

September 2008

Market Watch

Economic commentary

Economic statistics took a back seat during September as markets were buffeted by events surrounding the US financial system.

Excessive debt combined with holdings of assets whose values had fallen, saw various financial institutions come under extreme pressure. They were nationalised, taken over or allowed to fail.

Over the course of the month, government authorities in the United States assumed control of Fannie Mae, Freddie Mac and American Insurance Group (AIG). Fannie Mae and Freddie Mac are the two largest US mortgage finance providers while AIG is the largest insurance company in the US. Also during the month, investment bank Lehman Brothers filed for bankruptcy, Merrill Lynch was taken over by Bank of America, Washington Mutual was acquired by JPMorgan Chase and the UK's largest mortgage lender, HBOS, was taken over by Lloyds TSB Group, another UK bank.

Late in September, Wachovia, a large US bank, sold its banking operations to Citigroup; the Dutch, Belgian and Luxembourg governments stepped in to support large European bank Fortis while in the UK, mortgage lender Bradford and Bingley was partly nationalised and partly sold to Spanish bank, Santander.

The ensuing market turmoil, combined with an accumulation of impaired assets on the balance sheets of some US banks, saw normal banking operations virtually grind to a halt. Financial woes were now directly threatening real economic activity.

In response to the looming crisis, the US Federal Reserve and the US Treasury began working on a plan to take control of impaired assets from financial institutions much like it did in the late 1980s and early 1990s when the Savings & Loans crisis emerged. The article below provides a brief history of the last US financial crisis.

Click [here](#) for more information.

The announcement of the plan saw equity markets around the globe rebound from earlier losses. When the plan was later defeated in the US Congress, sharemarkets around the world retreated. While a new plan is expected to emerge, it will take time.

While Australian investors watched developments in the US financial system with interest (and sometimes dismay) the Federal Government announced a package to assist liquidity in the Australian residential mortgage market. Around \$4 billion has been earmarked for the purchase of residential mortgage-backed securities. The securities will be purchased for cash with the cash then being available for the provision of new mortgages.

Markets around the world now appear to be factoring in a US recession at the least and a global recession at the worst.

Weaker economic conditions threaten corporate earnings growth and take the gloss off commodity prices, a matter of particular concern to the Australian market and our economy.

For the record, unemployment in Australia fell to 4.1% in August. After a trade surplus in June, a trade deficit was reported in July while retail spending was up just 3.2% in the 12 months to August. Over the same 12 months, building approvals fell 8.6%.

The AUD fell again in September. It was down 7.8% from US 85.69 cents at the start of the month to US 79.02 cents by month end. Weaker commodity prices in the face of slower global growth hurt the currency.

The AUD bought 0.4439 UK pounds at the end of September and 1.181 NZ dollars.

Australian shares

The Australian sharemarket witnessed its second monthly fall of over 9.0% this year as the S&P/ASX 200 Accumulation index fell 9.9% in September. The market is now down 26.8% over twelve months.

Dragging the market down was the materials sector as fears of a global slowdown hurt commodity and share prices. Copper prices fell 15.3%, nickel was down 21.6% and platinum prices fell 31.7%. The price of oil fell 12.8%.

Reflecting these declines, the materials sector fell 22.7% in the month. BHP Billiton fell 24.0%, Rio Tinto was down 33.1% and Fortescue Metals Group fell 39.1%. A 5.3% pick up in the price of gold, generated by financial market uncertainty, saw Lihir Gold rise 17.2%.

Despite turmoil in the US banking system, sentiment towards Australian financials (ex-property) was relatively firm, falling only 1.6% in the month. ANZ Banking Group ended the month up 12.9%, QBE Insurance rose 10.7% and Commonwealth Bank rose 0.5%. There were weaker performances in the sector with Macquarie Group down 16.0% and Westpac down 8.8%.

While earnings in the Australian banking sector will be squeezed by a slower economy and higher costs, Australian banks appear well capitalised and profitable. The same cannot be said of many of their US counterparts.

On a 12 month basis there has been little joy among the various market sectors. Only the energy sector (+5.2%) posted a gain as oil, coal and gas prices rose. Over this period, Woodside Petroleum was up 4.3% while Santos rose 29.7%.

Other sectors to 'hold up' in a relative sense over 12 months were healthcare (-2.1%) and telecommunications (-2.4%). The large telcos had strong cash flows while healthcare spending was not deterred by the state of the economy. Over 12 months Telstra was up 2.3% while ResMed was up 10.2%.

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The short-term outlook for the market remains uncertain. An economic slowdown will not help matters but the possibility of lower interest rates combined with improved sentiment out of the US would help. Providing Australia avoids recession, companies still have the capacity to lift their earnings and their share prices over the next 12 months.

Global shares

Needless to say it was an awful month for global sharemarkets. Not even a 7.8% decline in the AUD could turn the decline in the MSCI World index into a positive number. The MSCI World index, a broad measure of global shares, fell 12.1% in USD and was down 4.7% when measured in AUD. Over 12 months, global shares were down 27.6% in USD terms and have fallen 18.9% in AUD terms.

The US was at the epicentre of a global financial earthquake and saw its broad market decline 9.2% in the month. Concerns over its economy and the sustainability of its financial system saw investors flee the equity market. In late September, the US Dow Jones Industrial index fell 777 points, its largest daily points drop in history but still well short of daily declines seen during the 1987 crash and after the 9/11 terrorist attacks. The next day it rose 485 points!

Whatever the outcome of the US government bank bailout package, the US economy faces a period of weaker economic growth as the flow of easy money for consumers and businesses comes to an end. Unemployment in the US looks set to rise and avoiding recession appears unlikely.

European markets also fell. The UK was down 13.0% for the month, France fell 10.1% and Germany was down 9.2%. None of these regions was immune from financial pressures as banking institutions began to unravel. Europe is also expected to see weaker economic activity over 2009.

In the Asian region, the Japanese market was down 12.7%, Hong Kong fell 15.3% and Singapore fell 13.9%.

Emerging markets fared little better. The MSCI Emerging Markets price index fell 17.7% in USD and was down 10.8% in AUD. China saw its market fall 12.5%, Russia was down 27.4% and the Brazilian market fell 11.0%.

Fixed interest

The turmoil in global financial markets has seen a flight towards government and very highly rated bonds and away from lower rated corporate bonds. Government bond yields have generally fallen while yields on corporate bonds have risen.

At the beginning of the month, 10 year Australian government bond yields stood at 5.76% while domestic corporate bonds with credit ratings in the range BBB- to BBB+ had an average yield of 9.17%. By the end of September, the yields were 5.40% and 10.22% respectively. The divergence of yields reflects the illiquidity in corporate bond markets and the relative risk of defaults.

In the US, the inconsistent treatment of bond holders in the various troubled US banks caused consternation, adding to uncertainty in credit markets and reducing confidence in the US authorities. Defaults among global corporate bonds have risen from historically low levels as economic and financial conditions in the US deteriorate.

The UBSA Composite Bond index returned 1.28% in September for a return of 8.37% over the past 12 months

The Reserve Bank of Australia (RBA) reduced its official cash rate from 7.25% to 7.00% in September. The UBSA Bank Bill index returned 0.59% in the month and 7.65% over 12 months

Listed property

The listed property sector fell 5.7% in September after a brief respite the previous month. It is now down 40.4% over 12 months.

Lower bond yields have the potential to support the sector, however unsettled financial conditions do not augur well for the sector's funding requirements. Over the next two years some \$15 billion in debt needs to be rolled over.

At the end of September, the estimated distribution yield on the listed property sector was 8.20%, compared with the 5.40% yield on a 10 year Commonwealth government bond.

Global property markets fell in September but were cushioned by the weaker AUD. The S&P/Citigroup BMI World Property index fell 2.3% in AUD terms but is down 26.1% over 12 months.