into Royal Bank of Scotland and supported the merger of Lloyds and HBOS with \$29 billion, took over mortgage lender Bradford & Bingley, and spent additional billions partly nationalizing Abbey, Barclays, HSBC, Nationwide Building Society, and Standard Chartered.
- The Netherlands and France bailed out Fortis with a combined \$43 billion.
- Spain set up a \$41 billion aid package to buy good assets from banks to inject liquidity into their financial system as a whole.

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While each country is attempting to address the crisis at banks within their borders, the lending extended beyond national lines. The adoption of the monetary union resulted in a low interest rate environment for some historically high interest rate countries in Western Europe such as Spain, Portugal, Italy and Ireland. The sudden access to cheap credit led to a spending boom fueled by banks in Scandinavia and Switzerland. The citizens of smaller and newer eastern European countries that joined the euro zone in recent years became intoxicated with consumption after having been previously deprived of credit. In the Baltics, countries like Estonia grew real GDP at a double-digit pace—faster than China—driven by consumption of imports that resulted in huge trade deficits and inflation for these countries. This spending was supported by borrowing from western European banks domiciled in countries that had slower growing domestic markets. France, Italy, and Greece are running sizable budget deficits, burdened by high government debt to GDP, and also have banks that lent heavily to emerging markets of Eastern Europe. For example, the troubled Italian bank UniCredit has extensively lent in Eastern Europe. With the countries focused on restoring lending within their borders, lines of credit to foreign markets are all but completely cut off, leaving eastern European countries in the Soviet-era destitution they had once fled and forcing them to look to the International Monetary Fund (IMF) for help. Belarus requested a \$2 billion emergency loan from the IMF shortly after similar requests by Hungary, Iceland, and Ukraine, illustrating how the financial crisis is quickly spreading through emerging Europe. The IMF resources are not sufficient to stabilize the financial systems of all of those nations unable to address the crisis on their own.

A potential restorative action would be the temporary suspension of the budget deficit limits imposed by the Maastricht treaty. This would allow member countries to run much higher budget deficits and inject borrowed capital into their financial sectors. However, once suspended it may be difficult to return to the limits without the creation of additional pan-European financial governmental authority. This course appears unlikely at the present. The potential exists for trashing the Euro, as a breakdown of other provisions of the treaty may result if deficits among member nations cannot be contained.

Europe is facing a protracted crisis. In the United States, direct measures to inject capital and restore funding to the interbank market are not



assured of success but face much lower hurdles than the European measures. In Europe, the systemic problems are much broader and deeper but can only be addressed with various discrete solutions aimed at resolving interconnected weaknesses. For the United States, the recent unprecedented policy responses might mark the beginning of the end of the crisis. But for Europe, this is likely to be just the end of the beginning.

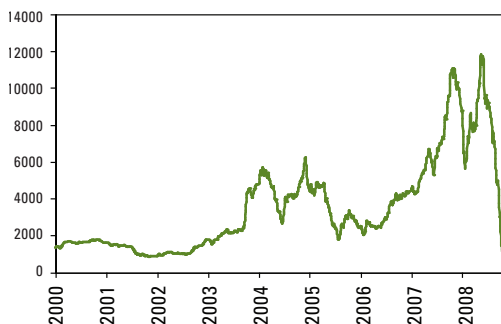
Asian Contagion

Rather than as in Europe and the United States where capital is scarce and lending is based on risk and return on investment, Asian economies have been flush with capital and tended to base lending on employment maximization to ensure social and political stability. This capital is funded by robust export growth and trade surpluses. However, this capital funding poses a risk as growth slows. If exports to the United States and Europe slow to the point that cash inflows are insufficient to support growth, these Asian economies will experience a protracted recession.

In Japan, the yen is rising as investors unwind low interest rate loans they borrowed from Japan to invest in securities around the world. As investors sell their investments, they turn around and buy yen to pay back the yen denominated loans. Global selling by hedge funds and others has resulted in a surge in demand for the Japanese currency, pushing its value up sharply in the past month to levels not seen in over 10 years. The rise in the yen makes Japanese exports more expensive in countries with weaker currencies. The slowdown in demand from the United States and Europe combined with a rising yen are likely to staunch the flow of liquidity into the Japanese economy from exports. The United States consumes 20% of Japan's exports, and the European Union consumes 14% percent. The slowdown is already having effects on Japan's capital. In August, Japan reported the first monthly trade deficit on a seasonally adjusted basis since 1982 as imports exceed exports. This is may be the start of a trend that pulls Japan into a prolonged recession.

The Chinese economy has rarely fallen below 10% growth since 1980, and it has rebounded rapidly after falling to about 4% during prior global recessions, as the communist Chinese government subsidized exports to maximize employment of its massive population of over 1 billion. However, China's exports are sliding. Reports from some Chinese exporters note that demand has fallen sharply. Official Chinese government statistics reflect some slowing, but we can look to other real-time measures of Asian trade activity and see a sharp decline. For example, the Baltic dry freight index—which tracks the rate for shipping dry (non-energy) materials along key trade routes and acts as a gauge of the demand for shipping and volume of goods being shipped—has plunged to the recession levels of the early 2000s. Most of China's growth is internally focused, but it is funded largely by trade. The slowing inflow of capital to fund internal growth results in rising stresses on the Chinese government to manage unrest, given that the vast wealth disparity among regions is exacerbated by the weakening economy. With demand for exports plunging, the Chinese government must either spend its vast capital reserves to subsidize export growth and artificially maintain production (which can lead to overproduction and deflation), or the Chinese

1 Shipping has Slowed Sharply Back to 2001 Recession Levels Baltic Dry Freight Index



Source: Bloomberg, LPL Financial



may attempt to use that capital in Europe or the United States to help alleviate the crisis and restore demand for Asian products.

How best to immunize against overseas losses?

Several steps can be taken to help immunize portfolios against further losses stemming from the worsening overseas outlook.

- We continue to recommend minimizing foreign exposure and eliminating exposure to emerging markets on a tactical basis.
- Hedge foreign currency exposure on European bond holdings to protect against a further weakening of the Euro.
- Overweight small cap stocks, which have the least foreign sales exposure of the domestic equity asset classes.

SMALL CAP VALUE HAS THE LEAST FOREIGN SALES EXPOSURE

Foreign sales as a Percent of total for S&P 500 Pure Growth and Value Indexes

	Growth	Value
Large	48%	18%
Mid	25%	13%
Small	16%	7%

Source: Factset Research Systems, LPL Financial

IMPORTANT DISCLOSURES

Investing in international and emerging markets may entail additional risks such as currency fluctuation and political instability. Investing in small-cap stocks includes specific risks such as greater volatility and potentially less liquidity.

Stock investing involves risk including loss of principal. Past performance is not a guarantee of future results.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rate rise and are subject to availability and change in price.

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