

Not since 1987, when Bob Hawke was Prime Minister and England last won the Ashes on Australian soil, has the Australian Sharemarket suffered a worse quarter.

Specifically, the All Ordinaries Index fell 15.8 per cent – its worst fall since a 41.4 per cent slide in the fourth quarter of 1987. The March quarter falls coupled with the late falls in the December quarter have amounted to a 21.1 per cent decline in the All Ordinaries index from its record high of 6,853 points on 1 November 2007 to a close of 5,409 points at 31 March 2008.

Characterising the market performance was the fact that only 35 of the stocks in the S&P/ASX 200 ended the three months in positive territory. The majority of these stocks are from the resources or materials sector which have been buoyed by record commodity prices.

Poor performing stocks came from most sectors. However, both the listed property and financial stocks were prominent amongst the negative performers. The table below is a snapshot of the performance of stocks in the ASX Top 20 from the high on 1 November 2007 to 31 March 2008.

Company	Percentage Performance 1/11/2007 to 31/3/2008
AMP Limited	-24.52%
ANZ Bank	-25.87%
BHP Billiton	-23.65%
Brambles Ltd	-29.96%
Commonwealth Bank	-32.18%
CSL Limited	6.15%
Macquarie Group Ltd	-37.90%
National Australia Bank	-30.69%
QBE Insurance Group	-32.12%
Rio Tinto	6.52%
St George Bank	-30.70%
Stockland	-22.59%
Telstra	-6.58%
Telstra Instalment Receipts	-12.19%
Westpac Bank	-23.54%
Westfield Group	-19.27%
Wesfarmers Limited	-8.59%
Woolworths Limited	-12.99%
Woodside Petroleum	4.30%

Whilst the above table does not make good reading, many analysts believe that we may have reached the “bottom” for the Australian sharemarket and that recent positive news may provide the market with good reason to recoup some of its losses in the short to medium term.

The Australian market wasn’t the only sharemarket to suffer with most major sharemarkets around the world declining sharply. The following table shows the returns of some key international sharemarkets:

Index	Country	3 month performance to 31/3/2008
S&P 500	United States	-7.9%
FTSE 100	United Kingdom	-11.8%
Hang Seng	Hong Kong	-17.9%
Nikkei	Japan	-18.3%
Shanghai Composite	China	-34.4%

Why has this happened?

If you’ve had your ear to the ground in investment news recently you may have heard two common phrases, “sub prime” and “credit crunch”, which have now become the cornerstone in the vocabulary of analysts, investors and to a lesser extent the media.

The “sub prime” issue involved thousands of homeowners in the United States (US) who borrowed money through “sub prime” or “low documentation” loans defaulting on the loans following a built-in increase in the interest rate, causing lenders to re-assess the risk that they were taking on by lending to certain types of borrowers.

The global credit crisis or “credit crunch” has developed from the US “sub-prime” issue. The problem essentially involves a lack of liquidity in debt markets. As lenders become more risk averse, it is becoming increasingly harder for companies to source debt and even those that are successful in obtaining or refinancing borrowings are suffering as they are paying a substantially higher interest rate to gain access to those funds.

There are also concerns that the United States will slip into recession as their banking sector writes off large debts associated with sub-prime loans and consumers in the United States reduce spending.

In addition, there has been a substantial increase in the number and value of margin calls as sharemarkets have fallen. Forced sales to bring margin loans into an acceptable loan to valuation ratio have compounded the fall in the share price of certain companies.

How has this impacted the Australian sharemarket?

The potential impact of the credit crunch was initially highlighted to Australian investors when one of our largest listed property trusts, Centro Properties Group, announced in late December 2007 that they had been unable to negotiate the refinancing of a debt facility that was due to mature on 31 December 2007. The share price of this company fell 76% in one day after the trading halt was lifted and the company now trades at around \$0.50 per share compared to a close of \$5.70 before it made its announcement.

In recent months, other high profile companies have also been forced to disclose to the market that they have had some issues in refinancing debt. The share prices of Allco Finance Group, ABC Learning Centres and MFS Limited have all suffered large falls upon making an announcement to the market.

These companies were characterised by high-gearing and complex financial structures, which in the bull markets of recent years were providing strong returns. However, in the wake of the credit crisis and the fact that the companies had too much debt subject to refinancing, these companies were punished by investors.

The fall of the above Australian companies coupled with the huge losses being reported by financial institutions in the United States and Europe, has created a large amount of nervous investors, not just in Australian but in markets worldwide.

The key result of an increase in nervousness or negative sentiment amongst investors has led to some widespread panic and indiscriminate selling, with investors unable to discriminate between the good, the bad, and the ugly.

For example, Australia’s leading banks have suffered on two fronts:

- (a) because they have had to increase their provision for bad debts
- (b) because investors have associated Australian Banks with their poor performing US counterparts, which have a much larger exposure to “sub prime” and companies suffering from the “credit crunch”.

It is this “guilt by association” that we, and many market analysts, believe has led to the overselling of some good quality companies with strong earning potential.

Where to from here?

We are yet to know if the US will head into recession, however, we note that the US Federal Reserve appears to be doing everything in its power to prevent a recession. In attempts to stimulate the US economy the Federal Reserve twice cut the Federal Funds Rate by 0.75% in the March quarter. These cuts were the two largest ever cuts in a single meeting and left the official interest rate at 2.25%.

In addition, the US Federal Reserve has taken the unprecedented step of allowing banks in the United States to swap the "equity" they have in sub-prime loans for US Treasury Bonds, to improve their level of capital.

These measures are an attempt to ensure that liquidity and confidence improves in credit markets and, whilst they are a step in a positive direction, we still expect periods of volatility to arise on the back of any negative news to come out of the United States.

The reaction of the sharemarket to recent events would suggest that if the United States headed into recession, the Australian economy would slow to a halt. Although a recession in the United States would impact most major economies around the world, the emergence of China in recent years and its demand for Australian resources to develop its rapidly expanding infrastructure, is likely to reduce the impact on the Australian economy.

In fact, if anything, the Reserve Bank in Australia is faced with the opposite problem to the US Federal Reserve – an economy that is very strong with demand outstripping supply, leading to increases in the rate of inflation.

In an attempt to cool the retail sector of the Australian economy, the Reserve Bank has increased interest rates four times since mid 2007 and the official interest rate is now 7.25%. Increases in mortgage and consumer lending rates over and above the increase in official interest rates by Australia's retail banks have most likely reduced the likelihood that the Reserve Bank will need to lift official interest rates further in the short term, with evidence emerging of a small reduction in retail spending and consumer borrowing.

The recent rise in interest rates and a refocus by Australia's retail banks to raising capital by way of customer deposits has resulted in term deposit rates increasing to attractive levels.

The unit prices of listed property trusts have fallen to levels where they no longer represent a large premium to their net tangible asset backing.

Shares, both in Australia and many overseas markets, also appear to be trading on valuations that are cheap by historical standards (as measured by the price earnings ratio). While these valuations may be justified in a slowing economic environment, sharemarkets in most western countries are factoring in a 20% to 30% fall in average profits, which would appear to be a worst case scenario, and is evidence of the negative sentiment currently being shown in many sharemarkets.

Whilst the recent negative returns experienced in your portfolio may see you feeling slightly apprehensive towards your portfolio's exposure to growth asset classes such as Australian and International shares, it is important to remember that the long-term investment strategies that have been implemented are reviewed and adhered to.

We are happy to discuss any issues or concerns you may have regarding markets in general or your investment approach going forward and encourage you to contact us at your convenience with any concerns.

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