

# An overview of investment markets and the Australian economy

presentation to Responsible Manager  
Forum for CMIL & CMPL

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Research

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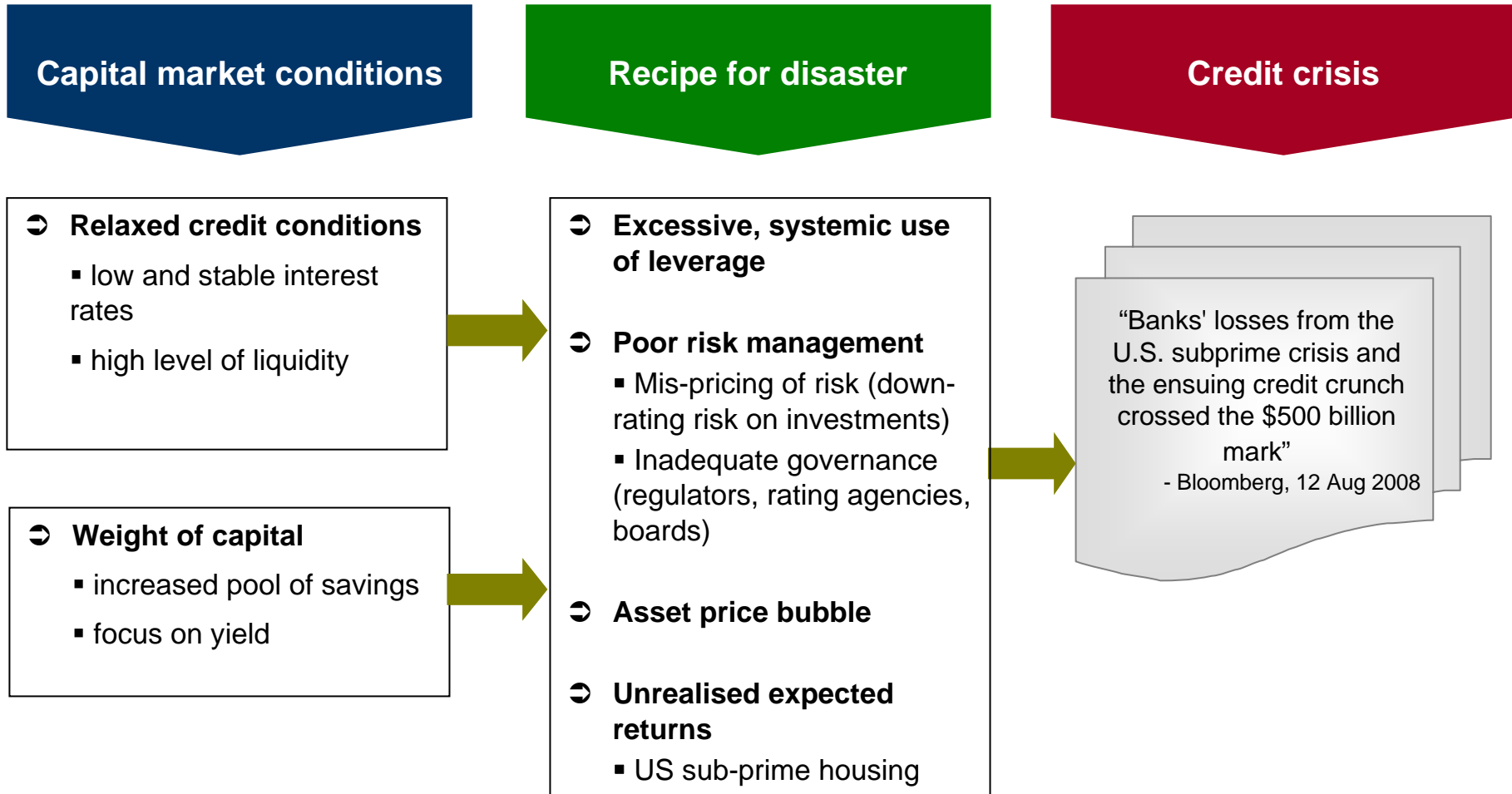
# Outline

- ① A review of the credit crisis
- ② Impact on the global economy
- ③ Some considerations

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# A background to the global credit crisis - fallout from an interplay of many factors



# The credit crisis

## - a combo of imbalances, leverage & innovation

### ➔ First phase

- Ratings agencies downgrade MBS's in July 2007
- Bank losses rise, exacerbated by mark-to-market accounting, spread contagion to other markets
- Lending in credit markets dries up
- Central banks pump liquidity into the system

### ➔ Second phase

- The collapse of Lehman Brothers makes overnight funding impossible as investors leave the interbank market and counterparty risk rises
- Requires increased intervention from regulatory authorities
  - deposit guarantees
  - re-capitalisation by governments
  - emergency Economic Stability Act in the US

### ➔ Third phase

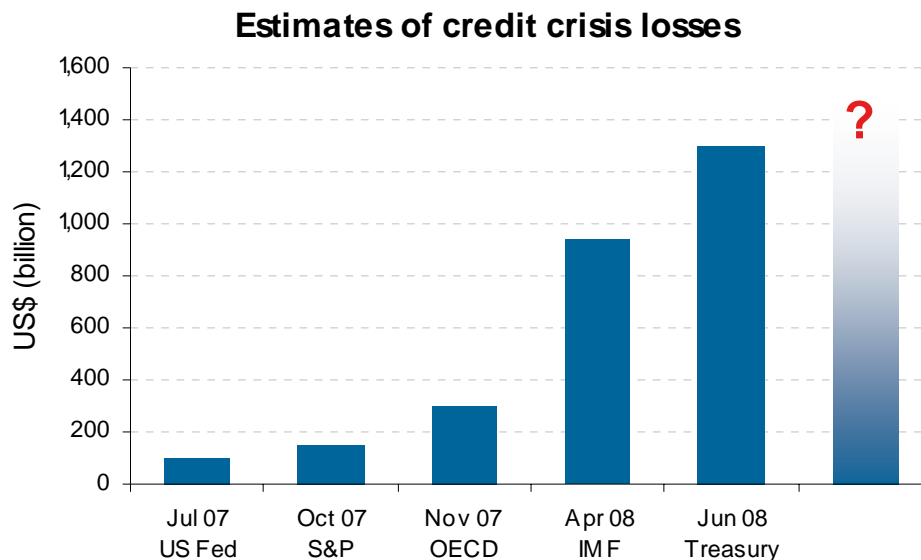
- The work-out; new banking regulations, growth in non-US capital markets, shift in investment to energy, climate change, technology
- Greater liquidity and a new cost of capital
- What is the impact on the Australian economy?

# Credit losses and write-downs

## - estimates being revised upwards

<b>Sub-prime debt write-downs</b>	
as at April 2008	
<b>Institution</b>	<b>US\$ billion</b>
UBS	38.0
Merrill Lynch	25.0
Citigroup	21.0
Morgan Stanley	12.0
Deutsche Bank	7.0
Credit Suisse	6.0
Bank of America	5.0
Royal Bank of Scotland	3.0
Barclays	3.0
Goldman Sachs	3.0
Bear Stearns	2.6
HBOS	0.5
Lehman Brothers	0.3
<b>Total</b>	<b>126.4</b>

Source: The Guardian & CFS Research



Source: CFS Research

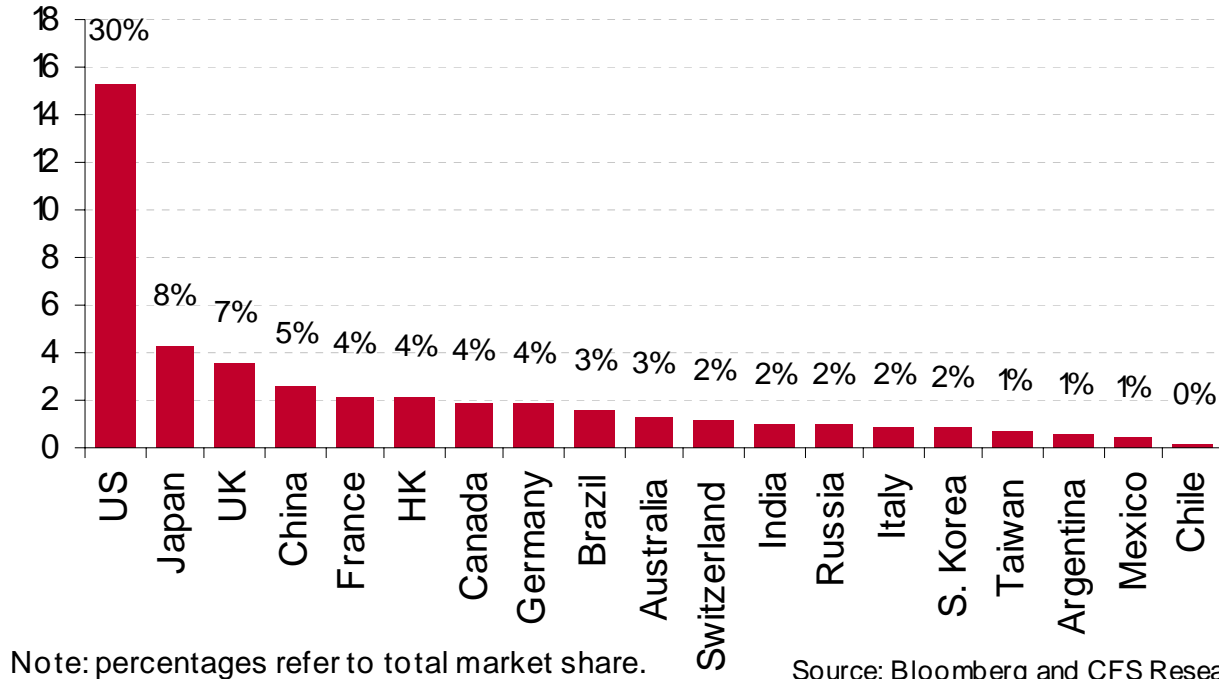
- Realised losses between 2007 to Oct 2008: US\$636 billion.
- BOE recently released a report estimating losses in the order of US\$2.8 trillion.

# Global impact driven by US

- due to concentration of financial risk in the US

## World stock market capitalisation

value of US\$50.8 trillion as at 30th June 2008

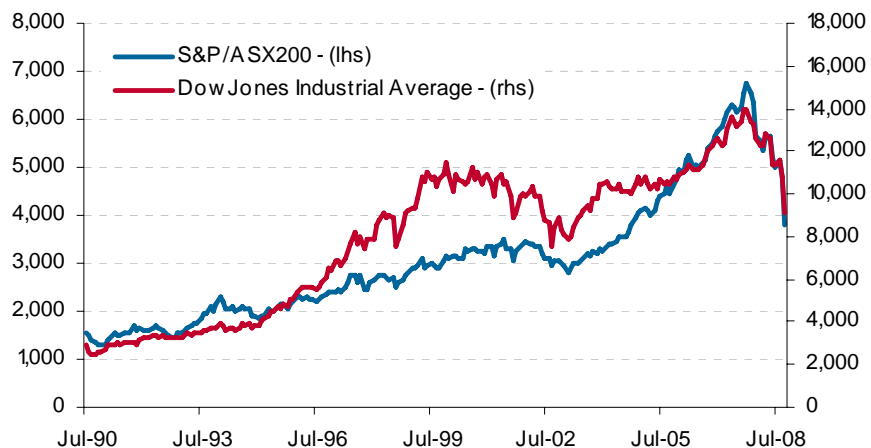


# Collapsing global equity markets

- driven by forced sales, price uncertainty & fear

## US and Australian stock market price indices

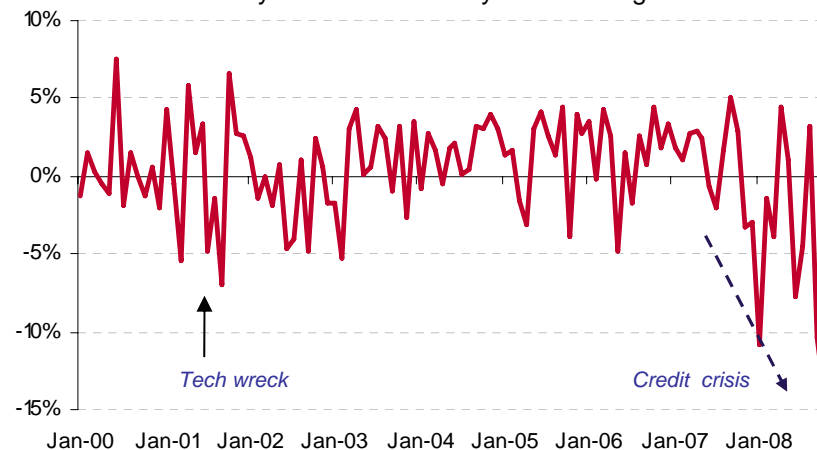
monthly rests ending October 2008



Source: IRESS and CFS Research.

## Return volatility of S&P/ASX200

nominal monthly returns on monthly rests ending October-08



Source: IRESS and CFS Research

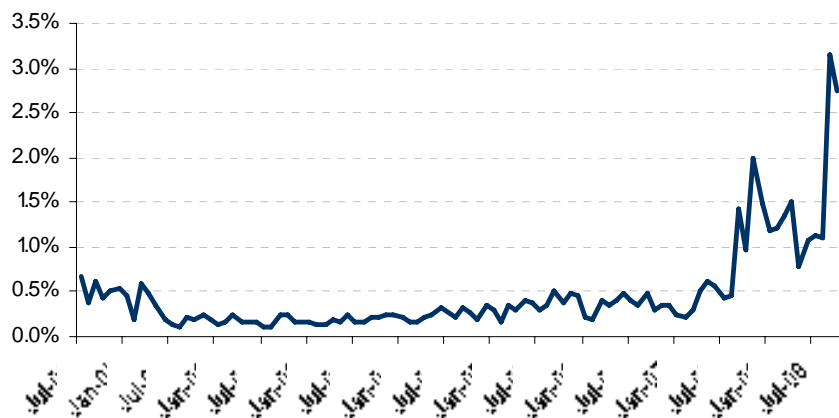
- ➡ The substantial falls in equity prices since has been driven by:
- the worsening of the credit crisis in September
  - forced sales of assets by leveraged investors, particularly from margin calls
  - worsening outlook for economic growth

# Credit markets

- desperately seeking liquidity - improving slowly

## The TED Spread Overnight

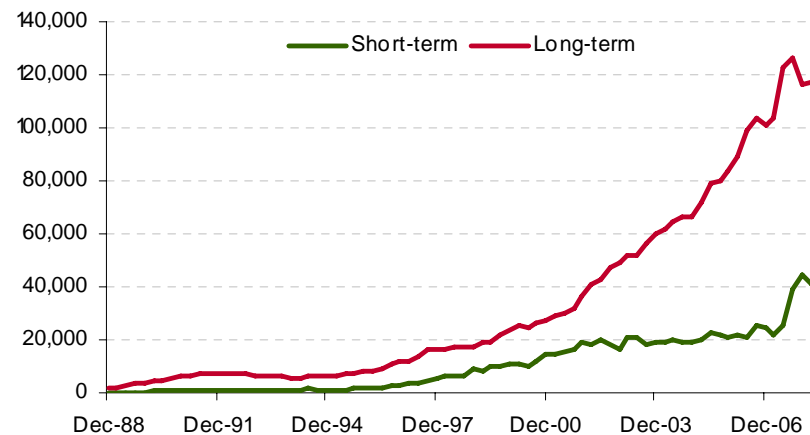
LIBOR minus US TB 3mth yield, monthly rests, ending Oct 08



Source: IRESS and CFS Research.

## Outstanding Asset Backed Securities

totals outstanding, qtrly rests, ending June 2008



Source: RBA and CFS Research.

➤ The impact of the intervention by governments around the world has been successful in increasing liquidity in credit markets:

- TED spread has fallen from 4.52% to 2.75% within October

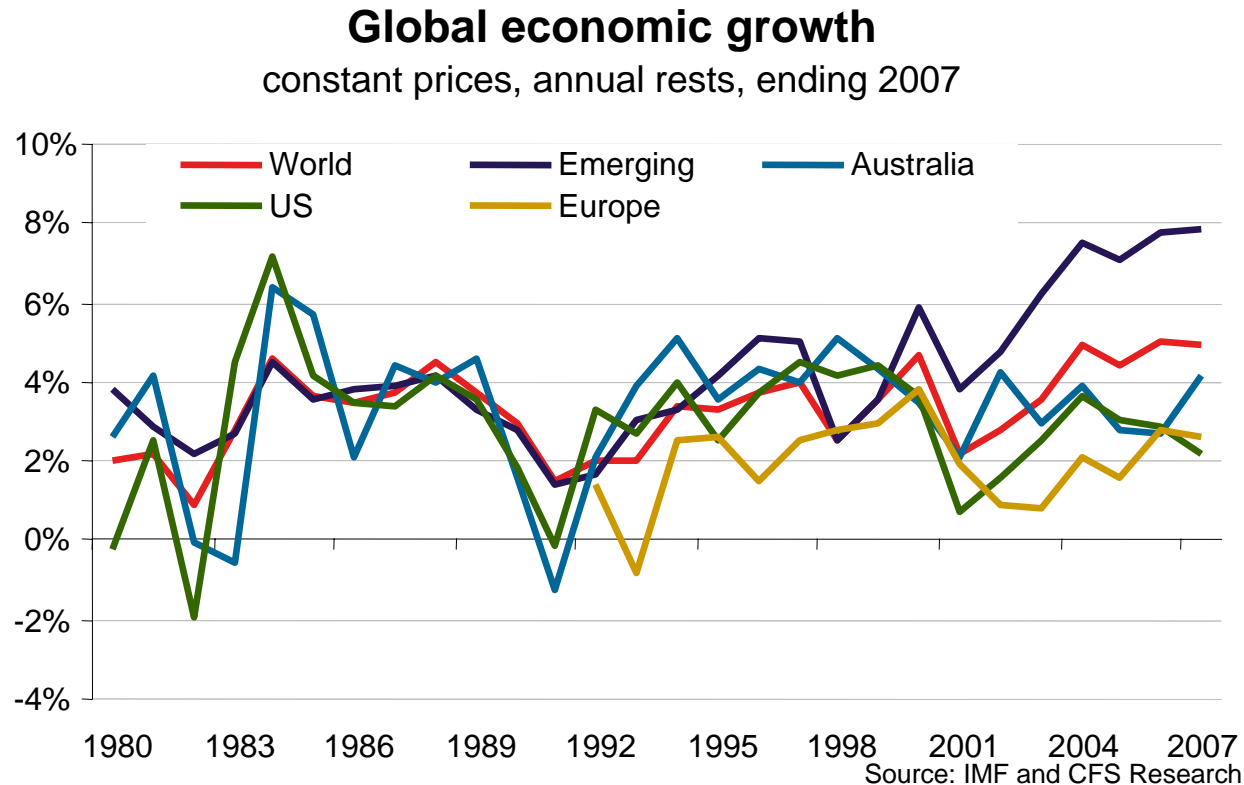
➤ However credit markets must change:

- shift away from the issuance of asset backed securities or securitisation
- new relative price for equity and debt

# Outline

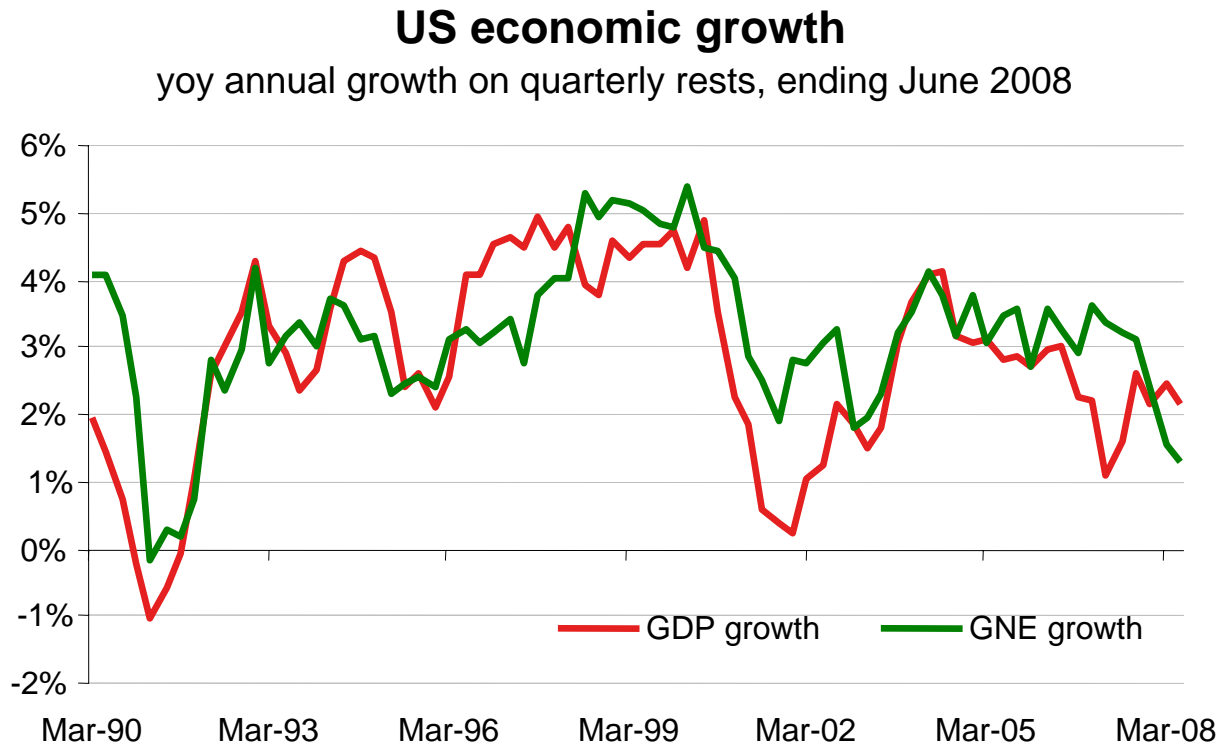
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# Global economic activity to slow markedly - coupling story becomes widely accepted



- The contribution of advanced economies to global economic activity fell from 63% of all activity in 1999 to 56% in 2007.
- Global annual growth forecast (by IMF) to slow from c5% in 2007 to c4% in 2008 and c3% in 2009.
- 11 ➤ Emerging markets enjoyed strong investment in fixed assets in addition to exports. Also set to slowdown.

# US growth slowing rapidly - domestic demand falling away



Source: BEA and CFS Research.

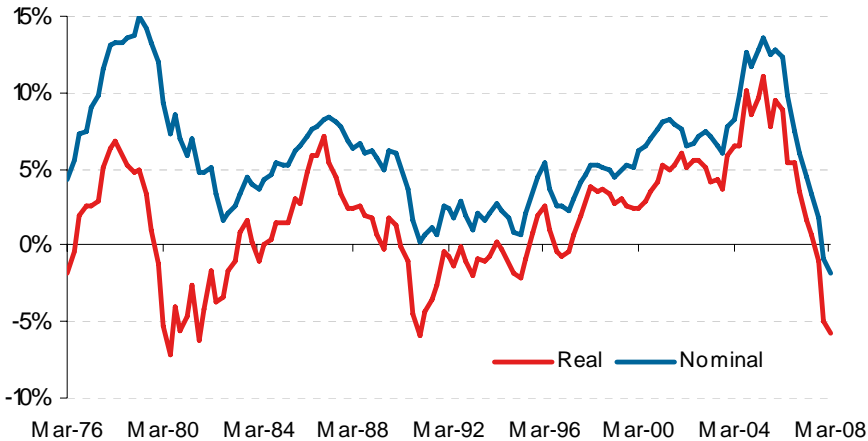
- US GDP growth held up in the first half of 2008 as a result of the strength in exports despite steep falls in domestic demand (with fiscal stimulus of <1% of GDP).
- The outlook remains weak, with domestic demand likely to continue to fall and the export sector suffering from the rise in the USD. The IMF forecast just 0.5% growth in 2009 from 1.6% growth in 2008.

# US house prices still falling

## - price growth falling since peaking in mid 2005

### OFHEO US house price index

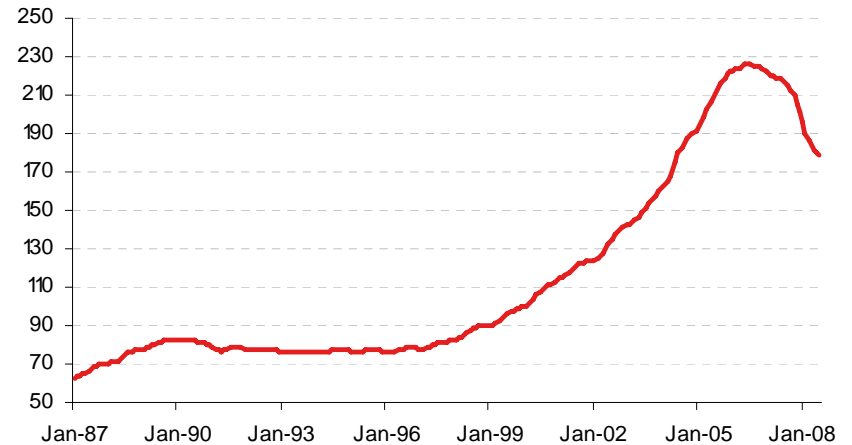
annual growth on quarterly rests ending Jun-08



Source: Office of Federal Housing Enterprise Oversight and CFS Research

### S&P Case-Shiller 10 city house price index

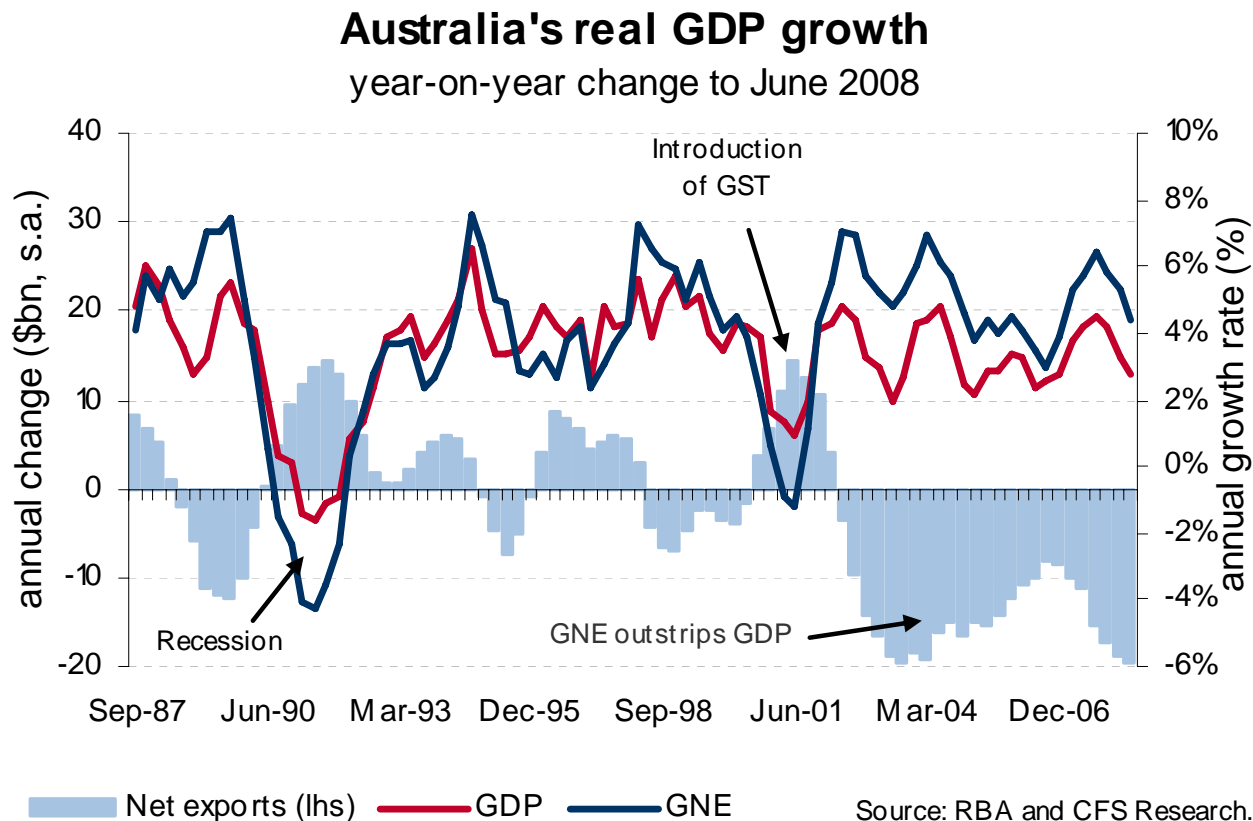
base year 2000 =100, monthly rests ending August 2008



Source: S&P & CFS Research

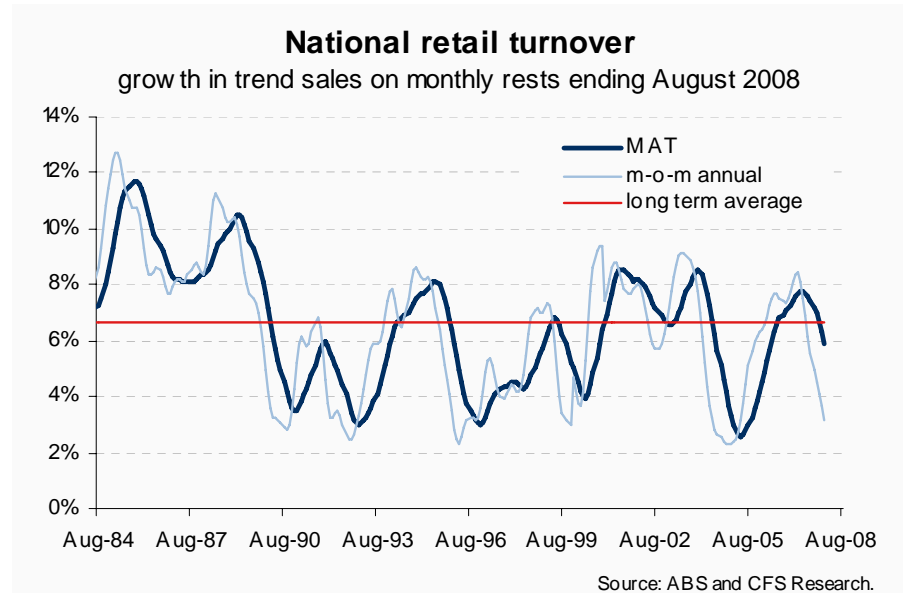
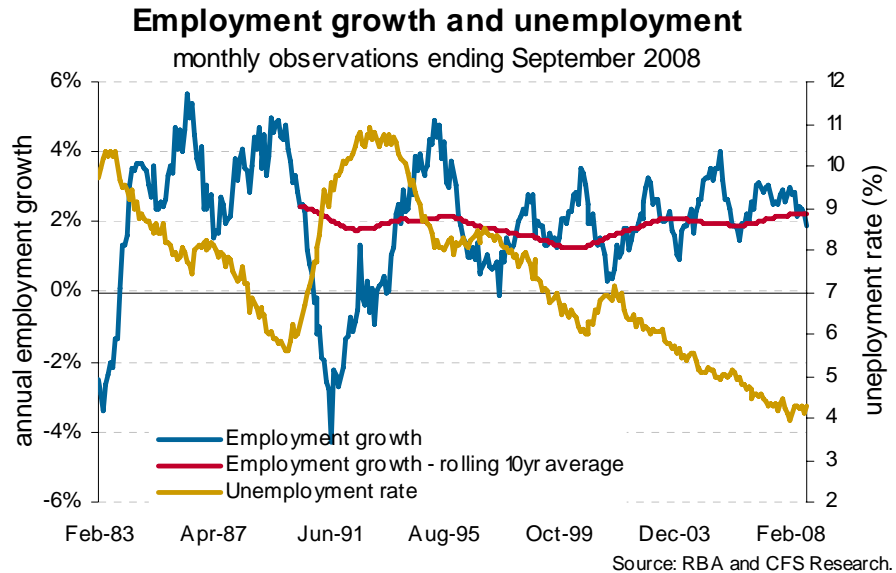
- Fall in house prices appear to be slowing, assisted by Freddie and Fannie.
- Data from Office of Federal Housing Enterprise Oversight Report's house price index based on single-family home sales.

# Australia's strong economic growth at risk - below trend growth over the short-term



- Growth has slowed sharply to below trend levels in the last three quarters. Growth slowdown has been broad-based with both the domestic and external sectors experiencing weaker demand.
- The extent of the slowdown will be dependent upon the return of liquidity in credit markets and the resilience of the labour market. CBA forecast 2.5% growth in 2008 and 2009.

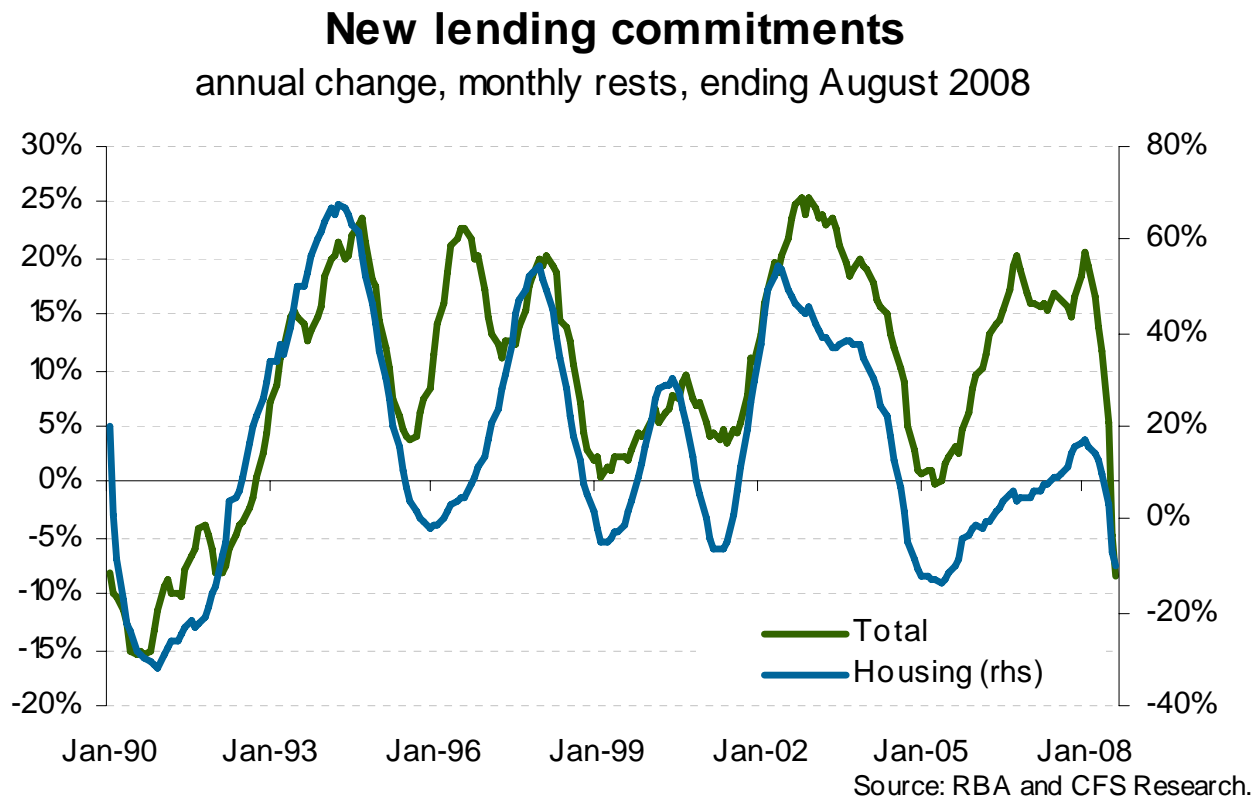
# Weakness in labour market & retail sector - driven by uncertainty but some relief on the way



- Over the next six months unemployment is forecast to rise to 5.0%, with future expectations dependent upon the outlook for the global economy. CBA forecast is 4.3% for year end 2008, rising to 5.0% in 2009.
- The outlook for consumers in Australia has been persistently weak for nearly a year: i) high petrol prices; ii) rising interest rates; and iii) uncertainty due to the credit crisis.
- Some relief with: i) interest rate cuts; ii) recent Government stimulus; and iii) falling oil price (offset by the \$A)

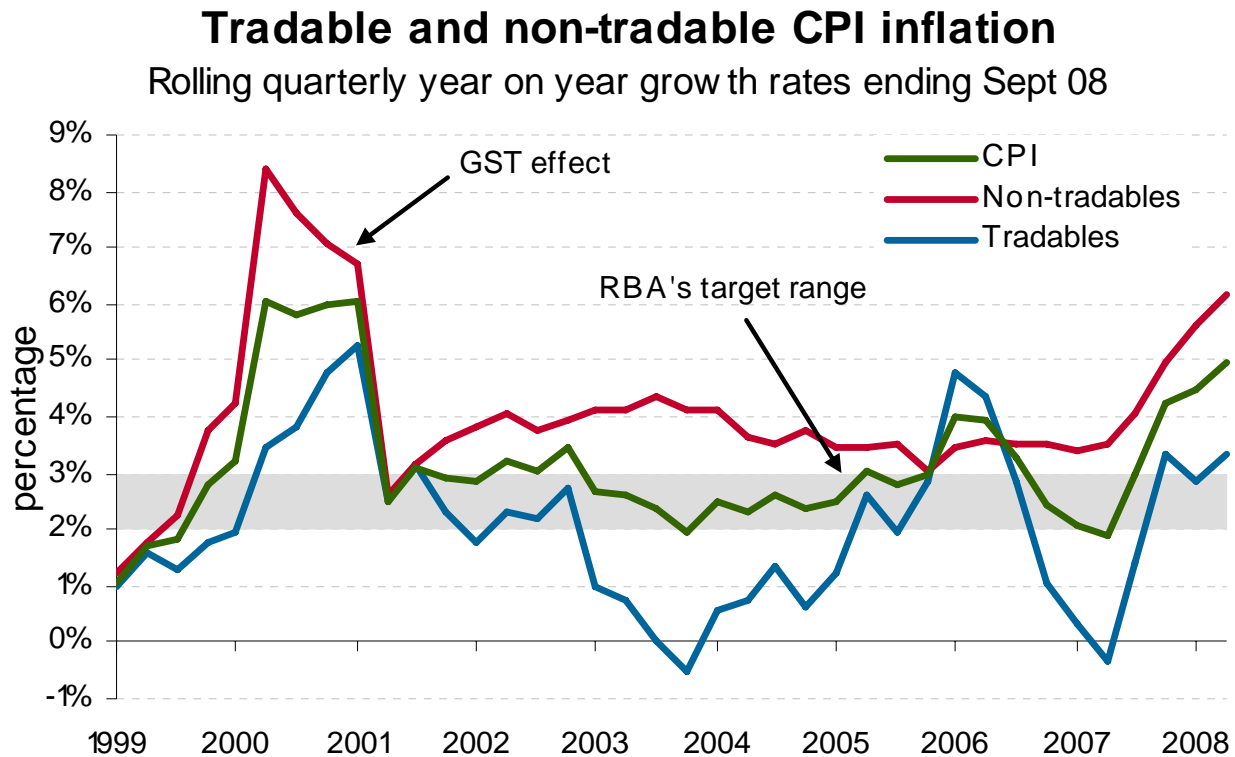
# Turning on the credit taps

## - how long can reserves last without credit



- Supply of credit has been limited despite demand for credit, as evident in:
  - business investment intentions
  - relative strength in housing markets
- As long as credit is not available, Australian policy makers, households and businesses will have to draw down on their reserves

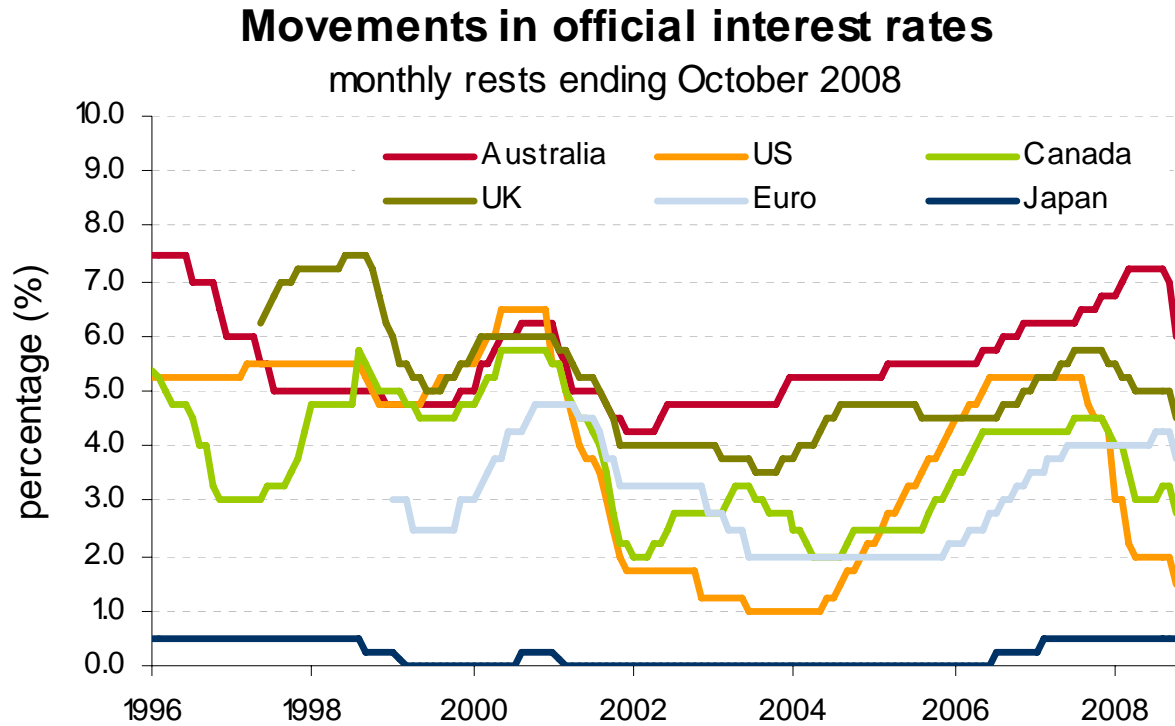
# Inflation well above RBA's target zone - however risks to growth driving policy agenda



Source: RBA & CFS Research.

- The trend of rising inflation has not eased despite the contractions in lending:
  - inflation has been primarily driven by domestic forces
  - weaker global growth is likely to slow tradeable prices relatively quickly
- 17 ➤ Strength of inflation makes policy setting more difficult despite economic weakness. The CBA believes CPI will fall to 4.7% by the end of 2008 and 3.0% by 2009.

# Globally, central banks cut interest rates - a joint effort to support world economic growth

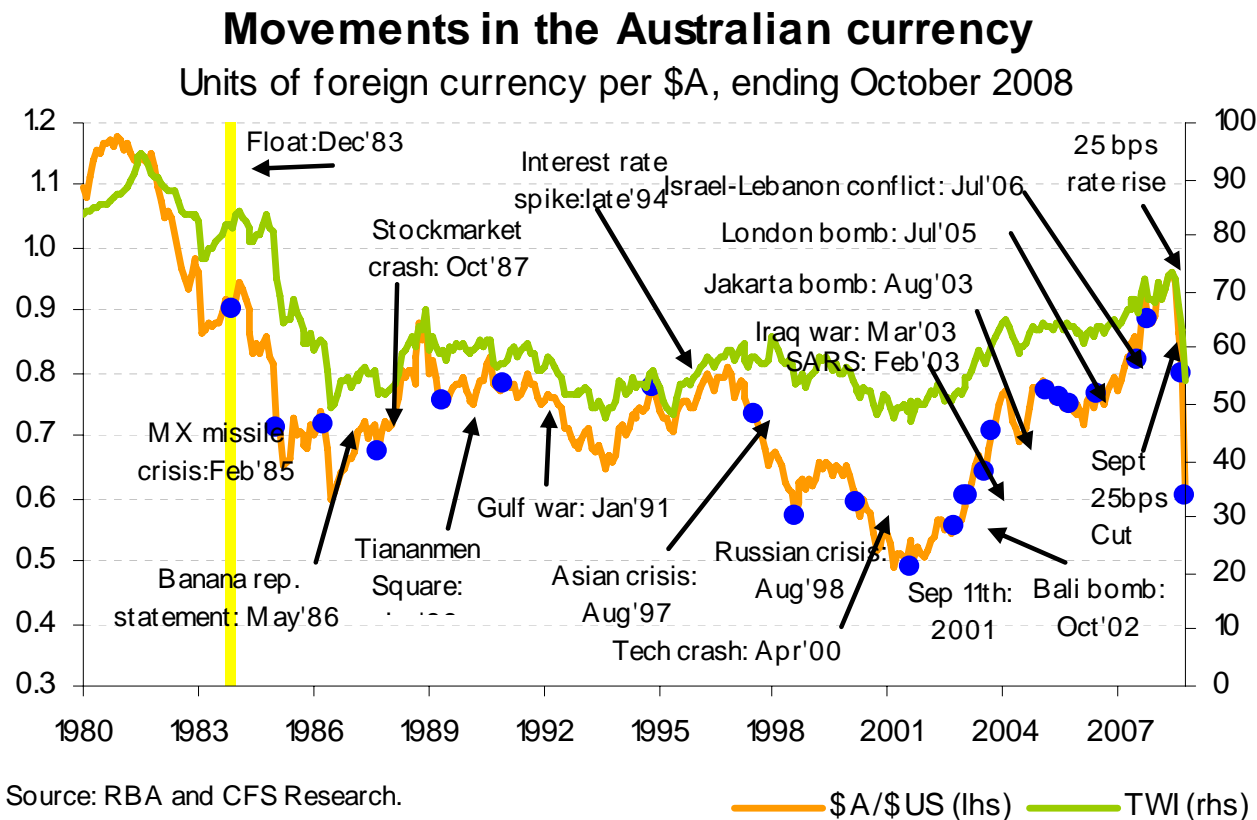


Source: RBA and CFS Research.

- The RBA and other central banks have cut interest rates over recent weeks:
  - The RBA's 100bps cut is the largest of any banks.
  - The aim is to lower default risk amongst borrowers, thereby decreasing counterparty risk and encouraging lending between banks.

# Impact on currency markets

## - stunning fall in the AUD/USD from 25 year highs



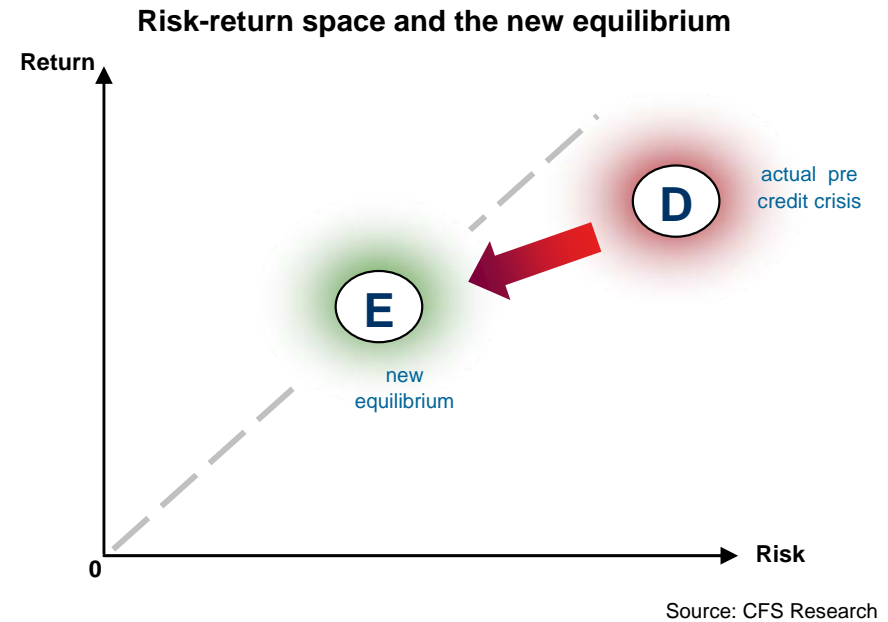
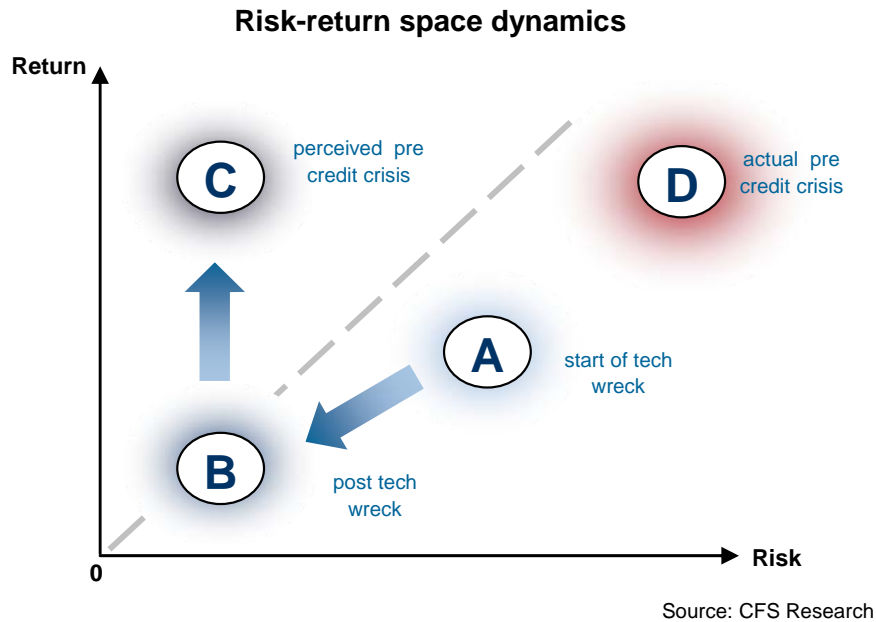
- The fall in the value of the \$A has been dramatic since August:
  - The \$A has fallen from US\$0.97 in August to US\$0.60 in October.
  - The fall in the \$A reflects the flight to safety away from commodity and high yield currencies to US and Japanese markets.
  - The fall in the \$A may have an impact on RBA policy making.

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# Investment implications

## - review of risk-reward space dynamics



# Resolution to credit crisis is complex - frustrated by multi-dimensional considerations

## ➔ Financial landscape

- stability of financial system
- restore liquidity for market participants
- consolidation in banking/financial services sector

## ➔ Re-assessment of risk-reward

- pricing of risk – trying to assess the risk premium
- confidence in the financial system and investment markets
- review of performance assessment – absolute versus relative

## ➔ Investment markets

- de-leveraging set to continue
- refocus on underlying fundamentals rather than financial engineering

## ➔ Economic environment

- short-term risk to growth; medium-term risk to price inflation
- deteriorating real global economy – led by wealth destruction
- demand boost: quest by central banks cutting interest rates

## ➔ Social-political environment

- US presidential election – 4<sup>th</sup> November 2008
- social-equity considerations
- review of regulation: greater transparency to investments

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