

Market Watch

US banks update

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.

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.

On 8 September the US government seized control of 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 effectively insolvent after a year of falling house prices and financial losses.

Immediately this development was viewed as positive news for the US economy and financial markets. It was the government's biggest step to date to improve the functioning of US debt markets and reignite confidence in the US economy and fragile financial markets.

However, events over the weekend of September 13/14 shocked the global financial market and led to the realisation that market volatility and issues within global debt markets required more time to work through.

Problems started when the 150 year old US investment bank institution, 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 trouble did not end there. Merrill Lynch agreed to be bought by Bank of America after also getting into financial trouble. America International Group, the largest insurer in the US is also having difficulties and has been actively searching for loans after suffering from liquidity shortages. 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 15 September, its largest loss since the terrorist attacks on September 11 2001. The global credit crisis remains very real and very large. This has sparked the US Federal Reserve into action with the Federal Reserve pumping additional cash into the financial market and encouraging a group of banks to pledge US \$70 billion in funds for any short term liquidity needed in the financial market. The Federal Reserve will continue to do all it can to reduce the damage on financial markets and the US economy from the wind up of Lehman Brothers and prevent further financial collapses in the US.

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Financial markets are now expecting the Federal Reserve to cut interest rates when it meets on September 16. This would be good news but is also a signal of the challenge facing the markets.

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 with this helping the economy, when combined with tax cuts. A strong export sector has also helped the US economy continue to grow.

However the prolonged credit market crisis and the weak housing sector mean the US economy could still slip into recession. The credit crisis might lead to a new wave where banks are reluctant to lend to each other, businesses and consumers. This would slow economic growth further.

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 reignite 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 likely 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 will have 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. The problems in the US will take some time to work through and this will likely dampen investor sentiment for the Australian sharemarket as well.

We would do well to remember that our 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 this financial crisis in the US. Our banks are well capitalised and well supervised and should withstand the current problems, albeit with some volatility experienced in share prices.



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What will happen to the performance of my funds?

In times like this we can't help but think of the performance of our investments. 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. Over time history has shown it is the patient investor who benefits from any upside that follows.

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.

Concerns over the future pace of economic growth globally and in Australia will likely lead to further volatility in the remainder of 2008. Expected further interest rate cuts in Australia by the Reserve Bank will be positive for the sharemarket.

Importantly the recent profit season showed profits were growing and we are still benefiting from the resources boom.

What is the impact on Fixed Interest funds?

In recent times, higher interest rates have boosted returns for Fixed Interest funds. However in this period of falling interest rates, returns for Fixed Interest funds will be impacted.

As interest rates fall, the interest rate (or yield) on any newly purchased fixed interest securities will be lower and reduce the return earned on your investment. The good news is that when interest rates fall, the value of any fixed interest security (the price), rises and investors will experience a gain in the capital value of their investment. This should help offset any loss from the lower interest rate.

It is important to remember that the lower interest rate will only impact on any new purchases of bonds etc the fund makes. All existing investments will continue to pay the same higher interest rate until they mature. This is good news with existing investments still benefiting from the recent period of higher interest rates.

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