

PREDICTIONS FOR 2009

HOW CLOSE TO DISASTER?



Contents

Preface.....	1
The big picture.....	3
The financial sector.....	13
The markets.....	27
Three key countries.....	48
A closing thought.....	59
About us.....	61
About M:Communications.....	62

Preface

Forecasting with both eyes fixed on the rear-view mirror is a hazardous business, but there is no other way. Divinely inspired oracles aren't a common feature of the modern world; studying animal entrails in the office violates health and safety standards. So financial seers can look backwards only.

The study of past forecasts promotes humility. True, breakingviews has consistently been more sceptical than many about the period of apparent prosperity that has given way to the current financial crisis. In 2005, we predicted that within a few years central bankers would be asking "just how Greenspan got away with arguing that asset prices were not the business of central banks". In 2006, the word "bubble" appeared in 90 stories – mostly attached to something like "will pop soon".

But while we were pessimistic, we were nowhere near gloomy enough about 2008. Our predictions book for the year got some things right. We said that private equity "like the Chinese Zodiac, goes from pig to rat", and that the UK economy was in a precarious position. But the impending failures and government rescues – Bear Stearns, Lehman Brothers, Fannie Mae and much of the US and UK banking system – went unpredicted. These inadequacies of foresight haven't deterred us. This book contains 24 pieces detailing our expectations of the key developments that lie ahead in 2009, and beyond. It's not a happy story. We don't see an early – or easy – conclusion to the tensions in the financial system. We also fear that bold programmes by governments could lead to big problems later.

The financial world is our home turf, and it's looking pretty rough. The end of the boom times will hit hard: in venture capital, investment banking, private equity and bonuses. As for markets, stocks are pretty cheap, but likely to stay that way.

Government bonds look like a bubble. Our best bets are traditionally defensive: bad-time stocks and gold, the asset for worst times.

If the forecasts presented here aren't quite perfectly synchronised, that reflects the range of judgements inside breakingviews and the difficulty of the task at hand. But we hope they are consistent where it matters most – in providing intelligent insight about the complex world of finance and economics.

Happy reading!

Edward Hadas
Assistant Editor, breakingviews.com

The big picture

Gloom not doom

By Edward Hadas

At the end of 2007, most forecasters were far too optimistic. But they deserve some sympathy – it was hard to know just how rough the credit crunch would turn out to be. In hindsight, US economic activity was peaking just then, according to the National Bureau of Economic Research. A year later, after the near-collapse of the financial system and in the early stages of a recession, it is easy – and right – to be gloomy. At best, 2009 is going to be tough for the economy – and probably for most financial markets.

True, central banks and governments are providing abundant supplies of cash and hyper-cheap credit. But the financial system remains dysfunctional. Banks in most countries are struggling with losses and cutting back on loans, while leverage-shy consumers and companies are cutting back on spending.

The conventional wisdom has been catching up to reality. US GDP is expected to drop by 1.6% in 2009, according to Consensus Economics. But that still sounds too optimistic. The interaction of bank deleveraging and economic shrinkage in the US and elsewhere will have more toxic effects than economists are typically willing to admit.

Even if governments decide immediately to force banks to lend, it will take at least six months before credit is significantly uncrunched for borrowers. A year or more of continued squeeze is more likely. By the time the banks are bouncier, unemployment will be up, international trade down and

confidence shot to pieces. A takeoff in growth will probably have to wait another two or three quarters.

Then there are the global imbalances to be reversed. The big US trade deficit and the corresponding surpluses in China and Japan helped create the credit bubble. A US recession should eventually help restore balance, but not before US import demand is devastated.

All in all, it looks like US GDP will decline by 4% over the next two years, with smaller falls in other rich countries. As for a recovery, it could start as early as 2010, but 2011 looks more likely.

That forecast may be gloomier than most, but it is actually a temperate grey. A truly dark picture would develop if the authorities slackened or screwed up. After a decade or two of excess, the path to recovery is difficult. Flooding the system with money is the right approach for now, and it should keep deflation at bay. But when recovery starts, the powers-that-be will have to be ready to suck up funds to keep a lid on inflation.

There is also the chance of an old fashioned balance of payments crisis in a big economy such as the UK, or even – whisper this – the US. That could provoke a longer-lasting global economic slump.

Assuming that doesn't happen and governments stay reasonably alert, asset prices should hit bottom before there is clear evidence of economic recovery. They have fallen sharply as credit has become scarce and economic prospects have worsened. The second half of 2008 has been tough for stocks, corporate debt, property, collectibles and commodities.

But a word of caution: prices had risen so high that there was a long way to fall. Bargains aren't widespread yet. After a 50% drop, stocks are only now selling at roughly the cost of replacing the assets. Oil is down more than 60%, but is still

expensive enough to make drilling new wells a winning proposition. And while spreads on loans have increased, making the loans look cheaper, so have the expected losses from defaults.

Still, for the first time in years, asset prices are low enough for patient investors to do reasonably well. Stocks, which are protected from inflation to some extent, look particularly good. Government bonds, which are currently very popular, look particularly bad.

The wait for a good return might be long, though. Prices aren't likely to go up and stay up until credit stops contracting and economic growth restarts. There may be many buying opportunities that are as good or better before 2011 comes around.

A troubling New Year

By Hugo Dixon

Recession or slump? As the New Year dawns, that is the question.

The difference between recession and slump is not merely a matter of degree. If the recession becomes too severe, it could generate enough tension to tip much of the world into a new – and deeply unattractive – period.

A plain old recession could purify the capitalist system. After the excesses of the past decade, some basic ethical principles need to be relearned – such as the importance of saving and how sustainable wealth comes from hard work and creativity, not gambling on rising asset prices or playing with other people's money.

A slump is different. It could trigger a backlash against the entire capitalist paradigm. With millions of people being thrown out of work and losing their homes, the ground would be fertile for demagogues. All sorts of bad policies might then take root.

Nationalisation and state subsidy of weak industries could turn back the clock on three decades of free-market reforms, sapping the private sector of its vigour. Governments would be sorely tempted to take refuge in protectionism – risking tit-for-tat measures that made everybody poorer. In general, countries would find it harder to collaborate. Things could get pretty bad – even if the world doesn't fare remotely as bad as it did the 1930s' slump, which spawned fascism and then world war.

Where is the tipping point between recession and slump? Economists don't have an accepted definition of a slump. During the Great Depression in the US, the unemployment rate peaked at 25%. But advanced economies would have entered a slump long before that. A reasonable guesstimate is that unemployment rates twice the current level – or 12%-15% - might constitute the dividing line.

The current consensus is that unemployment will peak at just under 10% in the US and the EU. But with confidence shot to bits, a worse outcome is all too possible. Consumers, businesses and banks are tightening their belts because they are afraid of the future. While such restraint is perfectly rational from the perspective of each non-spender, non-borrower and non-lender, the cumulative effect is a downward economic spiral.

Governments must therefore pull out the stops. They have, of course, already sprung into action – recapitalising banks, slashing interest rates, cutting taxes and increasing their own spending. These measures will start to have an effect in the New Year. But they may not be enough.

The paramount need is to restore confidence. Unless they are confident, banks won't lend, consumers won't spend and businesses won't invest.

On the other hand, there is a real danger that if governments themselves borrow too much money – in their attempt to prime the private-sector pump – they too could lose the confidence of the markets. Iceland learned that lesson in 2008. It is therefore vital that governments come up with credible pathways to balance budgets in the medium term - even as they embrace loose policies in the short run.

Restoring confidence is primarily a challenge of leadership. In 2008, the world was not blessed by having George Bush in the White House. Not only was he a lame duck president; he didn't appear to be on top of what was happening.

Elsewhere, the Japanese, Chinese and Europeans have done only a little better. Gordon Brown, the UK prime minister, did move boldly on bank recapitalisation. But his credibility is not that strong given that, in his previous incarnation as finance minister, he ran a loose policy that helped to lay the foundations for the crisis.

Many observers expect great things of Barack Obama. The US president-elect doesn't possess a wand to magic away the misery. But he is smart, seems to understand the importance of not promising more than he can deliver and is a great communicator. When it comes to restoring confidence, all three talents are useful. Still, he and the world have quite a mountain to climb.

The 12 days of Christmas retold

By Hugo Dixon

The deepening economic gloom will undoubtedly lead to much misery. But the crisis also has silver linings. Here's one cheery thought for each of the 12 days of Christmas.

On the first day of Christmas, my true love sent to me Barack Obama. Fingers crossed that will give a boost to world peace. If it hadn't been for the crisis, John McCain might well be the US president – and Sarah Palin vice president.

On the second day, my true love sent to me less global warming. As the economy takes a dive, fewer noxious gases will be spewed out into the atmosphere. That should delay the climate crisis for a year or two. The time shouldn't be wasted.

On the third day, she sent me three chastened dictators. When oil was nearly \$150 a barrel, Vladimir Putin, Hugo Chavez and Mahmud Ahmadinejad bestrode the world like colossi. With crude at \$50, the leaders of Russia, Venezuela and Iran will have more worries at home and less means to swagger abroad.

On the fourth day, she sent me more home cooking. As people have less money to spend eating out, they will eat in. People may even grow more of their own vegetables. This is good for family living and rootedness.

On the fifth day, she sent me more teachers, entrepreneurs and scientists. During the bubble, too many smart people from around the world were sucked into Wall Street and the City. Following the bust, bright youngsters will look to more noble ways of deploying their energies.

On the sixth day, she gave me cheaper homes. That's obviously bad for people who need to sell their houses. But

buying a house shouldn't be a way to make money – and cheaper house will make life easier for the next generation.

On the seventh day, she sent me less conspicuous consumption. In the boom times, some people were embarrassed if they didn't go for the vintage Krug, the Prada handbag, the private jet. Now, even those who still have money to burn may not feel it's fit and proper to show off.

On the eighth day, she sent me a saner financial system. The world ran amok because bankers were allowed to engage in massive “heads-I-win tails-you-lose” style bets. Now politicians and regulators are going to make Wall Street and the City less like giant casinos.

On the ninth day, she gave me more time. In the boom, everybody was frantic. The leitmotif was the banker checking his Blackberry in the middle of the night. In future, people could have more time to reflect – although the unemployed will have too much time.

On the tenth day, she sent me a bonfire of oligarchs. The modern-day barons created by the bubble often lorded it over their less ruthless or lucky brethren. But many were so greedy that they tried to multiply their fortunes with borrowed billions. Margin calls have cut them down to size.

On the eleventh day, she sent me more equality. In the upswing, the rich got richer and the super-rich got super-richer. The inequality got grotesque. In the downswing, the poor will get poorer – but the gap between them and the super-rich will narrow.

On the twelfth day, my true love gave me better role models. Popular culture in the boom was dominated by inane reality television such as Big Brother and the shallow celebrity of Paris Hilton, Posh Spice and the cast of Hello magazine. With luck, in

the new sober world, our children will be offered something more ethical and substantial.

Paradigm shift

By Edward Hadas

When the financial system crashed, a whole intellectual edifice fell down with it. New economic ideas are desperately wanted.

The writer Arthur Koestler once called communism "the God that failed."

The newest fallen divinity is sometimes known by its enemies as "free market fundamentalism," but that is a misnomer. Most free markets are working quite well, albeit with extensive guidance from regulators and policymakers.

The intellectual problem-zone is narrower. It was the belief that largely free financial markets - in old fashioned banking, newfangled investments and international trade - could deliver steady and rapid growth. In this creed, governments weren't exactly considered diabolical, but their relationship with markets was supposed to be distant and supportive, not controlling.

The hands-off approach to bankers and traders spawned disastrous financial innovations such as negative amortization mortgages and collateralized debt obligations. It also encouraged regulators to ignore fast-rising mountains of leverage and central bankers to watch from the sidelines as asset price bubbles grew and grew.

The confidence in cross-border financial freedom proved at least as misguided. The conventional wisdom was that free global financial markets could absorb whatever cash that trade

surpluses generated. That proved as valid as the White Star Line's trust in the unsinkable Titanic.

Now the world is in recession, banks are on government life support and financiers are in the doghouse. The idolizing of free-market finance has been thoroughly discredited.

Old believers - a group that includes Alan Greenspan and almost all other economists who study money and credit - have been mugged by reality. But failure has led few of them to start looking for completely new ideas. Instead, they have just dusted off some old ones.

John Maynard Keynes is now the name to invoke. According to the swelling band of acolytes of the early 20th-century British economist, the answer to an implosion of private debt is an explosion of public debt. No matter that similar, but less extreme, policies in the 1960s led to unacceptably high inflation. Or that almost two decades of Keynesian therapy have hardly brought lasting vitality to the Japanese economy.

Keynesianism might be the best package currently available in the intellectual inventory, but the trade should make a collective 2009 New Year's resolution: find truly new ideas.

Here are three quick suggestions to get the ball rolling. First, financial economists need to value balance at least as much as freedom. When it comes to debts, growth, trade and asset prices, moderation should rule. Whenever free markets produce extremes, economists should encourage authorities to pull them towards moderation.

Second, freedom in finance is particularly likely to turn into dangerous license. Investors who want to turn their nest eggs into fortunes often throw reason out the window. Ask any of Bernard Madoff's investors. And governments think their power to print money freely allows economic problems to be solved

without pain. Financial rules and policies should encourage responsibility and punish excessively wishful thinking.

Finally, economists should study philosophy. The risks that come with freedom - political, intellectual and emotional - have worried thinkers from Plato onwards. Financial freedom should be no exception. A new philosophy of money and credit - one based on the human inability always to act virtuously - could well be the key to a healthier financial future.

(This article previously appeared in Fortune magazine.)

The financial sector

Hedge funds' soft reset

By Richard Beales

Hedge funds suffered a shakeout in 2008. The average hedge fund fell almost 20%, according to Hedge Fund Research. No fund has yet required a bailout. But plenty are closing down, and many survivors are battered and bruised. Hedge fund managers must accept that the industry won't be quite the same again. Here are seven changes they need to prepare for.

Liquidity is the new watchword

Like investment banks, hedge funds didn't think much about the structure of their funding during the boom times. But a flood of redemption requests in late 2008 – just as they were struggling with illiquid markets and scarce credit – caught them out. Many hedge funds annoyed their investors by blocking withdrawals. In future, funds that invest in illiquid assets will need to lock in their investors for longer. And those wishing to give investors regular access to their money will have to focus on liquid markets.

Fees will face greater scrutiny

The archetypal hedge fund charges 2% of assets and skims off 20% of investment gains – the long-standing “two-and-twenty” structure. But some funds have had to offer fee holidays lately to persuade investors not to pull out their money. Investors will be more selective and are likely to put downward pressure on fees. All the same, it is probably too soon to sound Last Post for two-and-twenty.

High water marks will blur

If hedge managers lose money, they normally have to get the fund back up to its previous high for each investor – the so-called high water mark – before the investor has to pay any more performance fees. Broadly speaking, a fund that is down 20% from its peak and has a standard high water mark mechanism would need to deliver returns of 25% before getting back to its high water mark and earning performance fees again on further gains.

That prospect is daunting. It can leave hedge funds short of cash and their employees wondering where their bonus will come from. Some managers will throw in the towel. This is why some already use a modified mechanism allowing them to earn reduced performance fees on gains even before they have recouped earlier losses in full. Expect more funds to adopt similar policies.

Regulation will intensify

Many hedge funds, including big names like Citadel Investment Group, have had a torrid 2008. But unlike the banking sector, they haven't needed bailouts. That doesn't, however, mean hedge funds will escape tighter regulation. Big losses, excess leverage, unexpected curbs on investor withdrawals, and the impact of short-selling on fragile markets make hedge funds easy targets for a crackdown.

Regulators also missed warning signs surrounding Bernard Madoff, who is accused of running a Ponzi scheme that cost investors as much as \$50bn. His investment operation appeared hedge fund-like in that it was private and he purportedly traded options as well as stocks. Watchdogs and investors will, therefore, share a desire for greater disclosure, so long as it is meaningful. The challenge will be designing sensible regulations that can be applied across a diverse industry.

Concentration will accelerate

Consolidation among hedge funds was underway before the pain of 2008. It should now accelerate. Hedge funds are set to start the New Year managing little more than half the nearly \$2 trillion of investor money they held earlier in 2008. Only a handful of top performers – like Paulson & Co, which oversees \$36bn – are bigger than a year ago. Smaller firms, many of which have lost money and become smaller still, will be vulnerable to closure and consolidation. Funds under management will become increasingly concentrated among larger hedge funds, which are favoured by institutional investors and in some cases have achieved better investment performance than their rivals.

Funds of funds look a mess

These take another layer of fees, often 1% of assets and 10% of gains, for selecting funds for investors and doing due diligence. But they haven't managed to do any better than average for their investors. And the Madoff scandal has damaged their reputation: several of his biggest clients were fund of funds operations, whose investors - and regulators - are wondering what kind of screening efforts their fees were buying.

Unlevered returns should improve

The credit boom allowed funds to prosper even if their investment strategy was simply to use borrowed money to amplify tiny returns. But a smaller hedge-fund industry operating in a deleveraged financial world should be able to find more opportunities to make decent returns without exploiting leverage. A rebound in convertible issuance would be manna for the limited universe of convertible arbitrage funds. Distressed debt and even straightforward stock market strategies could also prove fertile hunting grounds.

That's another way of saying that after a rotten year, stable and committed hedge funds should be able to do well again. That's cold comfort for those who have lost big. But it suggests plenty in the industry will live to fight another day.

Investment banking: Unsteady as she goes

By Antony Currie

What qualifies as success on Wall Street? Usually, it's mega-earnings and bumper bonuses. But in 2008, it was simple survival. Those firms that lived to fight another day should be thankful. But the next 12 months are hardly going to be a picnic.

For starters, investor, counterparty and client confidence in the financial sector as a whole won't return just because the year has changed. Arguably only government intervention in the form of debt guarantees and preferred stock investments kept more firms from following the likes of Lehman Brothers and Washington Mutual into insolvency.

That intervention helped shore up stock prices: Goldman Sachs and Morgan Stanley ended the year 80% or more above their lows. But both still trade at a discount to book value, a sure sign that shareholders remain wary about their prospects. These and other banks will have to prove they have weaned themselves off government aid before true confidence is restored. And the real test of that won't come until around mid-year when the Federal Deposit Insurance Corp's debt guarantee programme is scheduled to end.

Meanwhile, Wall Street faces the prospect of more regulation. Some of that is already in place for Goldman and Morgan now that they have become bank holding companies overseen by the Federal Reserve. But lawmakers are also on the prowl: in December Congressman Barney Frank, chairman of the House Financial Services Committee, revealed that he regarded 2009

as "the best year for public policy since the New Deal". It's unclear what shape that will take, though leverage limits and even prohibition of certain types of products or investments have been mooted.

That would crimp earnings that are already under pressure. Goldman Sachs and Morgan Stanley each had to rely on some tricks to post even a 5% return on equity in 2008 after posting fourth-quarter losses: Goldman paid just 1% in taxes, while Morgan Stanley added \$2.8bn in revenue from buying back its own low-priced debt.

Sure, writedowns on dodgy assets should decline next year. There might even be write-ups if markets improve much. But that would probably be offset by losses stemming from any increases in the price of their own debt.

Accounting issues aside, Wall Street's core businesses are moribund. The boom in M&A and selling new stocks and bonds is over. And extreme volatility has made trading much more perilous: for some asset classes last quarter it was impossible just to hedge inventory needed to make markets for client trades.

Even in more stable markets it'll be harder to turn a profit in trading. Leverage has been slashed: Morgan Stanley, for example, has cut gross leverage from around 33 times capital at the end of 2007 to 11.4 times. Hedge funds, which provided much of the juice for trading in recent years, are shrinking. And the crisis has added another layer to assessing risks: a bad trade doesn't just mean a loss but could shatter whatever brittle confidence investors and counterparties may still have in a franchise.

Perhaps that's why Morgan Stanley has all but given up on proprietary trading, for now at least. Executives are now turning the firm's focus back to trading for clients, though that still carries risk, as the fourth quarter showed. Goldman's bosses,

meanwhile, are sticking to their risk-taking roots. That, they reckon, should earn shareholders a 20% return on equity over a business cycle. That's five percentage points more than their Morgan Stanley counterparts are expecting.

Hitting either target in 2009 is going to be tough, absent a sudden market boom somewhere. In fact, just about the only units likely to see much growth at either firm are their fledgling retail bank operations. That might give some comfort on funding costs for part of their balance sheets. But in an overbanked market that's hardly a boon for shareholders.

Private equity: Forget old acquaintances

By Lauren Silva Laughlin

The New Year can't come fast enough for buyout firms. The past one saw deals imploding and portfolio companies going bankrupt. It was nearly impossible to sell a company, and cash-strapped investors started whining about capital calls. Problems cropped up throughout the business.

But buyout bosses don't have much to look forward to in 2009. Debt markets aren't likely to rebound much. Restructuring opportunities might pop up, but traditional leveraged buyouts will be scarce and difficult. And many buyout firms have to repair relations with their bankers and investors.

The LBO business has come to a screeching halt. Deal volume fell around 70% in 2008 from the prior year's levels, according to Dealogic. Buyout firms only sold companies worth around \$6bn in the fourth quarter, a tiny fraction of the \$110bn of exits seen in the second quarter of 2007, at the peak of the boom. Portfolio companies started to succumb to the economic malaise and credit crunch. Several big-name LBOs toppled under the weight of their debt and went bankrupt, including Linens N Things and Tribune.

The slowdown in new deal activity was mostly due to the frozen debt markets. This, along with plummeting equity markets, made it difficult to sell portfolio companies. Economists aren't predicting either market will rebound next year. So 2009 deal volumes may be anaemic.

Some private equity firms might try to keep busy buying troubled companies on the cheap. Or they could partner with strategic buyers on mergers. But neither type of deal will keep them busy enough - the buyout firms, along with financial sponsors groups at banks, are already beginning to cut staff.

Even if private equity firms want to snap up distressed companies, they might have trouble getting financing. Their investors are running short on cash. Permira's biggest investor, SVG Capital, recently cut fund commitments by 40%. The largest US pension fund, Calpers, is seeking more liquid investments. TPG is letting investors cut their commitments by 10%. Even so, if other asset classes don't rebound, pension funds seeking to keep their portfolio allocations stable could be forced to sell more buyout investments at big discounts.

Next year may be worse. Valuations of private equity investments tend to lag the market, since they don't need to be marked down quarterly. So investors may endure drastic drops in their portfolio valuations well into next year from losses made in 2008.

Even if things rebound, before a raft of new deals can struggle to market, private equity firms will need to repair their relationships with banks. Lenders took huge losses on loans because of aggressive LBO structures and pricing. S&P Leveraged Commentary & Data pegged LBO loans at only 66 cents on the dollar in late December, meaning there are severe losses on the few deals that remain stuck on banks' books. Some big private equity firms have faced off against lenders in

court. Banks are likely to be much more careful about the terms of the deals they cut going forward.

Fees may also come under scrutiny. Private equity investors suffer losses incurred by funds. But buyout firm managers get rich off the fees they collect for finding and executing deals, as well as for managing investors' money - no matter how unsuccessfully.

Deal fees, in particular, could become a point of contention. Buyout shops collected nearly \$400m, in total, on the acquisitions of Harrah's and Freescale. They typically pay some of that cash to investors, but usually take a piece for themselves. The companies are now headed for trouble. If investors end up losing money on aggressive deals where buyout managers made big deal-fee windfalls, they will question managers' motives and judgment.

Publicly listed private equity firms look even worse off. Their increasingly aggrieved shareholders limit their flexibility. They don't have the luxury of closing shop for a while or making concessions on fees or investor funding commitments. That's in addition to the embarrassment of their battered stock prices.

The financial crisis has taught the buyout barons who strode the earth a mere 18 months ago important lessons in humility. Their education will no doubt continue in 2009.

Nothing ventured

By Jeff Segal

A decade of too much money and dismal performance has finally caught up with venture capital. Now, only a few well-connected firms can raise new funds. This means higher returns for the survivors. But most investors won't have access and funding for start-ups will be tight.

VC firms currently manage some \$260bn, or 14% more than during the waning days of the internet bubble in 2000. The glut of capital raised from investors who came to view VC as its own asset class, rather than as a niche, ensured pitiful returns for a decade. Money was wasted on below-par ideas. Competition was fierce, so promising companies received ludicrously favourable terms. For funds established since 1998, the best performing fund vintage was in 2002 – it returned a measly 5.7%, according to investment adviser Cambridge Associates. Many of the vintages posted negative returns.

Reeling equity markets worldwide have put an end to the cash gusher. Only 55 firms raised fresh capital in the most recent quarter, down 30% from the year before. And firms that were unable to find exits in 2006 and 2007 likely haven't had a single sizable exit since 2000. That could make raising new funds nearly impossible for many firms. Indeed, 96% of venture capitalists expect more firms to fail to raise money next year, according to the National Venture Capital Association.

The industry's best-connected firms still seem to be able to find investors, though. Sequoia Capital, which funded Apple and Google, raised \$930m for a new fund in September. And just last week Accel Partners, the firm behind Facebook and Real Networks, raised two funds totalling \$1bn.

The VC crash will eventually mean higher returns for the survivors. They will have their pick of the best ideas and won't have to enter bidding wars with lesser-known firms.

This won't mean much for most investors. As the number of new venture funds decreases, investors will find it harder to get access. And start-ups will find that, with less competition, money will be harder to come by and deal terms will be stricter. The coming years are likely to be tougher for venture capitalists and the companies they seek to fund.

Governments and banks: Brevity, wit and wisdom

By Richard Beales

Governments aren't used to running banks. But the British authorities control Royal Bank of Scotland and their US counterparts now have more than \$300bn of influence in their banking sector. How should they use their influence, and how will they use it?

The first principle should be: "Brevity is the soul of wit". Chris Cox, chairman of the often rightly maligned US Securities and Exchange Commission, correctly pointed out in a recent Wall Street Journal article that governments need exit strategies from their investments in financial firms.

The longer they stay, the more likely that policy, politics and conflict will creep in. Governments should encourage banks to buy them out as soon as they can afford it. If they haven't done that already, they should make concrete plans of their own to get out. Unfortunately, there's a danger they will outstay their usefulness.

The second basic tenet should be to leave management to a "pilot of very expert and approv'd allowance". Having set basic guidelines for their investments – and perhaps replaced discredited bosses – governments should avoid getting in the way. One example: politicians shouldn't try to force banks to pass the entirety of declines in their borrowing costs on to customers. It's unlikely, however, that they will resist meddling.

The exception should be when banks are abusing the taxpayer money they needed to get through the crunch. The Brits have set clearer parameters than Hank Paulson at the US Treasury. But even if there's some vagueness, the no-no's, until taxpayers get their money back, shouldn't be too hard to spot: they include big foreign acquisitions, hefty dividend payouts, and unrestrained bonuses for top bankers.

Longer term, governments should be out of bank investments – but into more effective regulation. Here, the key is not to be “a hare-brain’d Hotspur, govern’d by a spleen”. Rather than clamping down on everything that looks complicated or leveraged, lawmakers and regulators should work hard to develop stronger, better targeted rules and more effective preventive regulation.

They should keep close tabs on leverage at financial firms. They should consider regulating privately-traded derivatives, probably through central clearing houses, rather than banning them. They should ensure key regulators can observe activities right across today’s interconnected markets. And they need to encourage international cooperation and consistency.

That will require another watchword: “Bristle thy courage up”. Years of negotiation went into the Basel II rules for bank capital. And decades of official recognition have entrenched certain credit rating firms. These and other areas need radical rethinks. That’s much less likely to happen as time dims memories and allows banks to rebuild their finances and lobbying efforts. The sooner governments pull their money out of banks and focus on this, the better.

Au revoir, London

By Rachel Sanderson

The French, Italians and Germans who have thronged to London’s banks and bars for the past decade may look back on December 2008 as the month as the day that their love affair with “la vie anglaise” died. Sterling’s slide to as little as 90 pence against the euro had many of them thinking it may be time to go home.

London’s attractions during the boom years were manifold. It was the world’s leading financial centre offering the greatest opportunities and financial rewards. What’s more, those rewards were paid in sterling – a currency that at its height was worth E1.5.

The trend was also self-perpetuating. The more foreigners that arrived, the more the city changed to fulfil their needs, and the more they felt at home. Even the French learned to like the UK capital. Not for nothing did Marc Levy, the French author, cause a stir in 2006 when he suggested traditional Parisian life was easier to find in South Kensington than the City of Light.

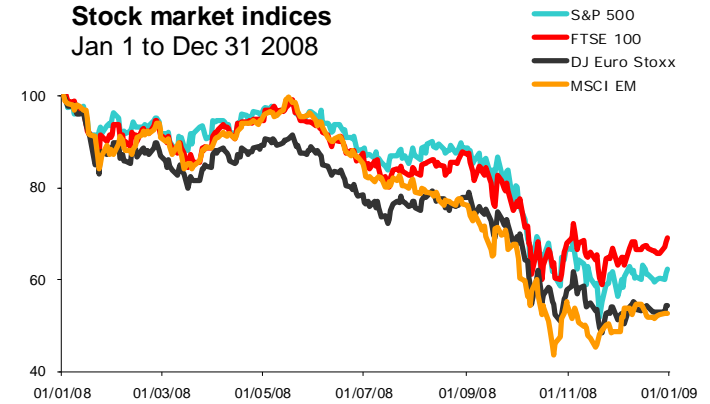
But the crisis is unwinding that vision of a buzzing, continental London. Job cuts, a proposed 45% tax rate for top earners and sterling’s fall means there are now fewer advantages to offset London’s drawbacks, such as: exorbitant prices, a decrepit metro system, inconsistent state healthcare and schooling, and grey, rainy weather. Strengthening the continental pull, unemployment benefit is typically more generous in mainland Europe.

True, London has been struggling with overcrowding. So losing some of the estimated quarter of a million French citizens who lived here at the height of the boom has a benefit for both employment and house prices. But the disadvantages for the city are arguably more profound. Foreign direct investment is worth £52bn to London with around 20% of that coming from European countries, according to ThinkLondon, the development agency. Poles and Australians – two of the largest groups of foreign residents – have already made high-profile exits lured home by stronger economies. More departures will leach funds further and hurt industries that sprung up to serve those communities.

London’s attraction to outsiders created a virtuous circle – the more diversity, the more competitiveness, the more financial success. The risk is that the circle turns vicious. London’s

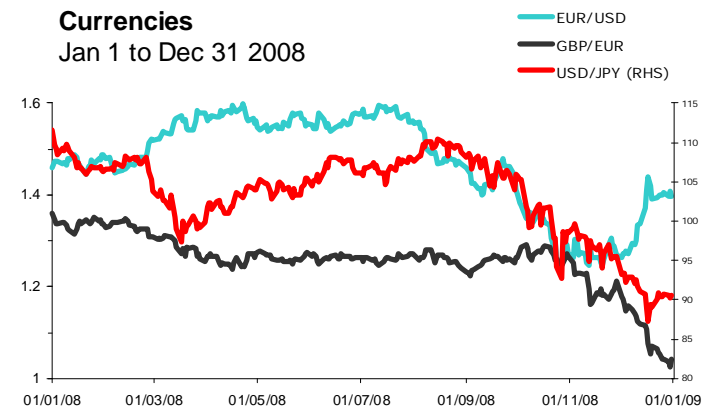
mayor, Boris Johnson, will want to stem the reversal before Americans – London's largest group of investors – also beat a retreat.

Stock market indices Jan 1 to Dec 31 2008



Source: Thomson Datastream

Currencies Jan 1 to Dec 31 2008



Source: Thomson Datastream

The markets

No rush to buy equities

By Christopher Hughes

On many historic measures, stocks are looking attractive. Plunging gilt yields and low returns on cash make them an attractive relative bet too. Equity investors will be worried about missing out on a hasty market recovery. But for now, they can afford to sit on their hands.

Three days after Lehman Brothers collapsed in mid-September, stock markets were in freefall. The world looked so gloomy that some equity investors hailed the week as the so-called "capitulation event" – the painful point of maximum bearishness that clearly establishes the trough of the market. The announcement of the US Troubled Asset Relief Programme arrested the selling.

But by late November, the MSCI World Index and S&P500 had fallen another 35%. Equities had fallen 54% from their October 2007 high, before the worst of the crisis hit.

Equity investors never know when they are at the bottom. But if the market rout prompted by Lehman was a false floor, the rally since late November is proving resilient. As of January 8, the World Index was up 22% from last year's low, touched only seven weeks earlier. The question facing equity investors is whether this is just another bear-market rally, and, if not, how quickly markets will continue to recover.

Bear markets usually last longer than two years. But the latest downturn has been particularly accelerated. And there are multiple arguments why equities have now found their floor.

While higher current dividend yields partly reflect the risk of imminent dividend cuts, the equity yields still look good compared to government bonds and cash, whose yields have plummeted. Cash has never looked so expensive. The equity risk premium is at its highest in a decade, according to Morgan Stanley. Furthermore, corporate insiders, who should know something, are buying at record levels.

Analysts expect the recession to cut corporate earnings in half, including a 10% decline in 2008. But equities appear to have fallen enough to reflect that savage drop. Global equities have not been so cheap on either spot or trough earnings for over two decades, says Citigroup. They are trading on a historic price-earnings ratio of around 11 times. Credit Suisse says historic consensus earnings multiples were an average 15 in the last four market lows.

Stock market history suggests that equity markets recover before bad news from corporations has stopped and while earnings are still falling. Equities can bottom out as early as five quarters before earnings trough, and do so on average after two quarters.

But to be buying now, equity investors need to satisfy themselves of two things. First, that earnings will indeed trough this year. And second, that this time will not be different, even in the face of a global deleveraging of unprecedented intensity.

Neither of those tests is easily satisfied. The risk that recession will become a slump, while not high, persists. The massive government stimulus packages that investors hope will underpin recovery carry risks of their own, in particular if weak currencies create an inflationary squeeze on corporate profits. The financial pummeling could slow the pace of any stock market recovery, even if profits are recovering. There must also be doubts about the new normal price-to-earnings ratio in a de-levered world.

And these uncertainties should be sufficient to keep equities cheap for a while yet.

Dollar leak – or leap

By Ian Campbell

Which currency will be a safe harbour of value in 2009? It is not an easy contest to call. Dollar, yen, euro, pound: each harbour has structural deficiencies and plenty of scope to leak value. But in this contest of inadequate defences, some harbour is bound to prove better.

Recent history teaches caution. In 2008 there was extreme currency volatility and an apparent disconnect between fundamentals and prices. The dollar plunged until August—and then, even as the US economy sank, rallied hard, before stalling in December. The yen powered up, late in the year, from multi-year depths—even as Japan headed towards recession.

The currency fight is not a straight economic one, especially now, in this time of global economic crisis. Deleveraging, forced liquidation, safe-haven flows: these are under-currents, powerful, yet deceptive and not so easily seen.

The dollar, the world's reserve currency still, has on the surface four huge forces against it: the cutting of interest rates to zero; huge boosts to the money supply through so-called quantitative easing; spiralling government deficit and debt; and an external deficit that remains close to 5% of GDP. All these risk sending the dollar to multi-year lows yet again. Were other countries without serious problems, that would be likely—and it may indeed occur. But other factors may weigh against it.

The desperate times for the countries that consumed their way into trouble – the US and UK – are also desperate times for

their suppliers. Germany, the world's biggest exporter, will suffer a big contraction in GDP in 2009 – a fall of 2.7%, according to the Kiel Institute. China, the second biggest, has cut interest rates five times since mid-September and announced a fiscal stimulus of \$580bn. Japan's exports were down by 26.7% in November on a year earlier.

Yet, the yen is close to a thirteen-year high against the dollar, partly because traditionally low Japanese rates are now matched by novel but just as exiguous policy interest rate in the US. But the yen's recent rally is also partly technical. For years speculators borrowed in yen in order to finance the purchase of higher-yielding currencies and assets. They have recently beat a rapid retreat. Once all those carry trades are reversed, the yen could suffer, especially if the Japanese economy stagnates while others show signs of recovery.

For the euro, too, the global trade slowdown brings risks. The European Central Bank has been slow to cut, but as unemployment bites it is likely to follow its peers in Japan, the US and UK in moving the overnight policy rate down to very low levels.

Eurozone economies face their first test by recessionary fire. That may inspire countries which once devalued in hard times – think of Spain and Italy – to think about leaving the single currency. Even vague talk of departures would unsettle markets, undermining the euro's appeal. The ECB's sloth, too, could hurt the euro if recession looks like deepening and persisting. Nor will a strong euro help recovery, especially as the currencies of so many of its important customers are weak.

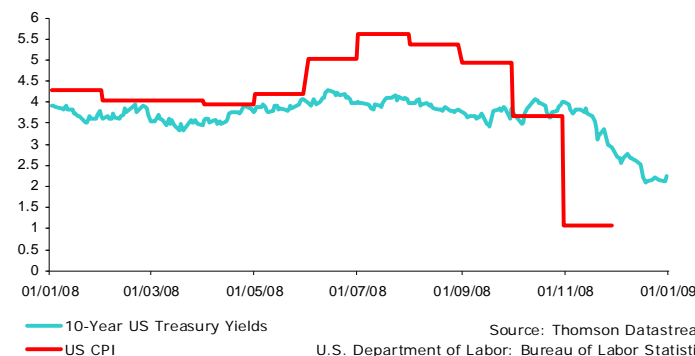
The UK is in that group. Recovery isn't near-at-hand there. The pound has plummeted against the euro and yen – and also the dollar. The UK has all the US's fiscal and monetary deficiencies – but the pound has none of the dollar's reserve status. Its path remains down. Its path remains down. Parity with the euro looks probable. The more challenging question is how close the

pound, worth \$2 as recently August, might come to parity with the dollar.

That suggestion may seem outlandish. But suppose the huge fiscal and monetary stimulus creates a revival of some sort in the US economy. Then the dollar could rise to, say \$1.20 per recession-weakened euro. If the euro has climbed to a value of £1.05, the pound would buy just \$1.14 – not far from parity.

So is the dollar the best bet in 2009? A currency supported by a zero interest rate, a deficit-ridden government and a recession-stricken economy ought not to be. And might not be. The currency risks investors will run in 2009 will again be frightening. Finding a safe currency is almost as hard... as finding a safe bank.

10-Year US Treasury Yields and US CPI
Jan 1 to Dec 31 2008



Treasuries: Bubbling over

By Dwight Cass

Investors nursing big losses on housing or stocks may see Treasury securities as a safe port where they can ride out the rest of the financial storm. But their burgeoning demand looks to have inflated a quasi-bubble in Uncle Sam's own debt. Those buying Treasuries now, at the top of the market, may be setting themselves up for more pain.

Investors' willingness to bear risk has evaporated as they've seen one asset class after another go down the tubes. Even securities that are all-but-fully backed by the US government itself, like the debt of Fannie Mae and Freddie Mac, are being shunned by many of their former big fans – foreign central banks – which are now less willing to bear the small risk that Washington might turn its back on the mortgage giants.

That leaves Treasury securities themselves. The latest flare-up of the financial conflagration late last year caused so many investors to stampede into three-month Treasury bills that it pushed their yields down to just shy of zero. Factor in inflation, and the interest rate on that debt was negative.

Several times last autumn short-term government debt, or overnight loans backed by that debt, actually yielded less than zero – meaning investors were so frazzled that they were willing to take a predetermined loss as long as they could be confident they'd get most of their money back.

Even the longest maturity US government debt – which bears the biggest risk of taking a loss over its three-decade lifespan – has seen its value surge. In the course of one week in mid-November, the yield on the long bond plummeted by nearly a full percentage point – an almost unprecedented move.

The investors, banks and governments scrambling for Treasury securities may find that danger lurks in these erstwhile safe havens. Sure, compared with ploughing into most other types of debt, Treasury bonds look solid. They're serviced by the world's largest economy, in a currency the government can print at will. And signs of a deepening recession – which typically would make Treasuries more valuable – are multiplying.

But even the US government has its limits. Through its plethora of financial rescue schemes, it has committed to providing collateralised loans, debt guarantees and capital injections totalling well over \$7 trillion – and that's not counting the \$1 trillion stimulus package planned by the incoming Obama administration.

Granted, most of that will be paid back, and only a bit over \$2 trillion has already been used. But that alone is about 14% of annual US gross domestic product. Credit Suisse analysts expect the government will have to issue \$1.5 trillion in new debt to fund its financial rescues in the next year.

Despite this, Treasury bond investors may find themselves most at risk if and when the government's massive financial rescue operations start to pay off. If they lead asset prices to stabilise and investor appetite for risk rebounds, money will flood out of low-yielding government debt and into higher-return investments, causing Treasury prices to plummet. Investors' safe haven will become suddenly very perilous.

KISS for bond markets

By Martin Hutchinson

Bond investors have lost over \$1 trillion from investing in complex structures and credits, some of them rated triple-A. They have learned their lesson. Risk-free yields are low, but there will be no repeat of the bubble year's dash for yield in 2009. Instead, expect a flight to simplicity.

The 30-year US Treasury bond offers an unappealing 2.8% yield, close to the record low. In the eurozone, the 10-year yield is 3.1%. Such returns aren't going to please pension funds expecting a 6-8% annual return. Even inflation-protected Treasury bonds are more compelling. In the US, they will beat straight government debt if inflation averages more than 1% annually - well below the experience of any prolonged period since the US left the gold standard.

Bond buyers will be willing to take on more risk in return for higher yields. But they learned two things in 2008: a triple-A credit rating is no guarantee of credit quality and incomprehensible credit structures cause trouble in a downturn. As losses on existing bonds pile up, buyers will seek credit simplicity. That means straight debt or perhaps a little "plain vanilla" securitisation - structures of homogenous and well understood assets.

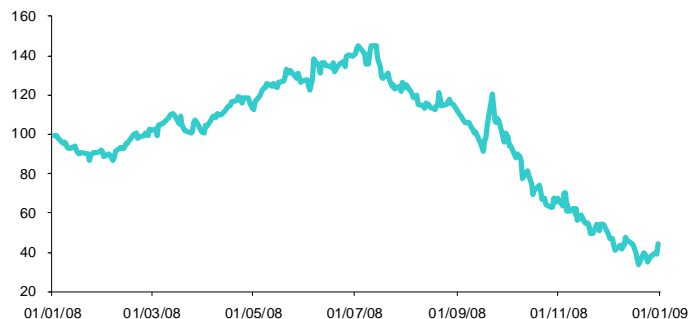
Corporate bonds investors will favour solid companies: those with recession-resistant businesses, strong balance sheets and no recent history of over-expansion. Financial services businesses may have a harder time raising debt on their own, but government guarantees will help smooth the path. Broadly diversified companies will be avoided, since their behaviour in a hostile environment is unpredictable.

For sovereign debt, the countries in favour will have little political risk and broadly diversified economies, as well as

governments that are unlikely to indulge in expensive stimulus packages or bank rescues. Triple-B rated Brazil fits that bill, and it even appears to be avoiding recession through domestic growth, not to mention high real interest rates that can be cut if necessary.

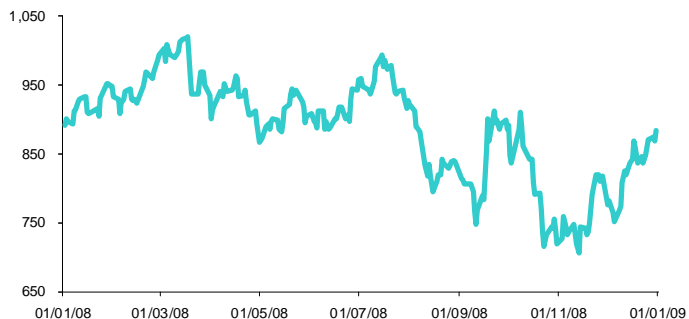
The new bond market in a single phrase: Keep It Simple Stupid.

NYMEX-Crude (\$/barrel)
Jan 1 to Dec 31 2008



Source: Thomson Datastream

Gold (\$/ounce)
Jan 1 to Dec 31 2008



Source: Thomson Datastream

Oil: Sticky supply, slippery demand

By Fiona Maharg-Bravo

Saudi Arabia, Opec’s most influential member, is targeting an oil price of \$75 a barrel. It’s not likely to reach that goal in 2009.

A year ago, oil was around \$100. Some prognosticators expected the price to rise a lot, and some looked for a sharp fall. Both were right. The price per barrel first shot up to \$147 and then fell back vertiginously to \$40. It’s enough to make anyone give up the prediction game.

That game is particularly tough in oil because the price isn’t set simply by the traditional factors of supply and demand. Financial flows, including foreign exchange and availability of credit, play an important role.

The supply dynamics seem to support a case for a higher price. Opec, the oil cartel, says it will implement a record-busting 4.2m barrels per day cut in the supply of oil – about 4% of the world’s total. If they follow through on their commitment, analysts believe it would lead to a shortage of about 1.7m – 2mbpd in 2009. In theory, that would boost the price, perhaps close to \$75 a barrel.

The problem is that Opec may not follow through on its cuts. True, the cartel claims it has already cut 1.7mbpd of the initial 2m it pledged in September. But cutting another 2.2m on top of that is a tall order for strained Opec governments.

On the demand side of the equation, the arrows point downward – to lower prices. The global recession has already hit demand, especially in the US. The US accounted for 80% of the overall fall in demand from OECD countries in 2008, according to Barclays Capital. And oil thirst is likely to get weaker from here. The more pessimistic the economic forecast,

the lower the oil price. It could easily drop down to \$30, but supply cuts should bring it above that level by year-end.

Then there are the financial factors. When money was easy, oil purchasers – both consumers and investors – had enough cash to push up the price. A weak dollar made oil especially attractive to buyers with other currencies. But when the financial turmoil forced many hedge funds to make massive redemptions, they sold heavily, pushing the price down at a furious pace.

Credit conditions aren't likely to get much easier in 2009. Even if banks start lending more, oil won't be an early beneficiary. After the 2008 debacle, it will take some time before commodity funds come back into fashion.

With supply sticky, demand down and credit scarce, the Saudi \$75 target looks out of reach for a while. But with governments creating money as if there were no tomorrow, there's a risk that inflation will eventually come back in a big way. Oil, a tangible asset, could look like a safe investment – and once more outperform.

Gold: The bubbliest bubble?

By Martin Hutchinson

Huge government deficits, low interest rates and rapidly growing money supply all add to the likelihood of renewed inflation - and a rising gold price. How high? Very.

The US money supply grew slowly for a while in early autumn, but in the two months to December 1 the St. Louis Fed's measure of Money of Zero Maturity increased at an 11.7% annual rate. That's a return to the trend that lasted from 1995 to 2008, when MZM grew 3.6 percentage points faster than nominal GDP.

The US is not alone. Around the world, governments have implemented large "stimulus packages". If the corresponding borrowing is not to crowd out the private sector, it must be financed by money supply creation.

That monetary expansion is not supposed to be inflationary, since the governments promise to take any money away before it can push up prices. Investors can be forgiven for scepticism. Higher inflation is at least possible once the global recession bottoms out. Gold provides good insurance.

Demand for gold from investors has increased rapidly in 2008, despite a falling price since June. The dollar value of gold demand was 45% higher in the third quarter than the second, and 51% above the previous year, according to the World Gold Council. Supply has failed to keep up, with mine output up only 2% from the previous year and central bank sales down sharply.

Gold's economics are truly mysterious; the commodity demonstrated negative price elasticity in 2007, when a higher price produced increased demand. Nevertheless, weak supply, strong demand and valid fears of inflation constitute a perfect mix of ingredients for building a gold rally. Any surge into gold by hedge funds and other speculators could overwhelm the market, turning the rally into a bubble.

In January, 1980 - just before the Fed led the world out of an inflationary catastrophe, the gold price peaked at \$875. That is \$2,430 in today's dollars. But the pools of speculative capital are much larger now than in 1980. A true gold bubble could well leave this benchmark far behind.

Emerging markets: It comes down to money

By Martin Hutchinson

Capital availability is the key question for emerging markets in 2009. Those who have it should do well. As for those who don't - it may be better not to ask.

Next year isn't going to be easy for the developing world. Lower commodity prices and slumping Western economies will damage growth. But with the United States, western Europe and Japan all in recession and unlikely to emerge quickly, whatever growth there is in the world - not much - will be concentrated in emerging markets.

Domestic momentum, high savings and relatively clean banking systems should allow some countries to flourish. China, Taiwan, South Korea, Malaysia and Brazil, for example, don't rely heavily on foreign capital and have large reserves of foreign currency -- Malaysia has a savings rate of 37%. They can stimulate their own economies and to pick up bargains elsewhere. Continued growth in China and India, even at lower rates, should keep commodity prices from total collapse, providing support for primary product exporters.

But life will be hard for countries that need to borrow. Spreads on emerging market bonds, according to the J.P. Morgan EMBI Global index, have trebled since January. For countries with junk credit ratings it's hard to get new finance at any price. Further, emerging market stock markets have suffered greater price declines than rich country markets, so foreign buyers of new shares have also largely disappeared.

Emerging markets with large current account deficits are especially vulnerable, even if their total foreign debt is moderate. Until June, these countries benefited from enormous inflows of foreign capital, so that even export success story Vietnam ran a trade deficit of 30% of GDP. Such gaps create

economies that are seriously out of kilter. They now have to find a better balance - in a hurry.

In the old days, the International Monetary Fund would ease the pain of transition. It is trying again, with bailouts agreed or expected in Ukraine, Hungary, Iceland and Pakistan. But the Ukrainian experience - the funds have been nearly exhausted in a few weeks - suggests that the cash drain may be too great for bailouts to be effective.

The leaders of the borrowing countries will be busy fighting off troubles in 2009. But if they have a few spare moments, they might spend them contemplating the rewards harvested by their more prudent brethren.

US stock selection: Enriched by the poor

By Rob Cox and Aliza Rosenbaum

There's money to be made from poverty. That may sound uncharitable. But the fact is, when people lose their jobs, buy cheaper goods and default on their loans, someone has to do the dirty work - and can get well paid for it.

So we at breakingviews.com present the Poor Getting Poorer Index - a basket of 22 equal-weighted stocks that includes the retailers, white-label manufacturers, repossession agencies, loan-sharks, dollar stores, pawn shops and other public companies poised to capitalise on rising poverty. This year the index would have generated a positive return of some 9%, besting the S&P500's 40% decline.

Back in 2005, Citigroup equity strategists coined the term "plutonomy" to describe economies powered by a relatively small number of rich people, and devised their own basket of luxury stocks like Bulgari, Porsche and Sotheby's. Now, with unemployment spiking and wages weakening, the downward financial mobility of the American consumer seems a better bet than the ascent of the gilded class.

So where is gold to be dug from the widening mire? Let's start with retailers. After all, notwithstanding the economic situation, shopping is an American pastime. But splurges at the fancier department stores that anchor malls are being replaced by carefully choreographed outings to discounters.

Among them, Dollar Tree and Family Dollar place great emphasis on how far a single greenback can go. Though Dollar Tree has already seen a 60 percent gain in its shares, the stock trades at a relatively low 15 times 2010 fiscal year earnings estimates. Family Dollar fetches just 14 times next year's earnings and has risen by a quarter.

Not all discounters have performed as well, however. Big Lots, which sells leftover inventory at cut-rate prices, is down 8 percent this year and recently reduced its earnings guidance. But trading at just around 8 times earnings, it's advertised as a bargain. Similarly, shares of members-only BJ's Wholesale Club have been flat this year. But its focus further down the socio-economic chain could give it an edge over rivals.

Of course, in retail it would be foolish to ignore Wal-Mart, whose motto is after all "Save Money. Live Better." The retailer's market share gives it an unrivalled heft in cutting back suppliers' prices. Outgoing Wal-Mart chief executive Lee Scott recently noted demand for food storage items and frozen goods rising, a sign that Americans are choosing to stay home rather than eat out.

That trend may benefit fast-food restaurants like Burger King, Jack in the Box and McDonald's. At the latter, a single \$4.09 deluxe breakfast provides nearly half of an adult's daily recommended caloric intake. Similarly, when buying food for home, generic brands made by Ralcorp, or Campbell's canned soups, are more likely to crop up on thriftier shopping lists.

Of course, even in a bad economy, people need to have fun. Pricy movie tickets can be replaced with a \$14 monthly Netflix subscription that provides two CDs at a time with no monthly limit. And though leisure travel will take a hit, discount carriers like JetBlue will attract those willing to take 3 a.m. flights from obscure airports.

For the unemployed, retraining will be the buzzword of 2009. And there's a good chance that federal money will be channelled their way. That could help publicly traded online educators like Apollo Group, Strayer Education and DeVry. As a result of high projected growth rates, all three sport price-to-earnings ratios above 20 times consensus forecasts, representing hefty premiums to the overall market.

All of the aforementioned members of breakingviews' PGP index are mainly the beneficiaries of consumers trading down. But there are others that prey on poverty and thrive on desperation. None are household names - at least not yet. Rent-A-Center and Aaron Rents lease appliances and furniture to the down and out.

America's Car Mart specializes in selling cars to buyers with poor credit. EZCorp runs a chain of pawn shops and Cash Store offers payday advances. And once consumers do default, there's money to be made as well. Portfolio Recovery Associates collects and manages portfolios of defaulted consumer receivables. So even on the lowest rung of the American economic ladder, enterprising companies find ways to profit.

(The prices in this piece are as of December 29 2008)

That's so 2008

By John Foley

The financial crisis of 2008 was full of surprises. Among the most stupefying were the tales of financial wheezes people thought were a good idea during the preceding bull market. More will surely emerge as gallons of toxic waste slosh out of banks and hedge funds in 2009. While waiting for the full inventory, here are seven we hopefully won't see again.

1 PIK toggles

These debt features were popular in 2007 – but it wasn't until 2008 that toggles started to get flicked. "PIK" stands for payment-in-kind, and means issuers can substitute more bonds for actual cash interest payments whenever they want. Sometimes the "rate" goes up when the toggle is switched. That's cold comfort when it becomes apparent the bonds aren't

worth anything like face value because the company is going to the wall. The high probability of which, it should be noted, is why the issuer put in a PIK toggle in the first place.

2 Minibonds

Retail investors in Asia hoovered up minibonds earlier in 2008, attracted by the fact these instruments, supposedly backed by a line-up of "safe" banks, had a higher than normal yield and were available in small amounts. The catch? They weren't bonds at all, but derivative products, some of which had Lehman Brothers as a counterparty. Investors were effectively paying for Lehman to insure its own portfolio. When Lehman cracked, so did thousands of nest-eggs.

3 Contingent value rights

CVRs help fudge the fact that a buyer and a seller can't agree on price. The buyer simply gives the seller a CVR, or an option on the spoils if the buyer's investment does well. KKR used a twist on the theme when it delisted its European arm, giving shareholders new US-listed stock and a CVR. There are two things wrong with these devices. Either they cripple issuers when payday arrives. Or they prove virtually worthless, thanks to reams of small print. Too clever by half.

4 Accumulators

The accumulator – known waggishly as the "I-kill-you-later" – is a device used to hedge cross-currency transactions. It limits the amount of profit the holder can make, but not the losses. That makes it cheap – and dumb. Citic Pacific lost \$2bn on accumulators when the Australian dollar fell hard. The normally staid conglomerate hadn't just hedged, but made a giant speculative bet. Citic Pacific was effectively taken over by Chinese parent Citic – the ultimate slap on the behind.

5 Cash-settled options

These options, which pay out in cash rather than actual shares, aren't new or bad. But in Germany they became a battering ram for corporate raiders. Schaeffler, a ball-bearing firm, used cash-settled options to seize control of Continental, a car-parts maker. These options don't need to be disclosed in Germany – even though the holder can, in practice, easily get the underlying shares. Germany hasn't outlawed this practice. But the fact Schaeffler is now buried under a mountain of debt should discourage imitators.

6 Debt accordions

These provisions in some loans let the issuer expand them later – like an accordion – to let in new investors. During the crunch, subordinated investors in a couple of leveraged companies got a grim ultimatum: slide into the accordion on the company's senior debt and take a big haircut, or end up with peanuts if the company goes bust. Senior lenders, meanwhile, faced the prospect of fighting for scraps with the newcomers if things really went wrong. Accordion facilities are thus as painful to the pocket as their musical counterparts are to the ear.

7 Ponzi schemes

Take money from Peter. Wait a bit, then take money from Paul. Use Paul's money to pay back Peter, proclaim your stupendous rate of return, rinse and repeat. The Ponzi Scheme, named after 1920s-sheister Charles Ponzi, reached new heights in 2008 with the discovery of a \$50bn alleged fraud by financier Bernard Madoff - who somehow duped the world's biggest and most conservative investment banks. These kinds of fraud are unlikely to die out in 2009. But the epithet may. Investors will now be looking out for the "Madoff Scheme" instead.

Three key countries

UK: boomed – and bust

By Ian Campbell

The UK faces recession in 2009: that is clear. What remains up for debate is whether the recession will be short and shallow or deep and long drawn out. The answer, almost certainly, is the less happy one: the UK is heading down, towards a contraction in GDP of about 2.5% in 2009, and is likely to stay down for a very long time.

It is not just that reduced credit and falling house prices are removing the bubbly dynamism the UK once enjoyed. The country's problems go deeper and recovery is therefore going to take a long time.

The downturn's roots lie in the housing upturn. Soaring house prices created a "wealth effect" as consumers tapped into their housing equity to borrow and spend. According to the Bank of England withdrawal of equity from housing amounted to £50.2bn in 2006 – adding about 6% to consumers' after-tax incomes.

But falling house prices are having an opposite, negative wealth effect. Consumers' balance sheets are damaged. So are those of the banks that lent to them. These trends have not yet run their course. Tightening credit, cowering consumers: these will people the UK's outlook in 2009 and 2010.

So will the growing ranks of the unemployed. Unemployment is what economists call a lagging indicator, yet it has already risen sharply, early in the UK's downturn. In November the total number of unemployed rose to 1.9 million, or 6% of the workforce, the worst since June 1999. It will rise much higher in

2009, probably to a total of about 3 million workers, about 10% of the workforce, and is unlikely even to begin to stabilise before 2010.

This dreadful prospect will worry the government and the Bank of England. Each is resorting to extreme and even experimental use of its policy instruments. The extent to which the instruments will work is in doubt.

The seriousness of the UK's plight is illustrated by the fact that in January the official interest rate will probably go well below 2%, and therefore to the lowest level in the Bank of England's 300-year history. Nor is that likely to be the end. An interest rate of below 1% or even zero is very probable as soon as the first or second quarter.

Not even that may be enough to provide reassurance that the downturn will not go on deepening. There is therefore a growing possibility that the bank will follow the US and take exceptional "quantitative easing" measures that seek to increase the money supply and assume direct influence over longer term interest rates. But the Bank of England's efforts to expand the money supply and credit will be battling against banks' reluctance to lend – and consumers' reluctance to borrow.

Borrow and spend is what the government is already doing. It borrowed £56bn in April to November 2008, almost double the level of a year earlier. Its already alarming projections – of a fiscal deficit of 8% of GDP and leap in government borrowing to £118bn in 2009 – look conservative. The UK's fiscal deterioration is astonishingly fast – and deep.

All this means that public debt is set to soar in a manner that may deter foreign investment – and trouble Britons, too. Unease about the government's fiscal position and the expectation that large tax increases are ultimately inevitable may make Britons unusually cautious spenders for years to come.

What both government and the Bank of England will be seeking to do is substituting for private spending and private credit. But the UK requires another, perhaps still more difficult substitution. The finance sector has been its big player in recent years, the leading source of growth, growing by 23% in 2003 to 2007 while overall GDP rose by 11%. Capital flows, meanwhile, offset a trade deficit that widened to £47bn in 2007, with spending on imports rising twice as fast on earnings from exports in recent years.

Now finance is set to shrink. A nation that has lived on financial services, asset price gains, high consumer spending and imports (cheaply bought with the mighty pounds) needs to adopt a new, healthier lifestyle, exerting itself in production and exports.

But in the third quarter of 2008 the UK's manufacturing output was only 2.9% higher than in 2003. During the years of the UK's housing boom manufacturing barely moved ahead. In the UK and global downturn, however, it has swiftly retreated: in October output was 4.9% lower than in the previous year.

All of which points to the need for a still weaker pound. In a depressed global economy in which selling anything will be difficult, the impoverished UK needs to be cheap to work its way out of the mess into which it has slid.

A decade after its chancellor, now prime minister, promised an end to boom and bust the UK has had a housing boom, is bust and is unlikely to be able to pick itself up again for some years to come.

UK: Déjà vu all over again

By Michael Prest

The ghost of crisis past is stirring in the UK. The International Monetary Fund's humiliating 1976 rescue scarred a generation. As the country plunges into recession again and investors desert the pound, a new generation may be similarly marked. The scars could be even deeper this time.

By December 1976, the time of the IMF standby agreement, the UK economy was on the rocks. The official papers reveal an air of elegant panic, much as contemporary papers probably will. Denis Healey, the chancellor of the exchequer, left his office for Heathrow to attend an overseas meeting but, as sterling nosedived and foreign exchange reserves evaporated, was called back before he reached the airport.

Bereft of alternatives, the Labour government agreed to borrow Special Drawing Rights 3.36bn or about £2.3bn from the IMF. It was the biggest loan the Fund had ever made and twice the size of the previous biggest loan – to the UK in 1967. The crisis was one of the lowest points in the UK's post-war history.

Yet the parallels between 1976 and now are disturbing. Then the public sector borrowing requirement (PSBR) was 9% of GDP; today, the budget deficit for 2009-10 is projected to be 8% and may well be higher. In less than two years, the pound had fallen by a third to \$1.46; it has suffered broadly similar depreciation against the dollar and the euro over the last two years.

Then there was borrowing. Domestic credit expansion – roughly bank lending to the private sector – was racing ahead at an annual rate of 24%; the UK has indulged in another orgy of borrowing in recent years.

True, there are differences. In 1975, wages increases were exploding at 30% a year; today, the figure is around 3%. Then, inflation was 25%; now it is a tenth of that. But if inflation is less of a problem, trade is more of one. The current account deficit was 1.7% of GDP in 1976; today it is around twice as high.

In return for the IMF loan, the UK agreed to stringent conditions. The PSBR was to fall to 5% of GDP in 1978-79. Domestic credit expansion was meant to decline from £9bn in 1976-77 to £6bn in 1978-79. The balance of payments was slated to swing from a £1.02bn deficit in 1976-77 to a surplus of £2.88bn in 1978-79.

This programme was to be implemented over the two years to 1978-79. It was hoped that clear, credible and published objectives over a specified period would reassure investors and begin to restore international confidence – probably the opposite of what the government's pre-Budget statement achieved in November 2008.

The basic strategy in 1976 was deep cuts in public spending designed to bring down inflation, encourage domestic investment and boost export industries. But the central problem – then as now – was the weak global economy which undermined UK exports even though the pound had depreciated. Slashing public expenditure amid rising unemployment – then as now – was also difficult.

The government tried to square this circle by protecting investment in export industries. As part of the IMF programme, it raised taxes on tobacco and alcohol and committed the extra revenue to increase interest rate relief for industrial investment. The government also planned to sell its stake in the company then known as British Petroleum.

It is very likely that a future UK government will have to go down the same path of squeezing public spending and reducing borrowing – and even selling the few spoons left at the back of

the drawer. But other tools used in 1976 are either no longer available or much harder to wield.

In 1976 the government also sought to improve the UK's competitiveness by strong-arming "voluntary" wage restraint in the private as well as public sector through agreement between the government, employers and trade unions – a long-defunct form of corporatism.

The IMF was particularly concerned about the UK's inability to control money supply growth. In 1976, M3 was expanding at an annual rate of 12%. Clamping down on public spending was part of the answer. Another part was imposing a supplementary special deposits scheme on banks, effectively quarantining cash. Today the government is urging banks – amid somewhat mixed messages – to lend more.

The government also hoped that growing North Sea oil revenues – now diminishing – and import controls – now impossible in the European Union and under international trade agreements – would repair the trade balance. A capital account deficit – despite heavy investment inflows to finance development of the North Sea – could be reduced by relieving the burden of the sterling balances, such as those held by Nigeria. That imperial remnant has long disappeared.

Anticipating present orthodoxy, the UK committed itself to a flexible currency regime, while emphasising the importance of a rate which stimulated manufactured exports – a concern which subsequent UK governments have largely ignored.

Compared with 1976, the UK's armoury seems depleted. Defending currencies in modern open markets is largely futile. Above all, the IMF does not have the resources to lend as much proportionately to the UK. Without these tools, the government budget and the currency are likely to bear even more pain.

The 1976 crisis discredited the Labour government, paving the way for Margaret Thatcher's election as prime minister three years later. The present UK government could find itself in the same bleak position.

China: Unlucky lucky number

By John Foley

Eight is an important number in China. Its association with good fortune makes it a big hit for licence plates and mobile phone numbers. It's no accident that the Beijing Olympic Games opened on the eighth of the eighth, 2008. But the number has another significance. If GDP growth falls below 8%, say some, China's masses will turn the country into a simmering cauldron of unrest.

That thesis has been bandied about by politicians and economists for years. But it could soon be put to the test. In 2009, China's growth is expected to fall to 7.8% according to HSBC economists, from almost 12% in 2007, driven down by the collapse in China's exports to the crisis-wracked developed world.

Social unrest is a rising threat in China. Recorded incidents increased almost eight-fold between 1994 and 2005 – after which the government stopped giving comparable data. When growth fell from 11% to 4% in 1989, ugly protests erupted. While the state apparatus has been tolerant of recent peaceful sit-ins by factory workers, co-ordinated action might leave only two options: impose order the hard way, or renegotiate the terms of government.

Fortunately, the "theory of eight" is probably wrong. What really matters isn't how much China's growth falls, but what happens to unemployment. The two aren't perfectly linked. A collapse in capital-intensive industries, for example, would have less of an

effect on jobs than a more modest decline in lower-value, labour-intensive work. Besides, unemployment isn't the only reason the masses complain. As they become more prosperous, they are more likely to protest about non-economic issues such as pollution and corruption.

What's certain is that unemployment is rising. Urban joblessness is already at 9.4%, according to the Chinese Academy of Social Sciences. The real figure may be higher, and the official national unemployment figure of 4% is almost certainly too low. Export sectors alone account for around 50m employees, according to HSBC estimates – and around 4m were laid off in 2008.

Meanwhile, economic volatility – which may have more impact on the lives of China's masses than any single number – is rising. A stable economy rests on two pillars: consumer and government spending, which tend to move slowly – say one or two percent a year. But 51% of China's growth comes from investment and exports, which can fluctuate by tens of percent a year. Huge falls in the equity and housing markets add to a sense of rapid, uncomfortable change – especially in a country only three decades into its modern economic history.

Can China manage this tricky period? Its almost miraculous economic achievement until now suggests it can. Government plans to spend Rmb4 trillion will help. If just 40% of that is new money, it should lift GDP growth by around 3 percentage points in 2008 and 2009 – though that's already factored into the 7.8% growth estimate. If implemented fast enough, it will absorb masses of workers into meaningful employment, in coastal cities and in the rural interior.

The question is what happens after the stimulus. At best, China will use the giant spending spree as a prophylactic against discontent, while managing the transition to a broader consumption-led economy – where widespread, stable employment means the risk of unrest is systemically reduced.

At worst, it will be no more than a stopgap, until US demand picks up again. Finding the better path will be China's big challenge in 2009 – and it has nothing to do with luck.

Russia: Road less travelled

By Pierre Briancon

Russia has the choice. 2009 will be the year of the declining rouble, fast-slowing growth, budget and current account deficits, increased poverty and social unrest, and western investors' continuing mistrust. Yet, faced with the serious possibility of an economic meltdown, the Russian government will still be faced with a simple alternative.

It can stop all attempts at reforms, extend even further the state's control over the economy, keep spending reserves and allow a corrupt judicial system to trample on property rights. But it can also use the Russian economy's current woes as a unique opportunity to keep pushing for the major structural reforms the country needs.

The bad news is that Russia is facing the worst crisis in a decade. The good news is that so far, its government has given no sign that it wants to go back on the main achievement of the last ten years: its opening to global markets.

Vladimir Putin, the strong man of Russia who currently rules as prime minister after ten years as president, knows the potential dangers of a major economic crisis. Russia has a tradition of regimes collapsing under their rulers' economic incompetence. The Soviet Union, which Putin served as KGB officer, disintegrated because it was bankrupt. And in the late 1990s, Russia's new democratic government led the country to insolvency, which helped ease Putin into power.

Russia in 2008 was hit by a triple-whammy. First, the liquidity crunch hit hard, as Russia's economy has been mostly foreign-funded, its own domestic financial system being too small and inefficient. Second, free-falling oil prices put a brutal end to the boom years: at around \$35 dollars a barrel, oil trades at about half what Russia would need to balance its budget and current accounts. Finally, the Russian government's own blunders – most notably the Georgia war - scared foreign investors.

The Kremlin reacted swiftly to the crisis, coming up with a \$200bn package to refinance over-leveraged oligarchs, help banks avoid bankruptcies, all the while trying to manage a slow and steady decline of the rouble.

Foreign capital won't flow back to Russia in 2009, at least not in the first half of the year. And oil prices don't look like they will recover to anything like the \$100 a barrel seen at the beginning of 2008. But at least the government has so far abstained from costly mistakes.

Even better, the Bank of Russia could even use the crisis to engineer a major restructuring of the financial and banking sector. Banks will disappear and merge, and the central bank could help speed up the process by raising capital requirements. Russia doesn't need 1200 banks. It needs much fewer, much better ones. The authorities could even encourage some foreign players to take over a few retail institutions.

The second silver lining is that Russia can still afford to buy time. It ended 2008 with about \$450bn worth of hard currency reserves. Much has been made of the \$150bn spent since August on fending off the crisis and defending the rouble. But the shrinking of reserves in 2008 was less than 5%.

The Russian economy is heading to a hard landing in 2009, with growth slowing down to less than 3% after years of 7-to-8% expansion. The government will have to pay a steep price for failing to diversify and modernise the economy in the decade

when booming oil prices made that possible. If the Kremlin doesn't seize the opportunity to enact major reforms, 2009 will be the year when Russians will realise that high oil prices, not Putin's policies, were the main reasons for their past prosperity.

A closing thought

Looking back at 2009

By Pierre Briannon

Investors and politicians may wish to rejoice at the string of good news that caught them by surprise in the last three months. But as the year 2010 dawns, euphoria would be misplaced. While the world economy is finally picking up, there is still a long way to go before the bill of past excesses is paid in full.

2009 was a strange year. The recession in the first half was worse than most economists' worst expectations. Stock markets sank down another 20% in the first weeks of the year and then established what came to be called "the long bottom". But the world economy rebounded strongly in October, once more surprising economists. It seems companies and banks decided the worst of the massive deleveraging was over. Stocks rallied enough to close the year up 10%.

Let's look back at the 2009 roller coaster. It started with the great hedge funds debacle of January. Then there was the Valentine's Day massacre in Vladivostock, when Russian Special Forces brutally suppressed a peaceful demonstration. The weekly Saturday Protests about higher duties on imported cars had gradually evolved into calls for the resignations of Vladimir Putin, the prime minister.

Barack Obama, the new US president, responded sternly by suggesting that Russia had a way to go before it could "share common ground" with the world's democracies. The result was a major geopolitical crisis, adding to the tense stalemates in Gaza and the Indian subcontinent. Commodities prices started rising, with oil ending the year at \$70 a barrel.

But disaster was avoided. And while the world fretted, the seedlings of recovery were about to push through the ground. The "trillion-dollar plan", as Obama's stimulus was hastily christened, boosted both spending and confidence.

The political twists and turns have been even more dramatic than the economic. Barack Obama is now one of the veterans in the world leaders' club. Angela Merkel was ousted in Germany after a slow response to the sharpest recession in two generations. Franck-Walter Steinmeier, the new German leader, could share stories with David Cameron, who replaced Gordon Brown. The former UK prime minister was foolish enough to call an election in June, but UK voters held him responsible for the fall of the pound, which closed the year worth only 80 euro cents. And they couldn't forget that Brown for the best part of ten years had been the chief cheerleader of a splendidly unregulated City.

Other European governments didn't fare much better in the polls, with ruling parties soundly defeated at the European parliamentary elections in June.

The new leaders can look forward to world growth of 3% in 2010, according to the latest forecasts from the International Monetary Fund. But they shouldn't go back to ruling as usual. Western leaders must work hard to persuade voters and markets that newfound growth doesn't portend a return to the days of unfettered enrichment. Governments must dedicate the proceeds of growth to paying down the debts amassed during the time of unchecked spending that started in late 2008.

Their task will be made easier by the profits made from privatising most of the banks that were nationalised during the crisis. But they will have to run surpluses for several years, while negotiating the end of global trade imbalances. Challenging times are still ahead.

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