

Markets update: rough ride for investors

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In November 2007, the benchmark S&P/ASX 200 hit an all-time high. Less than a year later, it closed September at near three-year lows. The story is similar across global markets. To unravel the problems hitting financial markets and find out what it all means for investors, we talked to Joe Bracken, Head of Global Macro Strategies at BT Investment Management.

The first of these problems has its roots in the US sub-prime mortgage market. Enough has already been written about the impact falling property prices and the increasing number of defaulting mortgagees has had on the US economy, and, in turn, on global financial markets. Nevertheless, if you're looking for a spark that started the fire, Joe suggests you should look no further than the US housing market.

According to Joe, the repackaging of sub-prime loans into debt securities which were sold on to investors helped spread the fire. "Instead of confining the sub-prime problems, securitisation spread the impact."

And it wasn't just investment banks affected. Since March of this year, the list of casualties has grown to include some of the largest financial institutions in the US - Washington Mutual Bank, Bear Stearns, Lehman Brothers and even insurance company AIG.

A similar situation has been unfolding in the UK property market, where real estate prices have also fallen. While not as severe as the fallout in the US, UK financial institutions have been punished, with local banks Northern Rock, HBOS and Bradford and Bingley just some of the high profile victims.

To top things off, the list of economies in, or heading towards, recession is on the increase. Certainly, growth has slowed: so far this year, the US share market is down -20.68%¹. On 30 September, the Dow Jones Industrial Average sank 777.68 points (6.98%), its biggest single-day point decline ever. It's a similar story in Europe and the UK, and parts of Asia.

What does this mean for investment markets?

Just one of these problems alone would be enough to cause a certain amount of chaos on financial markets. Instead, Joe highlights that investors have been faced with all three problems arriving on top of each other. The fallout, apart from rarely seen levels of volatility, has been a drying up of available credit - or what is now known as the 'credit crunch'.

"Companies have found it increasingly difficult to borrow money for expansionary activities, and company growth prospects have been affected. When there's little or no growth, we know the chance of recession increases."

Careful steps for Australian investors

For Australian investors, this remains a very difficult investment environment, with almost all asset classes except cash, now showing negative returns this year. Amid the market turmoil, however, Joe believes there are reasons to remain upbeat. Australia has many advantages compared to other economies. He cites the banking sector as an example, suggesting Australian banks don't have the same nasty surprises lying dormant as the American sector.

“Local banks either don’t have the same volume of ‘bad money’ on their books, or those that have shown distress are generally taking write-offs now.” The Reserve Bank of Australia also appears to be relaxing its inflationary concerns, cutting rates for the first time since 2001. A large contributor to inflationary pressures in Australia has been rising oil prices and food costs. The oil bubble seems to have burst, dropping from US\$145² a barrel to close September at US\$102.20 a barrel. Food prices also continue to come down.

Joe also believes that concerns around the impact any slowdown in the Australian housing market might have on the economy are legitimate, but it’s not all bad news. “Some may argue that Australian property is overvalued, but the lack of available housing - particularly in Sydney - should put a natural floor on any fall in housing prices.”

He also believes the demand for commodities will continue, particularly from China. “All economies go through cycles, and China is no exception. We do expect a slowdown from the meteoric growth levels we’ve seen over the past few years, but don’t ignore the demand for commodities generated within China. While China continues to grow (albeit at lower levels) demand for Australian commodities will continue.”

Where to from here?

From a valuation perspective, the market declines are now bringing most asset classes back to being attractive. However, valuation alone is not always enough to justify owning (or buying more) growth assets, especially when the outlook is uncertain. It’s likely we’ll see more unsettling news in coming weeks, so sticking to long-term investment strategies is still BT Investment Management’s preferred approach.

As for a recovery, Joe and the BT Investment Management team believe it’s still too early to call, but it’s possible we’ll start to see signs of stronger performance in the early months of 2009.

“The recent actions by the US Federal Reserve, including the much-debated US\$700 billion bail-out package, should put a bottom on the ‘credit crunch’. These actions should also be taken as a signal that problems with US financial services and insurance companies - like AIG, Fannie Mae and Freddie Mac - won’t be ignored. The US Federal Reserve is taking steps to safeguard markets - this might not happen tomorrow, but it will happen.”

A final comment

If the BT Investment Management view on the likely global policy response to the current crisis is broadly correct, then current dips in equity and credit markets could be used as opportunities to add selectively to a diversified portfolio. As always, investors should proceed with caution and seek professional advice.

1_Returns to 30 September 2008. US share market measured by the S&P 500 Index

2_Bloomberg