

What is happening in the market?

What triggered the decline in the sharemarket early this year?

Just prior to the federal elections in November 2007, the Reserve Bank of Australia (RBA) effectively declared war on inflation. It lifted interest rates in early November and followed this with further increases in February and March 2008.

In order to curb rising inflationary pressures, the RBA felt that it had to slow the pace of growth in the Australian economy. The prospect of weaker earnings growth by Australian companies sent the sharemarket tumbling.

At the same time, problems with sub-prime lending in the United States were coming to a head. US banks were announcing large losses and negative sentiment towards the US sharemarket spilled over into Australia.

The US sub-prime problem also reignited investors' awareness of risk. This led to a sharp increase in the interest rates at which companies could borrow money, if indeed they could borrow money at all. The banking system faced a crisis, a shortage of cash to borrow, otherwise known as a liquidity crisis. This would disrupt company earnings and contributed to the fall in the sharemarket.

After signs of recovery in April and May 2008, the market slipped back again in June as the impact of high interest rates and high petrol prices were felt by Australian consumers.

How have the authorities responded to these issues?

In the US, the authorities were faced with a slowing economy and a liquidity crisis, or what has been known as the "credit crunch". In Australia our economy was still growing strongly but the financial system did face the problem of a lack of funds to borrow.

To assist its economy, the US Federal Reserve reduced US official interest rates. Interest rates have been reduced from 5.25% in September 2007 to now stand at 2.00%. It also injected cash or liquidity into its banking system and assisted the takeover of Bear Stearns, a large investment bank that was close to collapse, by rival bank JPMorgan Chase. The US government also chipped in by announcing \$150 billion in personal tax cuts.

Around the world, and including Australia, central banks acted to ensure that banking systems had funds to continue operations. In the United Kingdom, the government went to the length of taking control of Northern Rock, a bank that was facing difficulties.

Market movements

From early November 2007 to mid-March 2008, the Australian sharemarket fell almost 25%. The S&P/ASX All Ordinaries share price index fell from 6853 points to 5163 points. From mid-March the market rose over 15% back to 6035 points in mid-May before tumbling down to 5022 points by early July.

The fall in the Australian sharemarket has been more severe than in other major markets. This was because Australia had to cope with rising official interest rates as well as the liquidity crisis triggered by US sub-prime lending.

A road to recovery?

The sharemarket rally in April and May came as authorities around the world stabilised and supported their financial systems, and as the US reduced its official interest rates.

Further bank losses in the United States and Europe undermined the rally as did the escalating price of oil.

Issues still to be faced relate to the pace of economic growth in the US and Australia. If higher interest rates in Australia slow the economy more than expected, then companies may issue further profit downgrades or profit warnings. This could unsettle the sharemarket.

Of particular interest will be the profits of banks. This group of companies make up around 20% of the sharemarket and their businesses have come under short-term stress due to rising interest rates. Banks have had to pay significantly more for the funds they borrow in global capital markets and this will affect the demand for loans by their customers for at least the remainder of 2008. By 2009, however, banks are likely to have picked up a larger share of lending as competitors struggle to raise funds at competitive rates.

The road to recovery in sharemarkets requires US house prices to stop falling. Falling house prices and low demand for US housing lie behind the losses that US banks have been reporting for the Market bulletin What is happening in the markets? July 2008 last nine months. A further cut in US interest rates may help, but official US interest rates have already been cut substantially.

When it becomes clear that official interest rates in Australia have stopped rising, investor confidence will be boosted. Due to ongoing inflationary pressures, this stage has not yet been reached. It remains possible that the RBA will lift interest rates again.

Finally, recovery will come when the market for corporate borrowing, known as the credit market, becomes fully operational again. At present, the desire to lend to companies is low. Trust needs to be re-established so lenders will offer interest rates that reflect the true risk of each transaction.

Positive news

Despite the gloom in markets we do well to remember that parts of the Australian economy are still booming. The resources sector has seen the prices of coal and iron ore rise significantly. Share prices for the resources sector were higher in July 2008 than they were in July 2007 despite some weakness since June 2008. Rains over parts of Australia should assist rural incomes and rural exports.

Finally, the boost to share prices from takeover activity is not dead. In recent months, takeover bids have been made for a number of Australian companies. The bidders believe that at current prices, including a takeover premium, there is value in their takeover target.

There are issues to be resolved but Australia remains well placed to grow over the next five to ten years.

What should an investor do in these times?

Fear, greed and patience are some of the dominant emotions associated with the sharemarket. After a brief respite in April and May, 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.

Despite the recent falls in the Australian sharemarket, share prices are still up 8% since the beginning of 2006 and up 70% since the beginning of 2003.

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

Source: Colonial First State, Market Bulletin July 2008

PRIVACY POLICY: You are in receipt of this publication because you are a client of Modoras Pty Ltd, or you or someone you know may have requested you to be included on the publication's distribution list. If you no longer wish to receive this publication please let us know via mail to PO Box 6530 Upper Mt Gravatt Queensland 4122, or via telephone to (07) 3219 2555, or alternatively via email to info@modoras.com.

IMPORTANT INFORMATION: The information and opinions contained in Financial Facets are of a general nature only and does not take into account the investment objectives, financial situation or particular needs of individual investors and does not constitute specific or personal advice. Any individual making an investment decision should make their own assessment taking into account their own particular circumstances. The information and opinions herein do not constitute any recommendation to purchase, sell or hold any particular investment. Modoras Pty Ltd recommends that no financial product or financial service be acquired or disposed of or financial strategy adopted without you first obtaining professional personal financial advice suitable and appropriate to your own personal needs, objectives, goals and circumstances. Please note that past performance is not necessarily indicative of future performance. Investment markets are volatile and time sensitive. Information, forecasts and opinions contained in Financial Facets can change without notice. Modoras Pty. Ltd. does not guarantee the accuracy of the information at any particular time. Although care has been exercised in compiling the information contained within Financial Facets, Modoras Pty. Ltd. does not warrant that the articles within are free from errors, inaccuracies or omissions. To the extent permissible by law, neither Modoras Pty. Ltd. nor its employees, representatives or agents (including affiliated companies) accept liability for loss or damages incurred as a result of a person acting in reliance of this publication Financial Facets © Modoras Pty. Ltd. ALL RIGHTS RESERVED. Financial Facets has been prepared by Modoras Pty. Ltd. ABN 86 068 034 908. Modoras Pty. Ltd. is a holder of an Australian Financial Services Licence (Number 233209) issued by the Australian Securities and Investment Commission.



FinancialLine

STRATASTREAM



Phone 07 3219 2555 Fax 07 3219 4432

Email info@modoras.com

Level 3, 18 Mt Gravatt-Capalaba Road
PO Box 6530 Upper Mount Gravatt Q 4122

www.modoras.com

Modoras Pty. Ltd ABN 86 068 034 908

Australian Financial Services Licence No: 233209