

September 2008 Market Update

In a recent survey to a sample of clients, we asked the question as to whether they would prefer to hear from us more frequently, when economic events dominate the news. Most clients responded in the positive, however we did have some who stated that the more that we contacted them, the more nervous they become. Clearly there is no right answer, so we are sending this email on the basis that those who are interested will read it.

The last two weeks has seen unprecedented activity in the US financial sector. The US Government decided it was appropriate to use taxpayer funds to bail out Freddie Mac and Fannie Mae, but not the 158 year old investment bank Lehman Brothers. The decision to let this bank file for bankruptcy (Chapter 11 in the US), saw the largest falls in US and European share markets since the September 11 attacks. If not for the Liberal leadership contest in Canberra today, this would probably be the largest news story on today's airwaves.

The Australian market is expected to fall today, commensurate with falls overnight in the US and Europe. Even though Australian banks have little or no direct exposure to Lehman Brothers, instability in the banking sector of the world's largest economy will always make share markets around the world edgy.

These events can of course all be tied back to the initial "sub prime" issues that commenced in the middle of 2007. Fortunately for Australian banks, our banking regulators enforce a vastly tighter level of prudential supervision, meaning that our banks have not embarked on the "structured debt" programs which, together with falling house prices, have caused so many problems in the US. Our banks are however net borrowers, and therefore rely on being able to access capital in world wide markets to lend domestically. The subsequent "credit squeeze" has seen the RBA pump an extra \$2.1 billion of liquidity into Australian financial markets yesterday, to avoid having this credit squeeze push interest rates higher.

To a degree, this is the underlying message that we must take from the current events. Although the share markets react to market forces, it has been clearly recognised that there are no winners created by instability in the US financial sector. To this extent, Governments and central banks are taking action to restore stability in this area.

Although it was harsh medicine, the decision of the US Government to not bail out Lehman Brothers is undoubtedly the correct one. By allowing this investment bank to fail, other US banks will now be sizing up affirmative action, knowing that it is unlikely that they will be bailed out as a last resort. The \$61 billion takeover of Merrill Lynch from the Bank of America is exactly the type of consolidation that must now take place within the US financial sector, in order to regain stability.

We sincerely appreciate that this type of instability is very unnerving to anyone with assets exposed to shares. All that seems to come from the US right now is further bad news, and it is always difficult (under these circumstances), to envisage a time when things are right again. It is however imperative to remember that it is in no one's interests for this instability in the US financial sector and efforts continue behind the scene to restore stability. It is highly likely that this will involve additional bankruptcies, further mergers and even Federal Reserve intervention with monetary policy (the US

Federal Reserve is bringing forward its interest rate meeting to tomorrow with a reported 61% chance of a 0.25% interest rate cut).

In spite of the US financial gloom, there have been some strong positives which have tended to be overlooked recently. Last night the spot price of oil fell to US\$95 a barrel. Remembering that this was almost US\$150 a barrel in July, the fall in prices will be extremely favourable in sustaining economic growth.

The most obvious question from all of this is “what should you do”? Long term clients of BL&A will know that our response is the same as it was after September 11 in 2001 and the Asian Economic crisis in 1997. Once markets start to fall, history shows that the worst thing to do is to try and take action after the event. Over the years we have used our “three bucket model” to ensure that investors have three years worth of spending quarantined in cash, away from the volatility of markets. **We have a fundamental belief that markets will come good at some stage and trying to pick the time to move out and in of the market is fraught with considerable danger.**

Having said this, we appreciate that everyone will react differently to this latest market volatility. At BL&A we are obviously happy to discuss your individual position further. If you have any questions, you should not hesitate to contact us.

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