

## October 2008 MARKET COMMENTARY

## Accord Portfolio Management

### Economic commentary

Economic statistics once again took a back seat as the global financial crisis continued into October. Australia's annual inflation rate rose to 5.0% but the focus was elsewhere.

The month began with the passing of the US Emergency Economic Stabilization Act. Around US\$700 billion will be made available to buy 'troubled assets' from US financial institutions as well as to provide equity capital where needed. To date, 28 US banks have accepted capital injections from the US Treasury. As yet no troubled assets have been purchased.

Early in the month, the Reserve Bank of Australia (RBA) cut official interest rates from 7.00% to 6.00%. Soon after, the US Federal Reserve, the European Central Bank and the Bank of England cut their cash rates by 0.50%.

Despite the rate cuts, equity and credit markets remained under extreme pressure. At a weekend meeting, leaders of the G7 and G20 countries agreed to use all available tools to support struggling financial institutions and prevent their failure. These tools included providing banks with capital injections. In a move calculated to put Australian banks on an even footing with European banks and to quell depositor concerns, the government announced that it was guaranteeing 'bank deposits'. Unfortunately there were unintended consequences that the government and the finance sector is now endeavouring to resolve.

Later in the month, the International Monetary Fund (IMF) agreed to make loans available to Iceland, Hungary and the Ukraine in order to stabilise their economies. World leaders will hold a summit in the US on November 15 to agree on a broad set of principles for reforming the international financial system. The IMF will take a leading role in making proposals on what changes need to be made.

The final twists in October saw the US Federal Reserve cut its federal funds rate by a further 0.50% moving it down to 1.0% and Japan cut its cash rate to 0.3%. China also reduced its official rates while at the same time announcing a US\$292 billion rail expansion programme, the largest rail building scheme since the US was opened up in the 1800s.

The Australian dollar fell in October. It was down 15.9% from US 79.02 cents at the start of the month to US 66.45 cents by month end. Weaker commodity prices, lower interest rates and the offshore sale of Australian equities all contributed to the decline.

The AUD bought 0.4114 UK pounds at the end of October and 1.139 NZ dollars.

### Australian shares

In October 2008, the All Ordinaries share price index fell 14.0%; its worst monthly fall since October 1987. Back then the market fell 42%. Why the slump? A US recession, fear of a global slowdown, weaker commodity prices, de-leveraging, margin calls, lower oil prices, a slowing domestic economy, falling US house prices and seriously negative offshore investor sentiment all made a contribution. The selling was complex in origin but relentless in execution. Investors were either taking very pessimistic views on future economic activity or they were forced sellers due to factors such as de-leveraging i.e. reducing debt.

No sectors were spared. The energy (-19.5%) and materials (-17.4%) sectors were among the hardest hit. With oil down 32.6% for the month, Santos fell 29.4%, Woodside Petroleum was down 17.9% while Oil Search fell 19.6%. However, Queensland Gas rose 42.0% on a takeover offer from British company BG Group.

Within the materials sector, BlueScope Steel was down 39.8%. The smaller resource companies sector fell 31.8% as investors sought the relative safety of larger, more liquid companies and as commodity prices slumped. Kagara, a zinc producer fell 80.9%, Mt Gibson Iron was down 75.3% and Platinum Australia fell 63.0%. Among the larger resource companies, BHP Billiton staged a late rally but ended the month down 9.7% while Rio Tinto fell 8.2%.

The 'strongest' sectors were healthcare (-2.1%) and telecommunications (-2.5%). Within healthcare are a number of companies with offshore earnings. The recent decline in the AUD should transform their USD revenue into larger AUD earnings. ResMed fell 8.3%, CSL was down 2.4% while Sonic Healthcare was up 4.7% for the month.

The telecommunications sector is dominated by Telstra, a company with very solid cash flows. Its share price fell only 1.4% as investors sought liquid, 'defensive' companies.

It was an exceptionally volatile month. On only 4 days in the month did prices move by less than 1%. On the weakest day, 10 October, the market fell 8.2% while the strongest day was a rise of 5.1% on the 13 October. The volatility reflected the frenzy of official activity outlined earlier.

The factors pushing the market down have not disappeared but actions, such as reducing interest rates and stabilizing the global financial system, will have a positive impact over time. In the meantime, the domestic economy is slowing and parts of the Western world are slipping into recession.

The S&P/ASX 200 Accumulation index (which includes reinvested dividends) fell 12.6% in October to be down 37.8% over 12 months.

### **Global shares**

Even with the cushion of a weaker AUD, global shares experienced a significant decline during October. The MSCI World index, a broad measure of global shares, fell 19.1% in USD and was down 3.7% when measured in AUD. Over 12 months, global shares were down 43.1% in USD terms and have fallen 20.7% in AUD terms.

Crises in a range of financial systems saw national governments inject billions of dollars, euros and pounds into various banks. The financial system now appears safe but recessions are looming in the US and Europe. Investors were glad for the rescue packages but fearful of recession.

The US, whose economy shrank in the September quarter, saw the Dow fall 14.1% and the S&P 500 decline 16.8%. The S&P 500 is now down 11.8% over 10 years. Over 12 months the Dow is down 33.1% and the S&P 500 has fallen 37.5%.

Volatility in the US market was extreme. The world's largest economy saw its equity market fall by more than 7% on two days and rise by more than 10% on two days. As in Australia, the volatility was sparked by a mixture of government actions and economic uncertainty.

Asia saw several national governments step in to assist banks and economies. Japan, China and Korea, among others, announced packages. They may well be needed.

The Japanese sharemarket fell 23.8% in the month, China's Shanghai B index was down 33.4% and the Korean market fell 23.1%. Japan's Nikkei index is down 36.8% over 10 years.

European markets also saw double digit declines. The UK, which according to the Bank of England is slipping into recession, saw the FTSE 100 index fall 10.7% in October to be down 34.9% over 12 months and down 19.5% over 10 years. For the month the German market was down 14.5% and the French market fell 13.5%. Adding to volatility in European markets were events surrounding Porsche's takeover moves for Volkswagen.

Volkswagen shares rose over 300% in two days before falling 45% over the following two days.

Emerging markets were caught up in the global sell-down. The MSCI Emerging Markets price index fell 27.5% in USD and was down 13.8% in AUD. The market in Thailand was down 30.2%, Russia was down 32.9% and the Brazilian market fell 24.8%.

### **Fixed interest**

Policy makers are working overtime to free up global credit markets. As outlined earlier, both liquidity and capital issues are being addressed. For global credit markets the next step is coping with the looming US recession and associated global fallout.

The turmoil in global financial markets continues to see a movement towards government and other very highly rated bonds and away from lower rated corporate bonds.

Government bond yields continue to fall while yields on corporate bonds edged higher.

At the beginning of the month, 10 year Australian government bond yields stood at 5.40% while domestic corporate bonds with credit ratings in the range BBB- to BBB+ had an average yield of 10.22%. By the end of October, the yields were 5.17% and 10.29% respectively.

The divergence of yields reflects illiquidity in corporate bond markets and the relative risk of defaults.

Government guarantees for overnight inter-bank lending, combined with capital injections, have seen the USD London Inter-bank Offer Rate (LIBOR) fall. LIBOR is a benchmark against which companies borrow money in wholesale offshore money markets. At the end of October LIBOR was 200 basis points or 2% above the US Fed Funds rate. This compares with an average differential of 40 basis points or 0.4% over the past few years and a peak of 330 basis points or 3.3% a few weeks ago.

The UBSA Composite Bond index returned 2.01% in October for a return of 10.59% over the past 12 months.

The Reserve Bank of Australia (RBA) reduced its official cash rate from 7.00% to 6.00% in October. The UBSA Bank Bill index returned 0.71% in the month and 7.80% over 12 months

### **Listed property**

The listed property sector fell a further 25.2% in October and is down 55.2% over 12 months.

The sector faces a significant debt refinancing task over the next few years and a slowing economy. In this environment, future distribution yields are uncertain. Global property markets fell heavily in October. The S&P/Citigroup BMI World Property index fell 14.0% in AUD terms and is down 35.1% over 12 months

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