Client Update – Market Conditions

Since the beginning of November we have seen very high levels of market volatility as well as some losses in global credit and equity markets. After the initial market meltdown we experienced in August (and the subsequent recovery) once again conditions feel difficult.

What is going on?

The key driver for the current volatility is the rapid decline of confidence that is occurring in the wholesale or institutional credit markets. When we wrote to you about the difficult conditions in August the market was expecting losses on US sub-prime and Alt A (poor quality) mortgages to be in the vicinity of US$200 billion. This would represent about a 10% loss in this US$2 trillion market and 1% loss in the total US$10 trillion US mortgage market.

Roll forward to November and these losses are looking much larger. Default rates in the US sub-prime and Alt A markets are may now be running around 25% and with US housing prices falling further than expected this could go higher. Added to the falling home value problem is the impact of the interest rate re-set effect when many of these poorer quality mortgages click over from their initial incentivised no interest or low interest rates to higher market rates. A large portion of these resets are expected to occur in the first half of 2008.

So, losses on sub-prime mortgages are now looking more like $US500bn and rising. These losses in themselves are not likely to collapse credit markets as long as they can be funded. The real issue is now confidence. The clever (clearly not so clever now) financial engineering that has been undertaken in converting poor risk credit investments (like sub-prime mortgages) into acceptable products for institutional, hedge fund and mum and dad investors to buy means that no one really knows who owns the losses on them.

Looking through the complexity of these structures is extremely difficult as they comprise a maze of derivatives and re-insurance arrangements with thousands of different counter parties around the globe. Not knowing who owns the losses and how big they are is creating a crisis of confidence.

Global wholesale credit markets only work if counter parties in this market are confident. Lenders need to know they will be repaid. For example if a large commercial bank needs short term funding they would normally borrow these funds on the short term money market (from other banks). If there is now a real risk that the borrowing bank might have some unknown or undeclared sub-prime losses that might seriously impact its balance sheet then the other banks may not lend to them.

Central banks are trying to ensure there are sufficient funds in the system but they also don't want to save those that should not be saved. The markets have not priced credit risk appropriately for the last 3 years in particular and the central banks don't want to prop up bad lenders…their failure and the re-pricing of credit risk back to more normalised levels is part of normal market operations.

So what happens now?

The situation is difficult and short term funding markets are nearly dysfunctional. Systemic risk is a possibility. Left unchecked a collapse of confidence could see global wholesale credit

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markets dry up further and borrowing become excessively expensive for nearly all types of borrowers (not just mortgages). This could affect private, corporate and finally sovereign (country) borrowing certainly impacting economic growth (and increasing the risk of US recession).

Will it come to this?

Despite the reluctance of central banks to get involved directly in rescuing lenders we believe they will now move increasingly quickly on marshalling banks together to provide rescue vehicles (some are already underway) to house and manage these sub-prime (and associated structured investment vehicles that own them) loans. The central banks need to ensure that wholesale or institutional short term credit markets can operate with confidence. This confidence for short term funding is the minimum platform required to deal with the longer term issues of sub-prime mortgage write offs.

Against the credit crises, US corporate balance sheets are in excellent shape and world growth continues well above long term trend levels with forecast growth next year of 4%+ driven by China, India and Russia in particular. Even if the US slows to very low levels of growth next year (or even a recession) the world economy is likely to continue growing at a reasonable rate. This should provide support to investment markets.

What should our investors do?

It is one thing to know something might happen. It is a completely different matter knowing when it will happen and how big the event will be. Trying to second guess shorter term events and their impact on markets is appropriate for shorter term investors or traders. This is not appropriate however when investing in longer term portfolios that have long term specific risk and return objectives.

All our clients hold asset allocations that have been specifically designed to suit their own longer term portfolio risk and return requirements. These allocations take into account the type of volatility we are now seeing. Additionally, the securities we recommend within those allocations are high quality assets. We have for instance never recommended our clients invest in junk bonds or debentures or non-investment grade credit or structured credit products.

We are confident that the asset allocations and securities our clients hold are appropriate for weathering difficult markets. From our experience we know that while current market conditions are unsettling it is very important to maintain a focus on the longer term game.

Please call either Wayne or Mike if you would like us to talk you through your portfolio.

Kind regards

Wayne Ross and Mike Newton

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