

This email represents our third attempt to send an email this week. On each of the other two occasions, Government and Central Bank intervention, coupled with volatility in the world share markets, made the content of our emails obsolete before they could be sent. In order to get this email out, we have opted to prepare it during the narrow window of when the US market ceased trading for Wednesday, but before the Australian market opens for Thursday trading.

It would be pretty much impossible to not be nervous about the current share market. No matter how seasoned you are with your investments, the degree of market volatility over the past week has been extraordinary. October has, in the past, been the bogeyman of the share market, and barely a week into it, it looks to be living up to that reputation.

As many of you would know, the Australian share market is not large, compared with the major markets of the world. With the Australian share market representing less than 2% of the world share market, it is only natural that it will demonstrate a high degree of correlation with other (larger) share markets across the world. To a very large degree, this is what we have seen over the past week. The problems of the US financial system are well documented, and have dragged down the US markets for the last six sessions (including last night). In spite of the fact that the Australian banking system is amongst the most regulated and safest in the world, the Australian market has been tarred with the same brush, and also been dragged down.

On Tuesday, we saw a brief glimmer of reality take over in the Australian share market. In its monthly meeting, the Reserve Bank decided to cut official cash rates by a full percentage point, the largest cut since 1992. Of 21 economists surveyed on a potential rate cut, not one accurately predicted a cut of this magnitude. This was truly a “courageous” move, given that underlying inflation in Australia is above the RBA’s preferred band width of 2-3%. A cut of this nature, putting \$200 per month back into the pocket of the average mortgage holder, has the potential to fuel inflation further, necessitating future increases in interest rates.

At the time that this announcement was made (14.30), the Australian share market was trading down, around 2%, following the negative Monday night lead from Wall Street. With the RBA taking the market by surprise, there was a sudden turnaround in the Australian share market, with the market ending up increasing by more than 1% for the day.

For that brief period of time, the market was logical. Although the market was expecting an interest rate cut that day, the size of the cut genuinely took the market by surprise. This surprise resulted in a positive swing of almost 4% in approximately 90 minutes. In a week when red hot favourites both lost football grand finals, it was nice to see something go the way that it was supposed to.

This compares to the US experience. Last night we saw six central banks (the US, Bank of England, the European Central Bank, Canada, Sweden and Switzerland) cut official interest rates by 0.5%, in a coordinated move. This was a “show of strength”, to show investors across the world that Central Banks world wide were looking to address the current problems, by stimulating the collective world economy. This announcement was made at 7.00 am New York

time, giving the US share market time to absorb this information before opening. The information was initially received well, with futures on the US market rising by 3%, suggesting that the Dow would rise by some 300 points last night. By the time that the market opened, the good news of the rate cuts had turned to pessimism, that the new US cash rate (of 1.25%) did not leave much room for future cuts. Consequently, at the opening bell the US market started to show immediate volatility, as it tried to determine whether to follow the good or bad news. Throughout last night, the US market traded in a range of some 430 points. With 30 minutes to go before the close, the market moved from 150 points up to fall, at the close, by 200 points.

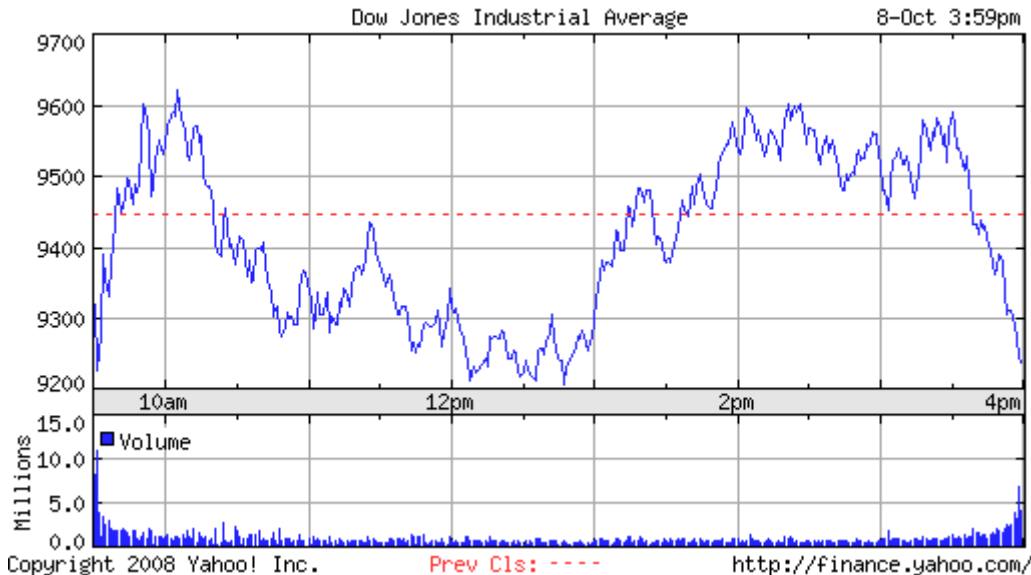
In another key economic development, this coordinated rate cut came on the same trading day as the British Government announced a \$122 billion bailout to British banks. This announcement (of the rate cut) was made at 12 Noon, London time. At that stage the FTSE 100 was trading in negative territory, but rallied sharply in line with the news of the interest rate cuts. This good news was short lived, with the markets starting to fall, drastically, about 90 minutes later. This can be seen by the chart below, showing trading on the FTSE 100 (UK) for last night's trading (Canberra time).



If there was ever a case of seeing the glass as being “half full”, this is it. In the space of a day, the market rallied 9% between 9 am and 13.30, to only see the market end down some 5% for the day.

Clearly, this is not rational. The share market is supposed to represent the collective value of the companies within the market. This takes into consideration the profitability of the companies, which obviously is going to fluctuate upon the health of the economy in which it operates. How is it possible, to consider the collective value of the 100 companies that comprise the FTSE 100, that it can change by this amount in a few hours?

This pattern of volatility was clearly demonstrated in the US market last night, as can be seen from the chart below.



As mentioned previously, the announcement of the coordinated interest rate cut was made before the US market opened, so much of the initial euphoria had disappeared by the time that markets opened. When markets did open, we saw a market with no idea on its direction. In a day with no major economic or political announcements, the US market went up and down like the proverbial yo-yo.

This was one of the highest days ever in terms of “intra day volatility” for the US market. In spite of the good news concerning the coordinated Central Banks’ interest rate cut, the market ended down by 2%. What then is leading to the pessimism in the US market, which is then flowing through to all other world markets?

The short answer to this is recession. Most analysts seem confident that the US financial system will sort itself out, aided by Federal Reserve and US Treasury initiatives (such as the bail out and interest rate cuts). There will also be continued rationalization of the industry, as the weaker players are absorbed. What is worrying the US market at the moment is the likelihood of recession and the impact of profitability on US companies. There are several key points to be made here.

The central banks have a role to play here. The rate cuts announced here in Australia, and across the world last night will help stimulate economic growth. This will, however, not happen overnight. There are likely to be further rate cuts right across the world in coming months, with the US Federal Reserve planning to meet on 29 October, where it is anticipated that the official rate will be cut from 1.25% to 1%.

To this extent, the RBA has considerably more flexibility than any other bank in the developed world. Even with the 1% interest rate reduction on Tuesday, our cash rate is at 6%, compared to

the US cash rate of 1.25%. Clearly there is substantially more scope for the RBA to continue to cut rates and stimulate the economy, compared with the Central Banks of the US and Europe where the cash rates are so much lower. This places the Australian economy with a significant buffer.

In terms of “recession”, this is not something unusual. Since World War II, the US has officially been in recession 11 times. Current unemployment rates in the US are around 6.5%, and it is anticipated that this could peak at levels of 7.5% to 8%. Even with this expected rise in unemployment, these levels of unemployment are far from the “depression” rates that commentators love to imply is “just around the corner”.

Last night the International Monetary Fund announced that it expected world economic growth to increase by 3.9% in the coming twelve months, down from 5% in the current year. It further expected this figure to slow to 3% in the next twelve months. Notwithstanding that this is a reduction in growth, the world is hardly in recession.

Clearly our market has been reacting in line with this pessimism – is this warranted? Our belief is that it is not, and there are some key factors that support this:

- Our banking system has virtually no exposure to “sub prime” issues and a degree of regulation far beyond that of the US;
- Interest rates are coming down, with the RBA having considerable scope to cut interest rates aggressively, if the need is perceived;
- Our trading patterns with the US have changed dramatically over the past 20 years. Since the introduction of various free trade agreements, the US now imports much of what we used to export from Canada and South America. A downturn in US demand will not have the same impact on our economy now, that it would have had twenty years ago;
- There is no evidence that housing prices in Australia will experience the same fall in value as we have seen in the US and Europe. If anything, the drastic cut in interest rates by the RBA this week runs the risk of seeing housing prices increase, as the cost of debt falls;
- Over the last two months we have seen a drastic fall in the value of the \$A. In mid July market commentators were talking about Parity with the \$US, as the \$A touched \$US0.97. We now have a rate around the \$US0.70. This makes our exports considerably cheaper, and our imports considerably more expensive. This is a real and unexpected positive.
- Unlike the US Government, the Australian Budget is in surplus. Our country has a very healthy balance sheet.

In spite of these facts, the Australian share market has followed the lead of the US. As far as today is concerned, that is probably a good thing, as the overall fall in the US last night was

“modest” (compared with the previous five nights), one would expect that the Australian market will follow suit when it opens at 10 am.

However, what has to be remembered is that the value of the Australian share market will, at some point, reflect its CORRECT value. As mentioned above, the value of the market should reflect the profitability of the companies that it is comprised of. If share markets accurately predict company profitability, then the only way that we can believe the 16% fall in the Australian share market since August 29, is to believe that company profitability, going forward, has also fallen by this amount. If company profitability has NOT fallen by this amount, then the market has been oversold, with investors acting on emotion rather than facts.

This is all well and good, to say that this fall is wrong, but at the end of the day the emotion is the reality right now, and this is what is reflected on your fund statements. Just as the euphoria of the RBA rate cut lasted only a day, tomorrow is a whole new day, and any announcement could send the US market up or down.

What is certain is that we are going to see continued volatility for the foreseeable future. This could be both positive or negative, depending on how the market perceives the news. There will be more headlines, good and bad in the weeks to come. What do you do?

There are always options, and in this situation there are two main ones. It is possible to take the view that things will continue to get worse before they get better, and simply sell out of all shares and move back to the safety of cash. The cut in official interest rates will see deposit rates on offer fall, so this strategy is starting to look a little less attractive already. Additionally, as we have previously said, the major difficulty with this strategy is then picking the time to get back in. The problem with a market which runs on emotion is that, with the right sentiment, it can turn positive very quickly. The real losers in a situation like this are those who are in the market for its decline, but sitting in cash during the rebound.

The other option is obviously our preferred option. This option suggests that, unless you immediately require the money invested in shares, you ride out the current volatility. Long term clients of BL&A will know that our “bucket model” keeps three years of spending requirements in cash, away from the volatility of the share market. As hard as it may be to avoid joining the panic selling, history tells us that this will eventually turn.

It would be pointless of us to try and estimate when this “turning” will take place, as this is dependent on the actions of Central Banks around the world and the US Treasury. With a share market being driven by emotion, the crisis is one of confidence more than anything else, and therefore it is difficult to quantify what will turn negative sentiment into positive markets.

In spite of the fact that we cannot have all the answers, we do urge our clients to keep lines of communication open with us. If you wish to discuss your personal situation, please do not hesitate to do so.

Yours sincerely,

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