

The signs of the times: How to stay ahead of volatile market conditions



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The Global Financial Crisis 101

The Global Financial Crisis

What went wrong, what we have learned and where do we go from here

History has shown us that markets go through a cycle that naturally goes up and down; however, the extraordinary market events that occurred between the years of 2007 to 2009 have left many market analysts and economists blindsided.

Certainly 2008 is a year that most investors would prefer to forget. The more prudent and observant ones may have walked away with less damage to their portfolios, but no one could ever have predicted the severity or duration of the market downturn and the subsequent panic that we have seen. So what went wrong? What have we learned? And where do we go from here?

Global Financial Crisis 101: A Brief History

In the years 2000-2005 the U.S. experienced a housing boom. During these years mortgage brokers greedy for big commissions talked buyers with poor credit into accepting expensive and complicated housing mortgages with little or no down payment and no credit checks (aka sub-prime mortgages). To mitigate their own risk, banks and other financial institutions typically repackaged these debts with other risky debts and sold them to worldwide investors as 'collateralized debt obligations' or 'Mortgage Backed Securities' (these are the CDOs and MBSs we heard so much about – basically, bundles of bad debt). Backed by some of the biggest names in investment banking and the belief that even in default the collateral behind these debts were sound, many jumped into the money-making bandwagon without truly understanding the risks involved.

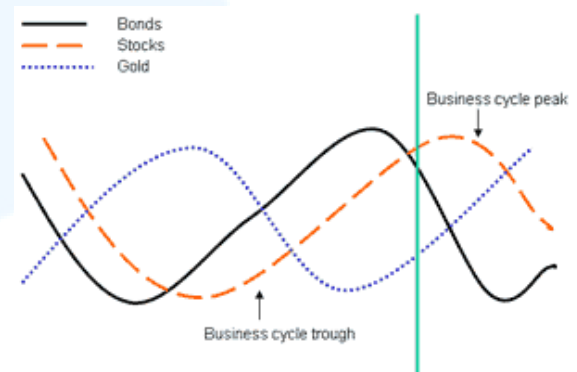
When the real estate bubble burst and the sub-prime loan defaults and foreclosures started to rise, investors realized that they were left with a debt much larger than the ever-diminishing value of the attached collateral. This caused investors to stop purchasing and / or selling all Mortgage Backed Securities because of the realized risk and exposure. Now investment banks were left holding billions in securities that they could not sell, and were ultimately worthless.

As it started to become obvious on how exposed some of these investment banks were to the bad loans, investors began to lose confidence (freaked out) and starting in June 2007, the system descended into a death spiral. Share prices tumbled as banks started to question the financial health of their peers. As a result inter-bank lending slowed to a trickle and the financial system started grinding to a halt. When the US authorities let the investment bank of Lehman Brothers fail, this led to the failure or rescue of numerous financial institutions across the US and Europe. The result was a massive crash in share markets, the tightening of credit markets, a plunge in commodity prices and big fluctuations in currency markets.

The slump in export demand and commodity prices has brought countries like China and Korea into the economic downturn (Korea's exports to the U.S. decreased by 73% their biggest drop in history). Advanced countries are on the way to recessions in a scale unseen since the 1930s. When the dust settled it was clear that what started out as a US crisis had long-reaching repercussions that caused considerable damage to the global economy.

What have we learned?

They say hindsight is 20/20, and maybe anyone with a lick of sense paying close attention to the markets could have predicted that the financial house of cards based on mortgages peddled by over zealous brokers to people with bad credit was bound to collapse. In reality though the voice of reason is usually the last to be heard when emotions are high and everyone wants to get into the action. (cont on page 2)



The Business Cycle

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So what have we learned? **That the business cycle still rules.** In the high of the boom people forgot the basic principles of the business cycle and ignored the signs of an inevitable bust. Sentiment also plays a big role in the market – as overconfidence and greed can fuel unsustainable highs, so can a loss of confidence and panic cause unreasonable market fluctuations.

From personal experience I can tell you that the key to surviving these uncertain times is to have a level head and to keep your eyes and ears open. It may sound very simplistic, but this has saved me and a lot of my clients financially. In a real-life example, during October of 2007, I decided to pull out of the share market and convinced my clients to do the same. What prompted me to make such a drastic decision? I knew what to watch out for and followed the warning signs in the market:

- Statistics show that there is a direct correlation between the rise and fall of inflation and market share prices. Inflation, as with the price of fuel and groceries had been rising exponentially (and much faster than expected) since 2002. In early 2007 the RBA had yet to lower their rates- with mortgages and increasing living expenses to pay, people had less money to spend. When people start tightening their belts, the economy and share markets are going to slow down very quickly.
- The market first started to rise in 2002. 2007 would have been the 5th year of unabated exponential growth. If we follow the rules of the investment cycle, market downturns are supposed to occur every 5-7 years. This would have indicated that 2007 will be the start of a market downturn.
- On a property standpoint, the western suburbs traditionally experience a more significant capital growth as compared to the rate of rental increase. Closer to the city rent tends to increase a lot in compensation for the lack of capital growth. In 2007 what was happening was the opposite – property values started to fall in the west, as rent increased dramatically, and this was starting to cause fear in the market. Inevitably shares started to drop.
- A combination of all these factors fueled a downturn in the economy (worsened by the events abroad). The market was fast approaching absolute capitulation – the bottom point where people are so scared that herd mentality takes over and shares will drop to a level much lower than what is considered a true value of those shares.

Where do we go from here?

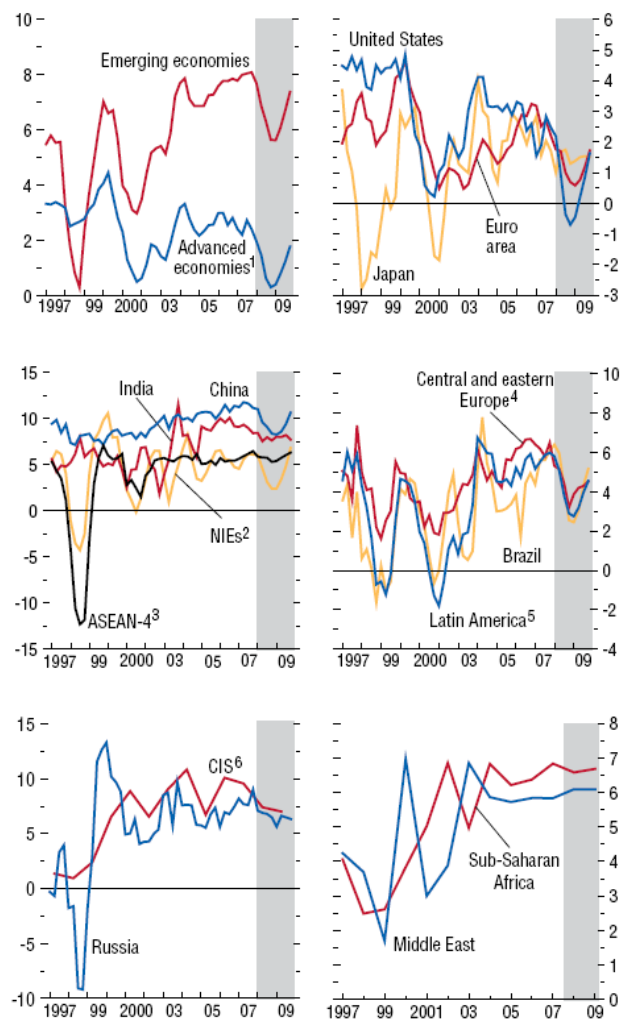
The good news is that it is not all gloom and doom. There are great opportunities for investors when market confidence has been shredded and residual fears are still keeping people very cautious. There are a lot of good shares out there trading well below what they are worth. How to tell the good from the bad:

- Look for shares trading on dividend yields well above bond and cash yields – this means that the companies the shares represent are still turning a profit, enough to regularly give out dividends. Since they are still earning good income, their “true” value is worth more than market value, and this will suggest that in time, maybe in a 5-year period, the share price will go up to reflect this.
- It is important to remember that our portfolios were not put together on a whim. Most of us had very good reasons to invest in these companies – in most cases the reasons will still be valid, and just because market conditions have affected share prices, it does not necessarily mean these companies have gone bad too. Don’t get caught in the wave of panic. Hold on to the companies you think still have a good future, and when markets stabilise the value of the shares will increase.

It will be prudent to note that the conditions in the U.S. pre-property market crash look scarily familiar to our current property conditions here in Australia, and it is true that we do have overpriced housing and little or no savings, but we are buffered by several mitigating circumstances: First of all as a result of massive immigration over the past 5 years, we are undersupplied in terms of housing. Second, with falling interest rates and petrol prices, our disposable income has actually increased by about 10%. Third, our percentage of sub-prime mortgages are much lower than that of the U.S. (it has been estimated that between 2004 to 2006 almost 20% of new mortgages in the U.S. were sub-prime, as opposed to Australia’s current sub-prime market of only 2%). Therefore perhaps we can escape a vicious bursting of the housing bubble, as markets have been slowly recovering from last years’ roller coaster ride. However, any complacency at this point can be disastrous, so be vigilant. Keep your eyes and ears open and you might just keep ahead of the market.

Figure 1.11. Global Outlook
(Real GDP; percent change from a year ago)

The global economy is projected to cool in 2008, before staging a modest recovery in 2009. Among the advanced economies, growth would slow the most in the United States, dipping into recession, but activity in the euro area and Japan would also moderate. Growth in emerging and developing economies would ease but remain at a rapid pace, with continued strength across all regions.



Sources: Haver Analytics; and IMF staff estimates.
 ¹Australia, Canada, Denmark, euro area, Japan, New Zealand, Norway, Sweden, Switzerland, United Kingdom, and United States.
 ²Newly industrialized Asian economies (NIEs) comprise Hong Kong SAR, Korea, Singapore, and Taiwan Province of China.
 ³Indonesia, Malaysia, Philippines, and Thailand.
 ⁴Czech Republic, Estonia, Hungary, Latvia, Lithuania, and Poland.
 ⁵Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Rep. Bolivariana de Venezuela.
 ⁶Commonwealth of Independent States.

* Sources: Recessions and Depressions an update by Phil Ruthven, The Business Cycle Goes on by Shane Oliver