

## **SPECIAL MARKET UPDATE**

### **REVIEW OF 2008 AND OUTLOOK FOR 2009**

To say that 2008 was a difficult year for investors is certainly an understatement.

We had an unprecedented decline in global equity markets. Australia was not immune to these declines, with all 10 sectors of the S&P/ASX 200 finishing lower. Cash and fixed interest were the only bright spots, posting positive returns.

Can we see the light at the end of the tunnel? Yes, but the timeframe depends on the effectiveness of the fiscal and monetary stimulus in the US and Europe and the return of investor confidence which has been badly hurt. For Australia, it will also depend on China's economic growth for the year as this will affect the price of commodities and the revenues earned by the Australian resources sector.

In order to get a feeling for how 2009 will progress, we have reviewed some of the major events of 2008, discussed what can be learned from these events and have tried to make some sense of the multitude of financial forecasts for 2009.

#### **SOME OF THE HIGHLIGHTS (LOWLIGHTS!) FROM 2008**

What a year it was for events and statistics! We have highlighted some of the major events of the year below:

**March.** Broker Opes Prime collapsed in March sparking a sell off in the Australian share markets. The result of this collapse affected approximately 25% of all shares.

**July.** The Australian dollar flirted with parity against the US before rapidly declining from \$0.9884 in July to a low of \$0.6059 in October.

**September.** In what could turn out to be "the year that changed capitalism", the US Treasury took over or bought stakes in a number of financial institutions. The two largest US mortgage providers Fannie Mae and Freddie Mac were taken over in September and the largest reinsurer in the world, America International Group (AIG) was bailed out shortly afterwards with a \$107 billion loan.

Lehman Brothers, an investment bank that survived all manner of crises during 150 years filed for bankruptcy. This bankruptcy was one of the catalysts that further weakened the financial markets in the second half of 2008.

**October.** Banks lost confidence in the banking system and stopped lending to each other. The LIBOR rate, which is the interest rate at which banks lend to each other, skyrocketed, rising to a record spread of 3.64% over official interest rates. To put this into perspective, in July 2007, before the sub-prime mortgage crisis became an issue, the LIBOR rate spread was 0.1%.

In response to the crisis unfolding in the global financial system, in mid-October, the finance ministers of the major economies, known as the G7 and G20, held a meeting and resolved to work together to achieve the following:

1. Take decisive action using all available tools to support struggling financial institutions and prevent their failure.
2. Take all necessary steps to unfreeze credit and money markets.
3. Ensure that banks can raise capital from public as well as private sources, in sufficient amounts to re-establish confidence and permit them to continue lending to households and businesses.
4. Ensure that savers' deposit insurance and guarantee programs are robust so savers have confidence in the safety of their deposits.
5. Take action, where appropriate, to restart the mortgage securitisation markets.

Following this meeting, governments in all major economies around the world announced large tax cut and spending packages to go with the guarantees provided on all bank deposits.

**November.** Barack Obama wins the nomination for the US presidency and immediately begins work on a massive \$1.1 trillion spending package to stimulate US economic growth which seems to have generated some hope for US investors and consumers.

**December.** The US, Japan and much of Europe confirmed that their economies were in a recession (the US having been in recession for 12 months!)

The major US car manufacturers, GM Motors, Chrysler and Ford, asked the US Congress to provide emergency funding to prevent them being forced into bankruptcy, causing concern in financial markets as to the economic impact this may have in the US and around the world.

Major commodity prices gave up between 50% and 70% of their values during 2008, with most of the falls occurring in the second half of the year.

## INVESTMENT PERFORMANCE

The following table shows the investment performance for the 12 months to 31 December 2008 of the major assets classes:

Market Performance as at 31 December 2008			
Asset Class	3 months	6 months	12 months
Cash	1.69%	3.66%	7.60%
Australian Fixed Interest <sup>^</sup>	6.34%	12.00%	14.95%
Australian Listed Property Trusts	-32.87%	-33.71%	-53.99%
Australian Shares	-18.48%	-27.20%	-38.92%
International Shares (\$A)	-11.41%	-8.27%	-24.99%
International Shares (Local)	-21.19%	-30.52%	-40.14%
North America (\$A)	-13.76%	-6.30%	-23.55%
Europe ex UK (\$A)	-11.14%	-14.49%	-33.43%
Japan (\$A)	2.77%	2.11%	-12.58%
Asia (\$A)	-7.71%	-3.94%	-27.24%
International Listed Property Trusts (\$A)	-27.72%	-16.00%	-31.02%
\$A Vs \$US	-11.33%	-26.70%	-19.72%

<sup>^</sup> The index used for this asset class includes exposure to government and corporate bonds, whose capital value can change, unlike traditional term deposits.

## LESSONS TO BE LEARNED

What can be learned from the financial crisis that affected the financial markets last year?

We have been reminded that some things never change and that tried and tested methods have usually stood the test of time. Below are some of our observations:

**1. The business cycle is not dead.** The business cycle refers to fluctuations in economic activity and involves shifts between periods of growth (recovery & prosperity) and decline (contraction or recession). Whenever times are good, forecasters will tell you that the world has changed and that the old rules no longer apply. This has recently been the case with the commodities market where demand from China and India was expected to fuel an indefinite commodities boom.

A looming recession in North America and Europe has put an end to the commodities boom for now and has resulted in some spectacular declines in the major commodity markets in the last 12 months.

**2. Avoid too much debt.** Companies with high debts have found it difficult to refinance their debt as banks have been unwilling to lend further. This has resulted in some high profile casualties such as ABC Learning, Allco Finance Group, Centro Properties Group and MFS. Analysts expect companies with low debt burdens and strong balance sheets to benefit from the current financial crisis, in some cases giving them the opportunity to buy assets at discounted prices.

Investors that have bought shares using gearing have been adversely affected by declining share markets and losses have been compounded.

**3. Back to basics.** Avoid financial engineering products. These products are usually hard to understand, expensive and may not perform well in declining markets. Hedge funds, too, have been caught out in the financial crisis. Some have over-leveraged themselves and hold illiquid assets that may be difficult to sell in the current markets.

If it is too good to be true, then it usually is. Avoid investment schemes that promise above market returns. These investment schemes usually fail to deliver on their promises.

**4. Income is good too!** The total performance of a financial asset includes income as well as growth. Share dividend yields have risen over the year and those shares that have paid a steady dividend have benefited their holders. These higher dividend yields should over time make shares more attractive to other investment alternatives such as cash and fixed interest. Please see further comments below regarding our outlook on shares.

Don't forget cash and fixed interest for generating income. In 2008, fixed deposit rates briefly rose above 8% during the year but have fallen recently.

**5. Diversification reduces the risk** that a negative performance of one investment will have a detrimental impact on the portfolio. As the table on the previous page shows, different asset classes (and sub-sectors within these asset classes) achieve different rates of return in different market conditions. By investing across the four major asset classes of cash, fixed interest, property and shares, returns will be moderated.

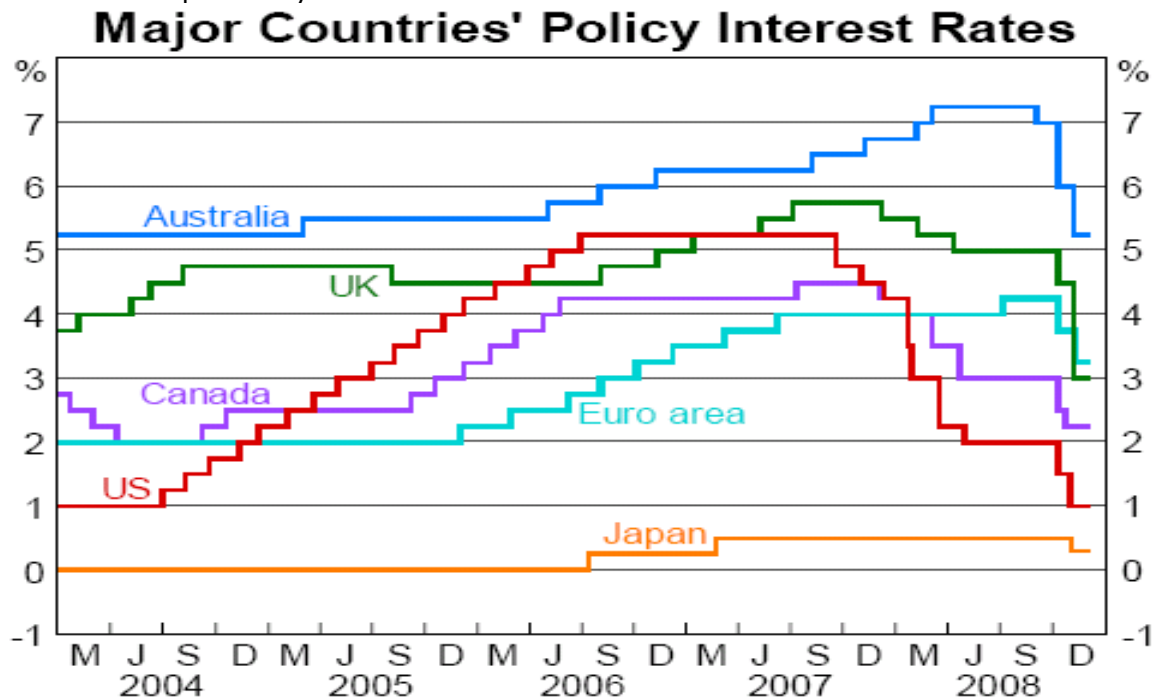
We note that cash and fixed interest have outperformed shares and property in the last 12 months and would have made a positive contribution to any diversified portfolio's return. However, even after the large falls experienced in 2008, Australian shares have outperformed cash and fixed interest over the last 10 year period.

## WHAT DOES THE FUTURE HOLD?

Financial publications and newspapers are awash with predictions from late December till early January from some of our brightest investment stars. Many of these predictions, although well thought out and thoroughly analysed, may not stand the test of time. Here are some of the forecasts:

### 1. Interest Rates

The consensus is that interest rates will fall further this year. The range of predictions of where the Reserve Bank's cash rate will end this year, vary from 2.5% to 3.5%. The chart below shows the sharp decline in interest rates by major central banks around the world in recent times up to early December 2008.



Source: Reserve Bank of Australia

Since the above graph was prepared in early December, all countries mentioned (with the exception of Japan) have reduced their interest rates further by between 0.75% and 1%. The Reserve Bank in Australia has reduced official interest rates by a further 1%, leaving our official cash rate at 4.25%.

In the US, Federal Reserve Chairman Ben Bernanke effectively threw away the rule book on US Monetary policy after the Federal Reserve Bank lowered interest rates to between zero and 0.25% in December. The Bank of Japan followed shortly afterwards by cutting interest rates to 0.1%, while the Bank of England has cut official rates in the UK to 1.5% in early January 2009, its lowest level in its 315 year history.

With interest rates near zero, the US Federal Reserve has run out of traditional ammunition and is now using quantitative easing in an attempt to kick start the US financial system. Quantitative easing is effectively printing money. The Federal Reserve is making loans to the private sector and is purchasing asset backed securities and mortgages outright.

### 2. Cash

Cash is King! It certainly was in 2008. However, with interest rates expected to decline, returns from fixed deposits and saving accounts may decline and returns may come more into line with the lower risk of holding these assets. Term deposits that paid up to 8% last year now pay less than 5% and these rates are expected to decline further.

### 3. Fixed Interest

Government bond yields have fallen significantly during the year, resulting in higher prices and a positive return for the year. The 2-year Government bond now yields only 3%, a whopping 1.25% below the cash rate. The 10-year Government bond now has a yield of approximately 4.27% which is just above the cash rate of 4.25%. There are concerns in the long-term, that the inflationary impact of both the Government's fiscal policy and the Reserve Bank's monetary policy could eventually see bond yields creep higher, resulting in lower prices.

### 4. Shares

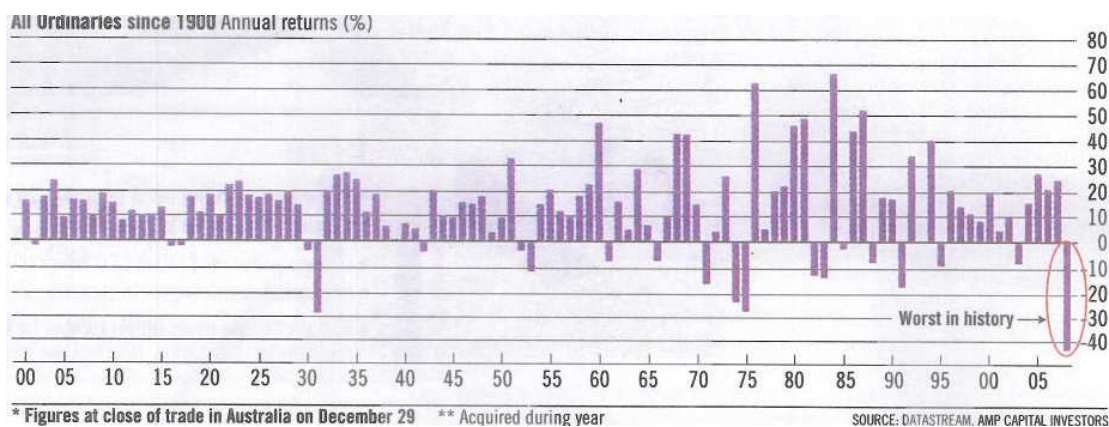
The average forecast from share market analysts surveyed by the Australian Financial Review is for a 27% increase in the S&P/ASX 200 Index to 4,600 in 2009. Well capitalised blue chip companies are expected to lead the recovery. The reason for this is that blue chip companies have the financial strength and diversified earnings to survive difficult times making them better placed to take advantage of any economic recovery.

At present, dividend yields are higher than cash on many blue chip Australian shares. For example, the expected dividend yields on the four major Australian banks are in excess of 8% fully franked. Of course, that assumes that there will be no cuts in dividends. However, even if in the worst case scenario, if dividends were cut by 30%, they should still exceed returns on cash. Dividend yields in the US range from 3-3.5%, well above current US cash rates.

The half-year reporting season in February will be closely watched by equities analysts for any bad news. In particular, the results of the big banks will be closely scrutinised for any increases in bad debt provisions.

Sharemarkets are viewed as leading indicators that anticipate moves in the economy and usually trend higher in the midst of a recession before the economy actually starts to recover. Simon Eagleton, head of investment consulting at Mercer, expects sharemarkets to start their recovery 6-9 months before the economy emerges from recession.

Sharemarkets, at times, also have a habit of pricing in most of the good or bad news. It is not unusual for a share price to trade higher after some anticipated bad news has been released. Waiting for a recession to end may result in missing out on some of the share market rally. Below is an interesting table that historically points out that large falls in share markets are usually followed by rebounds in following years.



Source: Australian Financial Review

## 5. Property

Current economic conditions are continuing to negatively impact the property markets. Lack of finance is a critical issue that has made it difficult for property investors to finance existing and future projects. There are market estimates that there may be approximately \$30 billion of buildings up for sale in the Australian market alone. The expected weakening of the world economy may also impact tenancy rates and the value of leases in the office, retail and industrial property sectors. These negative factors have resulted in investor uncertainty.

However, there may be some good news on the horizon. The lower interest rates have reduced the interest expense of holding real estate assets. In addition, many real estate investment trusts (REITs) have recapitalised in 2008 and have reduced their gearing.

## 6. Australian Dollar

Foreign exchange predictions are some of the hardest predictions to get right. The Australian dollar is expected to remain under pressure in the first half of the year as economic uncertainty persists and commodity prices remain subdued. Expected lower interest rates in Australia will also have a negative effect. However, the Australian dollar is not expected to retest its lows against the US dollar in October and may recover in the second half of 2009.

## 7. Commodities

The cooling in China's economy has taken the gloss of the commodities markets. Expectations are for commodity prices to remain weak during the first half of 2009. Any recovery of commodity prices will be closely linked to China's growth with some forecasters expecting a drop in Chinese annual GDP growth to below 8%, a minimum growth rate required to stop a rise in unemployment. In the long-term, emerging countries like China and India are expected to resume their economic growth and catch up with the developing economies.

## 8. The Economy

The International Monetary Fund (IMF) has warned that global economic growth amongst developed nations could contract in 2009, the first time this will happen since World War II.

The Weekend Australian Financial Review's annual Chanticleer outlook poll of 34 Chief Executive Officers (CEOs) published in their December 30, 2008 – 4 January, 2009 edition indicates that economic conditions for the next 12 months will remain tough. Some of the issues raised by the CEOs were rising labour and funding costs, with the CEOs of Australia's major banks expecting the economic slowdown to last at least into 2010.

The consensus is for the Australian economy to slow this year and to narrowly avoid a recession. The definition of a recession is two consecutive quarters of negative real gross domestic product (GDP) growth. ANZ chief economist Saul Eslake believes Australia will avoid the "traditional" definition of recession as he expects the government to time its fiscal spending in alternating quarters. However, if a recession is defined as a significant increase in capacity without a corresponding increase in output, then the expected increase in the unemployment level from 4.2% to at least 6% is consistent with a recession.

CBA chief economist Michael Blythe noted that "**Australia will probably avoid recession – unfortunately it will feel like one**".

However, there are some positive factors which should not be overlooked.

The government, through its fiscal policy, has injected approximately \$10.4 billion into the economy in December through handouts to pensioners and families. The fall in interest rates, petrol prices and consumer goods (due to major department stores bringing forward

their stocktake sales to pre-Christmas) has benefited household budgets and is likely to give a short-term boost to economic activity.

The weaker Australian dollar should benefit exporters, making their exports relatively cheaper in overseas markets, and should also offset some of the declines in commodity prices, aiding the resources sector.

Further interest rate cuts are predicted and the government is considering bringing forward promised tax cuts to provide further stimulus to the Australian economy.

## **CONCLUSION**

There is little doubt that 2008 will be looked back on as a year in which some extraordinary things happened.

Unfortunately, in terms of investment performance, the year was a dismal one. Such dramatic falls in the price of assets can lead even long-term investors to question their previous decisions and test their resolve to stick with their long term investment strategy.

The chart on the following page, prepared by Russell Investment Management Ltd, summarises the range of emotions typical investors feel as investment markets trade through their normal cycles.

In the past 12 – 18 months, we have seen investment markets go from record highs to recording record falls and volatility and experience almost the full range of emotions outlined in the chart. The severity of the downturn and panic that eventuated has caught even the most experienced and brightest market observers by surprise (note Dr Shane Oliver's comments in the attached Oliver's Insights article).

While no-one can be sure until well after the event when investment markets have reached their lowest level in any cycle, given the extent of the current downturn and the amount of negative comments reported in the media in recent times, it would appear as if the market is currently experiencing emotions consistent with "despondency" and "depression" (as described on the chart prepared by Russell Investment Management Ltd).

As the chart states, this stage of the cycle is potentially the point of maximum financial opportunity and should provide long term investors with some reassurance that they should stick to the long term investment strategy that they have previously implemented.

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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