

Markets Update

Just a short note to provide our view on present market conditions.

The current sell-off in global financial shares (predominately US) is a direct consequence of the failure of several US investment and commercial banks to raise capital to support their balance sheets in the wake of writing down their exposures to the sub-prime mortgage collapses.

These failures started with Bear Stearns and a US Treasury assisted sale to JP Morgan Chase earlier this year. Since then there have been a number of regional bank failures and all eyes have been on the larger investment and commercial banks who have been struggling to raise capital.

Last week the US Government effectively nationalised Freddie Mac and Fannie Mae to underwrite US\$5tr in US mortgages. They could not afford to let these institutions fail for the systemic risk they represented.

On Sunday, Lehman Brothers announced they had failed to sell their business to Barclays Bank after struggling to raise capital for months and subsequently have filed for bankruptcy. Close on the heels of this announcement Merrill Lynch have advised they have been bought by Bank of America.

AIG has also approached the Federal Reserve for funding reported at \$40bn.

In the absence of fresh capital injections or the ability to sell their assets, the US banks with significant sub-prime woes have little choice other than to be bought or merge with other banks with more capital (or shut up shop).

Importantly with the Lehman Brothers failure, the US Treasury is sending a clear message to the rest of the banks that they cannot necessarily rely on a Government bailout and that they need to more aggressively resolve their own capital requirements.

The US has some 8500 banks and it is likely there will be several hundred failures at the end of all this particularly for regional banks in areas where real-estate prices have been worst affected. Similar levels of failures happened in the early 1990s.

There will also be a few large US banks allowed to fail but where they represent significant system risk they will likely be propped up or supported in a sale by the US Treasury.

Globally, as we have said before, there are sufficient savings to support the global financial system. However, those with excess savings, namely the sovereign wealth funds of the far-east and middle-east have not had a good experience recently propping up US banks. Many made substantial investments in US banks in June and July only to see their value fall 25% to 50%. They have now firmly retreated to the sidelines to watch.

Where to from here.

The key to underpinning the US banks in the short term is fresh capital or the sale of mortgage assets. Both of these options are not readily available at present leaving mergers and bank takeovers most likely as those with stronger balance sheets take advantage of conditions to gobble up competitors.

In the medium to term stabilization of real-estate values is required to underpin the banks assets. To date, US real-estate is down -20% on average from the peak in 2006 with some areas down -50%. While prices will probably fall further, recent data is showing the rate of fall in prices is starting to slow.

In the meantime we expect that the US Federal Reserve may further reduce interest rates (to 1.75%) and there will be a rolling series of rescue packages as the US taxpayer is called on to prop up key banks and the financial system. It will be messy and a day to day process.

Markets Impact

Financial shares, particularly in the US are taking a battering, elsewhere they will also be affected but more as a consequence of sentiment than balance sheet issues. There are exceptions of course where non US financial institutions also have an exposure to US sub-prime mortgages.

Property prices in the UK, Europe and Australia are under pressure which will put reserving pressure on banks in those markets as well though the extent of poor quality lending is low compared with the US.

Global financial stocks have already been sold down significantly over the last year and represent good value in many markets. We expect there will be a recovery in those companies in the short term once the current market sentiment subsides.

Systemic Risk

The systemic risk of a dysfunctional global financial system is certainly real but has been relatively well managed to date. Much has been mentioned about the financial derivatives markets, particularly the credit default swap market and they remain a high risk. What we do know is that the central banks around the world are working together to ensure the global financial system continues to function albeit with higher degrees of risk and cost. The systemic risk will not go away until asset prices have fallen enough and have stabilised. While there are some early encouraging signs this is happening it may take another 6-9 months for this to happen.

Economic Impact

As balance sheets in the financial sector contract and asset prices fall so the impact is felt in the economy with less funding available for businesses and for household consumption. This deleveraging is happening globally and represents a reigning in of years of excess consumption and asset price inflation.

As a direct consequence global growth is slowing and the de-coupling theory is under pressure as the UK and Europe move into likely recession or very low growth levels alongside the US. Developing economies have also slowed but are still generating good numbers.

Overall global growth is expected to be about 3.5% this year and about the same in 2009. This is a far cry from the 5%+ growth of the last 5 years and represents a lower earning growth environment for business as well.

Slower company earnings growth has largely been factored into current global share prices but the recent rout in financials is likely to push prices down further in the short term.

What to do?

The sale, merger, bail-out and bankruptcy of weak US banks currently taking place is actually a good thing. This rationalisation allows for a re-basing of the financial system in the US which has become way too extended and supported by asset price inflation (real estate). In our view this current rout signals capitulation and an opportunity to clear the decks for a more positive outlook.

For our clients, we constantly monitor the assets they are holding in their portfolios (and undertake formal quarterly reviews of all assets) and we remain confident that the assets held are all high quality and portfolios are appropriately diversified to meet each clients risk and return targets. The assets will weather current conditions and recover value as things settle down.

If you have any concerns or would like to discuss current conditions please call Wayne or Mike on 09 377 5777.