

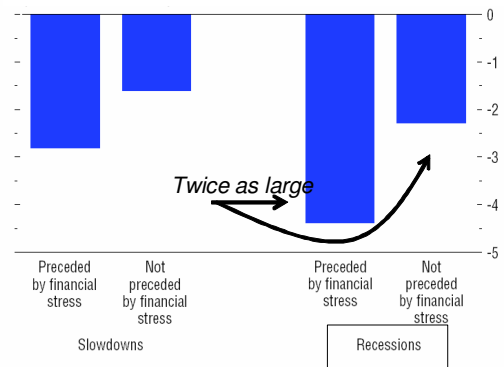
## ECONOMIC AND RESCUE PLANS: TAKING ON THE CRISIS ON MULTIPLE FRONTS

Financial markets are being rocked by a global banking crisis, and the global economy is slowing as several developed countries are in recession. After hesitating and attempting piecemeal actions, governments are now acting aggressively and in a more coordinated fashion to contain the flood of economic challenges to which they are confronted. This week's edition of the Marker reviews the context and measures implemented.

### FROM LIQUIDITY TO SOLVENCY, THE FACE OF THE PROBLEM MUTATES

Markets have been buffeted by consecutive shocks that have accelerated in frequency and magnitude since the failure of Bear Stearns in March 2008. The bankruptcy of Lehman Brothers had the effect of an accelerant poured over fire. Near panic set in with U.S. and European banks refusing to lend to one another out of fear their counterparties would prove to become insolvent. Those fears proved prescient with multiple bank failures occurring in sequence on both sides of the Atlantic. Up until those two catastrophic weeks in September, authorities had chosen to experiment with tools and policies on a case by case basis. Furthermore, responses to banking institution difficulties varied by country. Faced with the spectre of a complete loss of control over their country's respective banking industry, authorities switched course in approach and policy, focusing on bailing out their financial system rather than individual institutions. This change explains how even the greatest of all such policy programs, the U.S.' Troubled Asset Relief Program (TARP), has seen its focus move from purchasing troubled assets to injecting capital directly in financial institutions.

Cumulative Output Loss during Slowdowns and Recessions (median; percent of GDP)



Source: IMF

### WILL THE POLICY RESPONSE SUCCEED?

The crisis began in the U.S., which remains the largest economy globally; it is only therefore normal that all eyes are turned to the U.S. policy response. The above table highlights why authorities must get it right. A recession is underway, but its depth and length could be gravely affected by a lack of policy action. Japan remains the poster child for such policy failure. Economic growth from 1992 to 2002 was 0.2% per annum. In its current form, the U.S. policy response consists in deploying public sector balance sheets in a massive way. The key end result has been to transfer credit risk from investors' to the public sector's balance sheet. By seizing Fannie Mae and Freddie Mac, the government backstopped half the mortgage market. These two entities will now be charged with purchasing troubled mortgage securities from banks. With direct capital injections in ailing banks, the general public has now assumed a very large share of the housing market downside risk. Suggestions for the new administration to purchase homes and extend low-cost mortgages directly once installed in January are already being circulated. The question of whether the program will work remains unanswered. Yet, the determination of governments across the developed world to act in coordination - as with guaranteeing certain bank debts - has now been demonstrated. The critical test will rest with the authorities' will to expand the programs in size and duration. Policymakers will certainly be faced with numerous such tests of will and power. The sickening market volatility and the focus of the voting public on the issue will likely ensure they will rise to the challenge.

### NATCAN WEEKLY MARKER

The global banking crisis has now reached a third stage, that of a coordinated response accompanied by massive public sector involvement in the most *laissez-faire* country of all: the United States. The twin enemies of liquidity in the economy and financial sector solvency are being addressed head on. Relief programs such as those being implemented take time to alter the landscape. Investors will watch intently for an improvement to the current situation. Expect elevated volatility to prevail for several weeks.

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## FINANCIAL MARKETS

| RETURNS AS AT OCTOBER 17, 2008 (%) | MTD    | QTD    | YTD    | RATES AS AT OCTOBER 17, 2008    |           |
|------------------------------------|--------|--------|--------|---------------------------------|-----------|
| S&P/TSX                            | -18.55 | -18.55 | -29.40 | CAD/USD                         | 1.18      |
| S&P 500                            | -9.96  | -9.96  | -22.18 | CAD/Euro                        | 1.59      |
| S&P/TSX Small Cap                  | -23.70 | -23.70 | -43.18 | US Treasuries yield 10-yr/30-yr | 3.93/4.30 |
| Russell 2000                       | -13.52 | -13.52 | -17.02 | GOC bond yield 10-yr/30-yr      | 3.72/4.23 |
| MSCI EAFE                          | -9.84  | -9.84  | -31.30 | Fed Fund Rate (target)          | 1.50      |
| MSCI World                         | -10.65 | -10.65 | -27.05 |                                 |           |
| DEX Universe Bond                  | -0.50  | -0.50  | 1.32   |                                 |           |

Note: Returns in Canadian dollars, London 4h exchange rates. Source: Datastream, PC Bond, MSCI-Barra, and Bloomberg. PC-Bond, a business unit of TSX Inc. Copyright © TSX Inc. All rights reserved.

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