

Issue 20 – Jan 2008

## An Update on Recent Market Volatility

*There has been a lot of speculation about sharemarket volatility recently. We take a closer look at what has caused some share prices to fall so sharply and what's happened in the listed property sector.*

*In early November the Australian sharemarket reached a new high. The S&P / ASX All Ordinaries share price index reached 6853 points, 27% higher than it was a year earlier. Since then the market has fallen 8% and fell 4% in two days to 18 December.*

### WHAT EXACTLY IS THE SUB-PRIME MARKET?



Translated literally 'sub-prime' means 'below best', which is a reference to the credit rating of the borrower. In other words, sub-prime mortgages are loans granted to people who may not have the ability to make repayments and those who would not have qualified to borrow money under normal circumstances.

Many of these loans have moved into default, meaning that lending institutions began losing money. Investors then started selling shares in these financial institutions. As a result, some funds were suspended. Not a great outcome in any terms.

### What has been happening?

The US sub-prime issue is continuing to impact financial markets and is considered by various market commentators to be one of the drivers for the current market volatility.

Many of the large US investment banks have reported lower profit results due to their exposure to sub-prime investments. Some have even had to find emergency funding to continue to operate. This has led to increased nervousness by investors and increased sharemarket volatility.

### The change in the debt market

The heart of the problem has moved from US sub-prime mortgage investment losses to one of 'illiquidity'. This means that money can not be moved around - lenders are unwilling to provide cash and lend it to borrowers in the normal way. When spare funds for lending are scarce and lenders are more risk

averse this increases the interest rates that companies are charged when they borrow money.

Companies with high amounts of debt are feeling the pressure of funding loans as well as having to pay a substantially higher interest rate to gain access to these funds. This is starting to hurt and could impact on profits for those companies which borrow.

Although the problems were not home grown, Australian companies are not immune to the worldwide credit crunch. Companies who have more debt than equity have been hardest hit. They have found it challenging to refinance debt. When they have been able to find funding they have been forced to pay a high price to do so. The sharemarket has punished companies that have experienced problems in this area.

### The impact on the listed property sector

The listed property sector has seen some companies flounder. In the 2006/2007 financial year, the listed property sector had a solid year, rising 25.9%\*. Since July of this year returns have been subdued as valuation and concerns over the level of debt in the sector affected returns.

One such recent event was the announcement by the listed property trust group, Centro Properties Group that it was struggling to refinance \$1.3 billion of loans. The sources of funding that have been available to companies in the past have evaporated, and Centro Properties Group cut its profit forecast and suspended its dividend payments in response.

Given poor market sentiment, Centro's share price fell dramatically, down 76% in one day. The listed property sector also experienced significant falls on the same day as Centro's announcement. Traditionally trusts in the listed property sector have a larger amount of debt than the companies in the broader sharemarket. Some listed property trusts also own US properties. This made investors nervous and the sector was sold off in response. Investors are nervous and reluctant to hold any shares where even a sniff of trouble is found.

*\*Past performance is no indication of future performance*

### What is the outlook for the listed property sector?

In the short run, investor sentiment has the potential to drive returns lower, based on higher borrowing costs and exposure to the US by many trusts. There are many factors that could influence the future of the property market. These include:

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- A strong Australian economy and property fundamentals.
- Low unemployment and rising wages has translated into strong retail sales. Continuing growth in retail sales leads to trusts reporting high occupancy levels and rental growth. Tax cuts will also support retail sales in 2008.
- The outlook for the office sector remains sound. Business investment is strong, assisted by good economic conditions and this is expected to remain into 2008. The business sector is demanding office space to take advantage of the positive economic conditions. Low vacancy rates are expected to continue given relatively low amounts of supply coming onto the market and this can lead to rental growth.

## Where to from here?

Without doubt, uncertainty and fear in global credit markets are acting as a drag on the sharemarket. In the first instance it is affecting sentiment towards financial institutions but it is also increasing the cost of borrowing for Australian companies. This higher borrowing cost is eating into company profits.



Sentiment is currently negative and investors are nervous. The credit problems need to be worked through in time as investors become willing to lend again and take on risk and financial markets revert to normal operating conditions. The US has cut official interest rates and this should help the financial market work through the problems in time.

## What's the outlook for the Australian sharemarket?

So far, the Australian economy has to date been well positioned. Indeed, the Australian economy is growing strongly, and the Reserve Bank lifted official interest rates in November to encourage us to 'cool our heels'!

Australia's economic growth is based on a number of factors. These same factors should affect the sharemarket in 2008.

We are in a resources boom. China is liberalising and urbanising. It is unleashing economic forces that have been held back since the early 1950s. India is also not far behind!

Australia has an independent Reserve Bank that can help manage inflation and interest rates

Governments have accepted that their spending and taxing needs to be kept roughly in balance over time.

To date, outlook reports received from company annual general meetings have been generally positive with a few comments on increased costs and the impact of the higher Australian dollar.

Despite this the market has been volatile.

Investing in listed property as well as shares is a long-term investment and has a minimum suggested investment timeframe of 5-7 years. There will be volatility from time to time however this does not change the long-term nature of these investments.

**We recommend you speak to your financial adviser to help you understand what impact this recent volatility may have on your investments. Importantly, they will ensure you are still on the right track to achieving your financial goals.**

**This article has been prepared in conjunction with Colonial First State.**

## Staff Update

Congratulations to Sue Paul on the successful completion of her Diploma of Financial Services.

As an avid investor, Sue has a wealth of knowledge that is sure to benefit our clients. Sue will soon be appointed an Authorised Representative and making appointments with clients.

***If you need help with investing in Managed Funds, Super or other wealth creating strategies, please call Jillian, Donna, Sue or Dominic on 0249 625 814.***

## Together we can.....

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Comments and contributions always welcomed.

Ph: 02 4962 5800 Mob: 0488 260 152 Fax: 02 4962 5900 Email: info@i-group.com.au