

## Market Update

### Overview

Developments in financial markets since our last update at the end of August are without precedent. Beginning with the placement of Fannie Mae and Freddie Mac in conservatorship, financial markets rapidly spiralled out of control as Lehman Brothers filed for bankruptcy, Bank of America bought Merrill Lynch, AIG got emergency funding from the Fed and Washington Mutual was closed.

The dramatic drop in inter bank liquidity triggered by Lehman's collapse led banks across Europe to turn to their domestic governments for support – including Hypo Real Estate, Fortis, Dexia, ING, UBS, HBOS and RBS as well as numerous institutions in smaller European states such as Ireland. The Icelandic financial system effectively collapsed as its three largest banks were placed under regulatory control and defaulted on their senior debt obligations. At the time of writing Iceland, Ukraine and Hungary have accepted IMF loans and several emerging market sovereigns find it difficult to raise finance.

US and European authorities stepped up intervention to prevent self fulfilling panic and capitulation from engulfing the entire market.

The US Troubled Asset Relief Program (TARP) was passed by congress on its second attempt and although its \$700bn war chest was initially intended to purchase 'troubled' assets from bank balance sheets, its focus shifted to direct investment in financial institutions after markets deteriorated quicker than expected. The US has invested \$125bn in preferred shares of the nine largest institutions and is expected to invest a further \$125bn in regional lenders. The remainder may be used to purchase assets although support for the insurance and monoline industries is now mooted. FDIC now guarantees certain new unsecured bank debt and demonstrated its willingness to support financial intuitions as required when the Citi / Wachovia transaction was initially agreed. FDIC estimates the debt / deposits now covered by its various guarantees at ca. \$1.8trn.

European governments responded with a combination of direct bank obligation guarantees and capital injections though the form of intervention has varied by jurisdiction. Total Eurozone guarantees are currently ca. €1.5trn, with €130bn of capital injections. The UK announced £250bn of new debt guarantees and £37bn of capital injections by the state.

The worlds principal central banks co-ordinated emergency rate cuts on 8 October and this, together with other rate cuts, broadening of asset criteria eligible for central bank funding, and liability guarantees has gradually led to an easing in inter bank borrowing costs – 3 month US\$ LIBOR is 163bps off the highs (3 month Euribor: 60bps). In a further example of the willingness of authorities to take whatever steps necessary to address the crisis, accounting rules were relaxed, reducing the level of assets that must be marked to market which should help to ease capital concerns as many assets without any evidence of credit deterioration have severely negative mark to market positions.

Concern is now shifting from the immediate liquidity threat to financial institutions to the broader implications for the economy. Though corporate credit spreads have eased somewhat they still trade wider than the levels reached in an earlier wave of the credit crisis prior to the purchase of Bear Stearns by JP Morgan in March.

### ABS Markets

The broader financial market developments have completely overshadowed the US and European ABS markets. The markets are best characterised by an absence of liquidity as bid lists reportedly fail to clear and dealers mark assets without reference to actual trading activity. The default of Sigma, the last remaining SIV, and the supply of collateral from its repo counterparties has put further pressure on asset prices. The TARP has yet to have a positive impact on

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ABS pricing as many details of how an asset purchase program would work have yet to be announced.

The default of Lehman Brothers has also highlighted structural weakness in the securitisation market with several transactions where Lehman Brothers was a swap counterparty now on watch negative.

### US ABS

Problems facing the US RMBS market are well documented. Arrears and foreclosures continue to increase month on month. Weak performance first seen in the subprime space has filtered through to the Alt A and Prime RMBS sectors. Furthermore prepayment rates continue to fall as borrowers' ability to refinance is largely closed off. We expect to see further rating pressure on this sector.

### European ABS

Spreads have continued to widen against the backdrop of very light flow in the street. CMBS have continued to come under pressure as falling commercial property values has led to breaches of LTV covenants in some transactions.

### Market Outlook

General market conditions continue to deteriorate as the credit crisis spills over in the general economy. While the actions taken by the ECB, Bank England and Fed are easing liquidity concerns, Bank balance sheets remain stretched and bank funding spreads remain wide.

We remain cautious in the short term and expect continued debt reduction to weigh heavily on the general economy.