

## SEPTEMBER 2008 MARKET COMMENTARY

## Accord Portfolio Management

### US Banking situation update September 18th 2008

You may be understandably concerned about the recent volatility in investment markets so to keep you informed of what's happening we provide a regular update from Hans Kunnen, Head of Investment Markets Research. In this article we try to make sense of the events over the last week and understand what influence this may have on investments markets and the economy both in the short and longer term.

### What has happened in the US recently?

After signs in August that the sub-prime issues were starting to be resolved, events in September reignited volatility and uncertainty. The recent volatility re-emerged on September 8th when the US government assumed control of troubled mortgage lending giants, Fannie Mae and Freddie Mac. This was in a bid to support the US mortgage market. Between them, Fannie Mae and Freddie Mac own or guarantee at least half of the US home loan market.

The government took control given the mortgage giants were struggling for liquidity after a year of falling house prices and financial losses. Immediately following the announcement, this development was viewed as positive news for the US economy and financial markets. It was the government's biggest step to date towards improving the functioning of US debt markets, reigniting confidence in the US economy and stabilising fragile financial markets.

However, events over the weekend of September 13th/14th shocked global financial markets and led to the realisation that market volatility and issues within global debt markets required more time to work through. Events further into the week of September 15 also rocked the market.

Major problems began when the 150 year old US investment bank, Lehman Brothers filed for bankruptcy protection in the US. Several quarters of financial losses and the failure to find a buyer or a capital injection gave Lehman Brothers no choice.

The troubles did not end there. Merrill Lynch agreed to be bought by Bank of America following liquidity issues. America International Group (AIG), the largest insurer in the US also had difficulties before being rescued by the US Federal Reserve through a US \$85 billion loan. Control was handed over to the US Federal Reserve with AIG deemed "too big to fail". The collapse of AIG would have had dire consequences for the already strained financial market. Share prices for these companies and the rest of the Financials sector plunged.

The US sharemarket, as measured by the S&P 500, fell 4.7% on September 15th, its largest one day loss since the terrorist attacks on September 11th 2001. Further falls throughout the week have placed the S&P 500 index at levels not seen since April 2005. There have been implications for the Australian sharemarket as well, with bank shares falling, pulling the market lower.

It is reassuring to note how authorities are reacting to this situation. The US Federal Reserve has acted effectively and quickly over recent days and pumped additional cash, or liquidity into financial markets. Over \$100 billion has been pushed into US financial markets in recent days to calm markets and provide funds to those financial institutions that need it. The US Federal Reserve is also encouraging a group of banks to pledge US \$70 billion in funds for any short term liquidity needed in the financial market.

The US Federal Reserve will continue to do all it can to minimise the damage on financial markets and the US economy from the wind up of Lehman Brothers. The US Federal Reserve can still cut interest rates if need be to calm financial markets and assist the broader economy. This would be good news but is also a signal of the challenge facing markets.

Further consolidation within the US banking system would not be a surprise. Banks remain unwilling or unable to lend to each other and undertake normal lending activities. Morgan Stanley is considering a merger with another US bank while in the UK there are also talks of consolidation. The global credit crisis is serious and will have lasting implications which seem unlikely to be fully resolved in the short term.

### Will the US go into a recession?

Despite 12 months of a weak housing sector and financial market issues, the US economy has not slowed as much as first feared. The US Federal Reserve acted aggressively by cutting interest rates starting in September 2007. This helped the economy in the first nine months of 2008, especially when combined with tax cuts and export growth.

However the prolonged credit market crisis and the weak housing sector mean the US economy could still slip into recession. The credit crisis is likely to impact the real economy through the reluctance in the banking sector to lend to each other, businesses and to consumers.

US consumers have also seen the value of their houses and shares decline in value and this will impact on future spending. For the past several months the US economy has also witnessed job losses. Restricted lending by banks when combined with the weaker consumer sector seems likely to slow economic growth

further. This will have implications for the global economy and the Australian economy. The recent intervention by the US government into the mortgage market through the effective nationalisation of Fannie Mae and Freddie Mac is good news. This could lead to lower mortgage interest rates and entice buyers back into the market. If the US housing sector improves this will be one log jam that is cleared to rekindle economic growth in the US. It is important to remember that the current financial crisis in the US will take time to work through and will dampen growth for some time. The good news is that authorities are working hard to ensure an effective "work out" of the issues.

#### **What impact does this have on the Australian market?**

The recent events in the US are having a flow on effect on the Australian sharemarket. Investors are nervous with emotion and uncertainty driving reactions.

The impact on the Australian sharemarket will likely be felt for the remainder of 2008 and into 2009. The problems in the US will take some time to work through and this seems likely to dampen investor sentiment for the Australian sharemarket into 2009.

We would do well to remember that the banking system in Australia is not faced with the same issues as the US banking system. Our housing sector remains firm and we have not seen the pickup in mortgage default rates that started the financial crisis in the US. Our banks are well capitalised and well supervised. They should withstand the current problems, albeit with some volatility experienced in their share prices. Slower economic growth is likely to affect most companies.

#### **What will happen to the performance of my share funds?**

In times like this we can't help but think of the performance of our investments. Recent losses in the sharemarket will impact on share fund performances. It is important to remember that the Australian sharemarket is still higher over 3 years and 5 years.

It is important to remember that fear and greed are some of the dominant emotions associated with investments, especially the sharemarket. Fear appears to have regained the upper hand. History has shown it is the patient investor who benefits from any upside that follows.

#### **What is the outlook for the Australian sharemarket?**

Concerns over the future pace of economic growth globally and in Australia will likely lead to further volatility in the remainder of 2008. Financial markets are expecting further interest rate cuts in Australia by the Reserve Bank. If this occurs it would be positive for the sharemarket.

Importantly the recent profit season showed profits had grown and that we are still benefiting from the resources boom. The implications of the events noted above will take time to work their way through the system. The medium term outlook for the Australian economy is still positive, assisted by the resources boom, population growth, tax cuts, infrastructure spending and a stable government. The economy should continue to grow enabling companies to earn profits, which is good news for the sharemarket over the medium term.

#### **What is the impact on fixed interest funds?**

Turmoil in credit markets has affected returns from cash and fixed interest funds. As official interest rates rose in 2007 and 2008, returns from cash increased. If official rates fall in 2008 or 2009, returns from cash funds would decline from their current levels.

Funds that invest in government and corporate bonds generate their short-term returns from two sources. Interest payments received and changes in the capital value of the bonds. When interest rates on corporate bonds rose, as occurred during the initial phase of the credit crisis in late 2007 and early 2008, the capital value of these bonds fell but the interest income from new investments rose. This tends to hurt short-term returns but means better interest income flows in the future.

The opposite happens when interest rates fall. Capital values increase but future interest income is reduced. Recent events have seen many investors move towards the security of government bonds. This will lift the capital value of government bonds but means that future interest income will be a little lower. At the same time, corporate bond yields have risen providing good future interest income flows but hurting short-term capital values.

The widening credit crisis has seen a mild increase in corporate defaults from historically low levels. There is potential for defaults to grow as the crisis continues and economic growth slows. In these cases, interest payments cease and capital values fall sharply, potentially to zero. It is for this reason that portfolios hold a wide spread of bonds and the impact of individual defaults is minimised.

The key feature of fixed interest funds is that when good quality bonds are held, investors who hold bonds to maturity receive their original capital and interest income earned along the way. They should be viewed as three year plus investments.

In the current environment before you make any major decisions think through the issues and speak to your financial adviser about your individual circumstances.

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