

Is the worst before us? How to thrive anyway?



As the attached cartoon published in yesterday's Barcelona journal La Vanguardia suggests, the difficult times we are living may not be over soon and the governments' response may not be up to the gravity of the situation.

At the Gaim International Fund of Funds conference in Geneva last week, a very gloom picture was painted by the eminent professor Nouriel Roubini. Pr. Roubini's opinion is that we are in a **L** shaped recession that will extend to the whole world, as the global economy is re-coupling with the US economy and a hard landing in the main emerging countries is likely, above all when it is considered that even a 6% growth rate means a hard landing for China.

As consequence, the main concern is **deflation**, following over-investment and over capacity in emerging countries, rising

unemployment and a possible further drop in commodity prices.

This situation may turn very difficult for Central banks as they may run out of ammunition, after having lowered interest rates again and again. If deflation spreads, interest rates will be actually positive, feeding the vicious recession circle.

So this could mean the worst is still ahead of us: a few countries can default, stock markets could fall another 15 to 30%, big companies or institutions can be in trouble, which would translate to a catastrophic bursting of the CDS (Credit Default Swaps), as counterparties will default. This would last all 2009 and start improving through a mild recovery by mid 2010.

The only hope to limit this recession comes from a massive public intervention to restore confidence. The G20 response is to include fiscal measures to boost demand rapidly; monetary policy steps as appropriate; more funds for the IMF to support emerging economies. Traditional monetary measures have nevertheless proven not to be very efficient so far to ease the confidence crisis and ways have to be found to get protagonists starting lending again.

But worst is never certain and though recession will last a few more months, let's hope all these governments' actions will at least smooth consequences for the real economy and make the recovery stronger, sooner.

As hedge funds are the main victims of this crisis through the de-levering processes and the anticipation of the flight to liquidity (cash is king), let's name a few strategies that seem to have

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a chance of performing well in the very near future:

- CTA /managed futures are doing extremely well in these conditions as they benefit from the high level of volatility. A great number of these funds have achieved YTD performances of 20-40%.
- Global macros, for the same reason and because they can follow or anticipate short term variations
- ABL (Asset Based Lending) strategies will benefit from these market conditions as traditional lenders (banks) turn shyer and shyer. The paradox is funds using these strategies have been among the mostly hurt through the mark-to-market effect, the de-levering process and the rush to liquidity. They experienced a mismatch between the liquidity terms offered to investors (quarterly, sometimes monthly) and the liquidity constraints of the underlying investments (3 months to 3 years horizon). All banks are in this situation, but the difference is they are backed by the Central Banks. Hedge funds are not, and they have used leverage which amplifies the effects. When dust settles, we'll see new funds emerging, investing massively in these strategies, but with different liquidity terms: self liquidating funds and/or private equity like.
- Credit lending strategies are a fantastic opportunity through the distressed but sound opportunities available today, for those who have the knowledge and the capabilities of selecting the right vehicles.

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Michel Benveniste
Tel. +41 79 792 3667
mbe@etsior.com

ETSIOR Sarl
112 Route de Florissant
1206 Geneva (Switzerland)
<http://www.etsior.com>