Collins Stewart
Wealth Management

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Fear and Greed

From Capitol Hill to investor capitulation

If there is a single message we would like to convey as a result of the market dislocations of the past few days it is this – please don't panic. If you would like to adjust your asset allocations, or risk positions, now really isn't the time. Recent market dislocations have been largely sentiment driven with implied equity market volatility closing yesterday at it's highest ever level (see Figure 1). This reflects investor uncertainty, or capitulation, in the face of macroeconomic risks captured in the hopes, and then fears, surrounding the Paulson/ Bernanke Plan. We also suspect a quarter-end window dressing dynamic at play here too - capitulation.

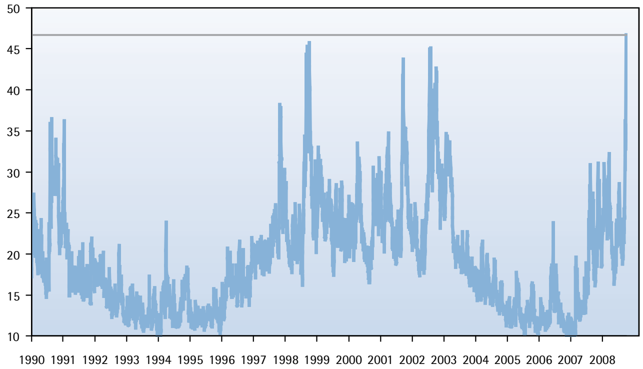
"Too late to panic. The Paulson plan has been delayed not abandoned"

"markets have over-reacted"

"The all time high in VIX (implied volatility) has driven up the price of put protection"

"another sign that investors have capitulated"

Figure 1: US VIX index (implied equity market volatility)



Source: Bloomberg. Collins Stewart Research

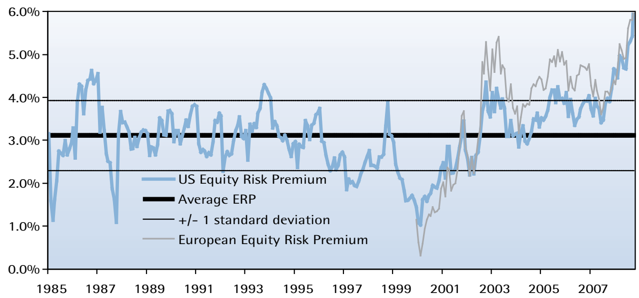
We can only assume when Congress narrowly voted against the Paulson Plan last night the politicians weren't expecting the overwhelming market reaction just hours later as the S&P closed down 8.8% and implied equity risk premiums rose to their highest in more than 20 years (see Figure 2). With the exception of low yielding government bonds, there has been simply no place to hide.

Clearly the Hill has been embroiled in an ideological debate, along partisan lines, and a sensible bailout plan was amended into something unacceptable to either side. There clearly is a political consensus for a rescue package, and there clearly is a plan – Paulson and Bernanke have been very clear about the way ahead. The difficulty has been the political implementation of that road map, and the failure yesterday should been seen as a setback rather than the end of the road. That said, the market reaction has raised the stakes further, making an eventual solution more likely in our view.

"driving up the market implied equity risk premium to 20 year highs"

"there has been no place to hide"

Figure 2: US and European market implied Equity Risk Premiums



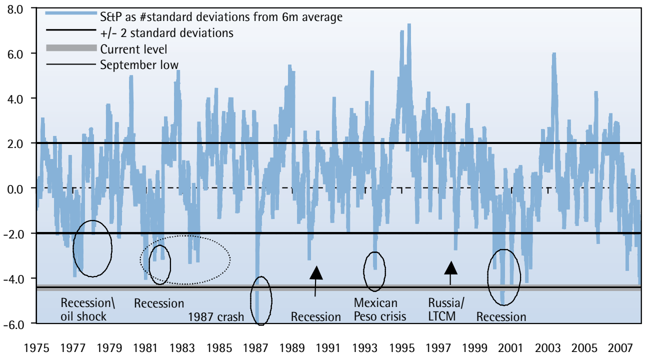
Source: Bloomberg. Collins Stewart Research

> "as a result equity markets have rarely been this oversold"

At the close of play last night, the S&P moved into truly oversold territory at more than 4 standard deviations below its moving average. That kind of panic has been seen twice before in the past thirty years. The last time was in 2001 during the dot-com market deflation, and before that the 1987 crash, which quickly rippled out into most developed financial centres and in many ways felt most like the current situation.

> "it feels like capitulation"

Figure 3: S&P overbought/oversold indicator



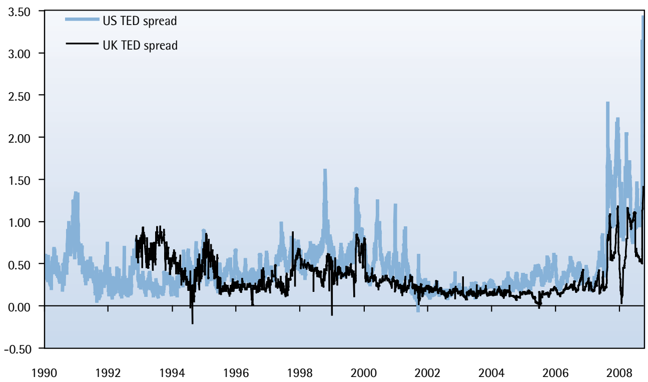
Source: DataStream. Collins Stewart Research

> "In the two previous occasions markets have been this oversold, they bounced 10% (1987) & 5% (2001) within 20 days"

The good news is that in both cases, once markets had become this oversold (see Figure 3), they stabilised – within 20 days of the market hitting these oversold levels, the market bounced by 10% (1987) and 5% (2001). The clear message is whilst investors may be capitulating, this is not the time to panic. There will be better opportunities to adjust your asset allocation positions.

> "whilst taking no action can be one of the most difficult decisions to make, this is not an environment to be reactive"

Figure 4: TED spreads (difference between 3m government bills and LIBOR)



Source: Bloomberg. Collins Stewart Research

> "These same dynamics have also been expressed in money markets, where the absence of liquidity, solvency and counterparty risk has driven TED spreads to all time highs"

We are disappointed the equity market rally we are positioned for has so far failed to materialise, but remain confident the measures taken will prove sufficient to eventually restore confidence. Whilst taking no action can be one of the most difficult decisions to make, this is not an environment to be reactive.

> "We are confident our asset allocation decisions, which are based on sound and rational decision-making, will bear fruit"

We are confident our asset allocation decisions, which are based on sound and rational decision-making, will bear fruit. We still expect a rally to take place, as we do believe that market conditions will become more favourable. We will, however, continue to closely monitor market developments and stand ready to make any changes to investment policies judged necessary.

NC, 30th September 2008