

Restoring confidence

People were last week in what I call "Panic Mode". Selling at any price, getting into cash, physical gold or US T bills.

A few main factors were at the origin of these irresistible behaviours that concluded in a 20%+ drop of the markets and the massive intervention of governments, at last.

The first one is of course the **vanishing of confidence**.

Confidence must exist between banks and financial institutions. Even the best banks and insurance companies are unable to repay their obligations on short notice. Confidence means counterparties trust that banks and other financial institutions are there for the long run. If this confidence disappears, then the credit flow is stopped. This can take the form of nobody wanting to make a bid on the Forex market: usually instantaneous bids just vanished because the bidders are no longer sure they will be paid. What happened in the generally very liquid Forex market was observed for all types of credit, with the risk of collapse of the real economy, just like an engine without lubricant. Even the massive liquidity injected by the Central banks were not enough to restore confidence.

The second one is the **deleveraging process**

When investors start to withdraw their money from all financial instruments, stocks, mutual funds (65 billion withdrawn last week!), hedge funds and the like, this generates a domino effect. Leveraged instruments like certain hedge funds or funds of hedge funds see their leveraging providers calling back their financing. Consequently, they must get rid of their positions at any price, accelerating the movement. When this ground swell leads to the discovery of a massive fraud, this adds to the devastating effect.

The third one is **recession**

What started with the bubble in the housing market in the U.S. generated by the need to get underlying mortgages at any cost to build these toxic CDO's is extending to the real economy. The U.S. real estate market has still to hit a bottom and the recession is there. Auto market is down, unemployment rising and this is spreading to Europe and though to a lesser degree to Asia.

The only way to break these vicious circles was a massive implication of the Governments. And they have delivered.

It may be fair or not, this is now fully irrelevant.

The major task of the Governments was to restore confidence, putting aside some of the principles of liberal capitalism. The European Union reacted with common massive measures, probably the most important one being the guarantee of inter banking loans. By the way this re-enforced Europe, demonstrating that per obligation it has a role to play.

I am confident the measures taken will be successful and bring back calm to the markets, restore confidence and avoid a too strong and long recession.

The next step will be to regulate the financial system enough to avoid such contamination in the future while not breaking with capitalism and market which remain the best systems found so far.

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