

The Pain Report

The running of the bears continues

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In view of the extraordinary events of the last several days and weeks we felt it necessary to provide an update on our views.

Monday 15 September 2008 will no doubt go down in history as one of those defining moments. As we said in our last Pain Report, The Mother of all Credit Contractions, and in earlier papers, we have commenced a painful period of de-leveraging (credit contraction) and the events of the last 24 hours have served to accelerate that process.

Lehman's collapse was a story about excess leverage. Fannie and Freddie's admission to "conservatorship", or intensive care, was similarly a story about excess leverage and the bursting of the American debt bubble. It would be both dishonest and naive of me to suggest that the painful process of de-leveraging is behind us, now that Lehman has gone and Merrill Lynch has been acquired. In the days ahead we still face the agony of watching both AIG and Washington Mutual fighting for survival.

The events of the past few weeks serve to only re-enforce and moreover accelerate the credit contraction that the Pain Report has been highlighting for the past year. In essence we are in a bear market that has further to run. The pain in Wall Street has now migrated to main street and the economic outlook has therefore worsened.

Many people have asked in the last 24 hours if we have seen the ultimate low in stock markets. I know only too well that there is a huge constituency of money managers who have been telling you for the last year that we have seen the low. Events in the last 24 hours clearly highlight the degree of panic in the markets and as a 25 year investment contrarian I can't wait to call the bottom in markets. That time will probably come when the last "bull" is dragged out kicking and screaming.

We are in a secular bear market and corporate earnings forecasts for the next 12 months remain ridiculously high. We need therefore to see some capitulation by "bottom up" equity analysts before we can call a market bottom. Similarly we need to see some stabilisation in US house prices. I am watching this particularly closely.

We also need to see significant reductions in official interest rates. The cut in interest rates by the Peoples Bank of China yesterday, for the first time in six years, is a step in the right direction. The RBA needs to cut rates to 5% very soon and possibly lower. As we said last month the risk here is not inflation, but recession. Most of the global economic pain in the years ahead will be felt by those who gorged the most at the trough of debt. No need to mention their names. Fortunately the Asian nations have vast reserves at the national level and at the household level to help alleviate some of the economic pain.

Similarly the sharp decline in oil prices has even exceeded our short term target of \$100, mentioned in the Pain Report dated 24 June 2008, and will help ease some of the economic burden.

The economic adjustment that we face, particularly in the Anglo Saxon world, will be difficult but very necessary. It is the adjustment "we had to have" and ultimately the world will be a better place and the days of shameful, and moreover, predatory lending will be abolished.

We are, as I write this, close to a short term capitulation low in equity markets, however I unfortunately do not believe it will be the ultimate low.

All the best,



Jonathan Pain

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