

** Not worth hanging on*

4 October 2008

- **We are returning to a significant underweight position in equities. Credit markets are worse, not better and the real economy is deteriorating fast. Any rally based on the passing of the Paulson package or from coordinated central bank interest-rate cuts will be short-lived.**
- **We remain short the euro versus the yen and long gold for now.**

We went overweight equities in mid-July. They stayed pretty flat until the September crisis, when they fell back sharply (Figure 1).

At the moment of maximum meltdown, we told clients not to sell equities and to wait for better news. But there is none. So we are returning to our maximum bearish stance, in the full knowledge that we may miss a rally, but not the depths of the bear market to come.

We have no other risk asset positions that are not already at maximum bearish. In currencies, we remain short euro and long yen and gold — and those calls have worked well.

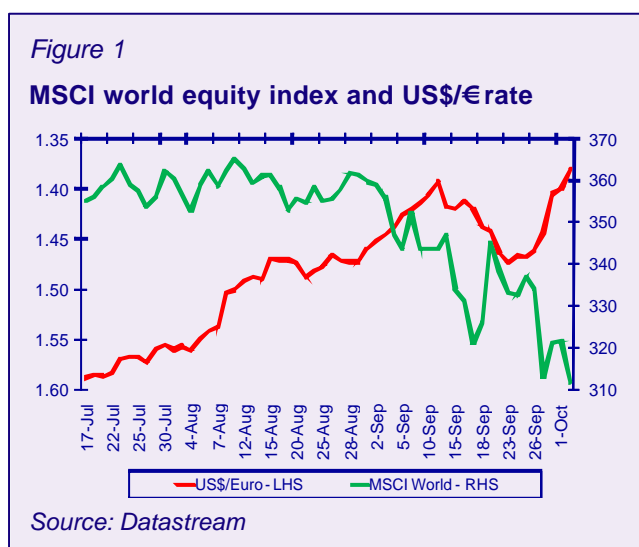
We are deeply pessimistic about the future of the dollar, but we are waiting to go short until the technical underfunding of the liquidity-starved non-US

banks is less pronounced. Currently, this is forcing them to sell non-dollar currencies to buy dollars, despite the generous credit lines extended by the Fed to other central banks. That, rather than any relatively better growth prospects, is what is sustaining the dollar temporarily.

Things have got worse more quickly than we expected. The ‘second’ Paulson package is even more stupid than the first, demonstrating that it is possible for humans, but not dogs, to have an inverse learning curve. It does nothing to write off the dud assets of banks in a meaningful way, close the hopeless and refinance (through temporary nationalisation) those institutions worth saving, while wiping out existing shareholders and management.

The package continues to bail out banks at unrealistic prices and potentially their borrowers too, who need equally to be punished for over-borrowing and over-consumption, if the underlying causal flaws of the credit cycle are to not to be repeated.

There are a few reasonable additions, like increasing deposit protection, but most additions are just yellow populist ‘post it’ notes stuck onto the face of the original. It will make the banking problem worse, fail to solve the distrust issues that have frozen money and debt markets and deepen credit contraction and the global recession. The best that can be said of the Bush regime is that it is exiting history with a big (destructive) bang rather than a whimper.



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INDEPENDENT STRATEGY

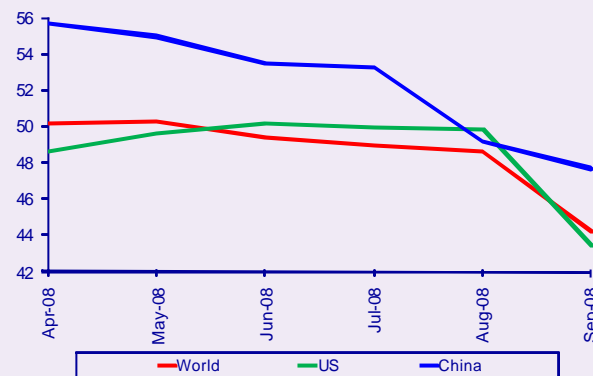
The news on economic activity globally is disastrous. Purchasing managers indexes (PMI) everywhere are falling off a cliff (Figure 2). And that includes emerging market PMIs like China's — a solid tombstone for the absurd theory of decoupling.

We had expected the major global central banks to see the light and initiate coordinated interest-rate cuts. We were wrong. The ECB may have debated rate cuts at its meeting yesterday but jaw-jaw is no substitute for action when the house is burning down, as every leading economic indicator in the Eurozone says it is. Of course, this merely delays the inevitability of coordinated rate cuts, but it now looks at least a month way. The Fed is likely to go it alone and cut first.

All of this points to a continued freeze of credit markets, more insolvencies and a worse global economic recession. It is no time to bet on an optimistic outcome of misguided and tardy policy reactions.

Figure 2

World PMI indexes



Source: JPM, CLSA, Datastream