

Client Update – Market Conditions

There has been a lot of financial markets news in the press over the last two weeks following continued retractions in global bond and share markets.

The reason for the market falls is the anticipated flow-on effect from expected lending losses in the US sub –prime (lower quality) mortgage market. Over the last 4-5 years in particular credit has been getting cheaper globally. Lenders have been taking on higher risk loans and these higher risk loans have to a large degree been funded by mum and dad savings through their investments in finance companies, high yielding and often leveraged funds, junk bonds, as well as structured products and some hedge funds.

The tide turned in the US sub-prime mortgage market earlier this year with an oversupply of housing stock in the US (driven by real estate speculation) reaching a tipping point. As house prices fall, borrowers have been stuck with negative equity in their homes and poorer quality mortgages have gone into default. The extent of the losses on these mortgages is growing and could be as much as US\$200 billion). This represents 1.5% to 2% of US GDP and while it remains unlikely to tip the US into recession it remains a risk.

All this news is not new and it has been around for months. What is new is that the bond and share markets were not expecting the degree of losses and the follow on impact that is now taking place. It is now a classic 'fear and greed' environment that has now firmly stepped over into the 'fear camp'. Interest rate 'spreads' (or the difference between good quality and bad quality fixed interest investments) are now widening to reflect a more normal level of risk. These spreads are likely to continue to widen with poorer quality fixed interest yields rising further and their values falling further as investors sell and move to better quality assets.

Overall, we expect that higher risk lenders will continue to suffer with losses in the sub-prime US market likely to grow further. The widening of interest rate spreads is quickly tightening money supply and the very easy credit environment that has been the norm for the last few years is rapidly disappearing.

Tight money supply will affect many company mergers and acquisitions that rely on borrowings to work and we subsequently expect the takeover premium that is priced into many shares in many markets (including NZ) to unwind further as deals and potential come off the table resulting in share price falls.

In addition to seeing lower quality finance company difficulties there will likely be further hedge funds (with leveraged exposure to lower quality loans) problems and structured product failure.

So what to do?

At SELECT we always take a very careful view on asset risk. Despite the increasingly high yields being offered by many fixed interest investment products and

securities over the last few years we have never lost sight of the risk they contain. For this reason we have avoided using finance companies and structured products for the very reason that the risk they present does not justify the return they provide.

The investments we have recommended to our clients are designed to provide the best possible return for their risk.

When market volatility is high however, even good quality asset prices are affected. So we expect client portfolios will be negatively impacted over the short term as markets fall. As markets start to recover (and they will) then these assets will be the ones that also recover and we expect their values will be supported over the next few months.

SELECT does not encourage clients to try and time or trade the market. Our experience over many years (and in very difficult as well as very good market conditions) has taught us that trading adds little if any value and often subtracts value. That is why we focus on longer term strategic asset allocation setting. That is the prime driver of risk management and attainment of long term returns.

During these difficult market conditions we recommend our clients to sit tight as they have good quality assets. They should also be secure in the knowledge their portfolio asset allocations have been individually built taking into account these types of market conditions.

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

Kind regards

Handwritten signatures of Wayne Ross and Mike Newton. The signature on the left is 'Wayne Ross' and the signature on the right is 'Mike Newton'.

Wayne Ross and Mike Newton