

18 September 2008

A challenging week on Wall Street...

Hi,

After signs in August that the sub-prime issues were starting to be resolved, events this month have reignited volatility and uncertainty. Within the past few days, Bank of America has bought out Merrill Lynch, Lehman Brothers, a 158 year old investment bank has filed for bankruptcy protection and now the American International Group (AIG) the world's largest insurer, has received a life line from the US Federal Reserve.

Of course, prior to the events of the last few days, the US Treasury seized control of mortgage lending giants Fannie Mae and Freddie Mac, the two biggest mortgage companies in the US – a move viewed as a very positive step for the US economy and financial markets. This relief was obviously short lived. As a result of the above events, the US sharemarket has fallen by about 7% over the last 3 days, with the Australian markets performing a little better.

Clearly, market volatility and global debt markets will require more time to work through and in times like this we can't help but think of the performance of our own investments. At the risk of sounding like a broken record, there is no way of knowing when the turmoil in financial markets will come to an end, just as it is virtually impossible to identify when such crises are likely to start. But we do know that crises of varying magnitudes and durations occur regularly, and that every crisis, every recession and every bear market comes to an end. When that happens, sharemarkets not only recover lost ground, but inevitably move much higher.

Some quick facts...

US housing/economy

Despite 12 months of a weak housing sector and financial market issues, the US economy has not slowed as much as first feared. The US Federal Reserve acted aggressively by cutting interest rates starting in September 2007 with this helping the economy, when combined with tax cuts. A strong export sector has also helped the US economy continue to grow. However, the prolonged credit market crisis and the weak housing sector mean the US economy could still slip into recession. The credit crisis might lead to a new wave where banks are reluctant to lend to each other, businesses and consumers. This would slow economic growth further.

The recent intervention by the US government into the mortgage market through the effective nationalisation of Fannie Mae and Freddie Mac is good news. This could lead to lower mortgage interest rates and entice buyers back into the market. If the US housing sector improves this will be one log jam that is cleared to reignite economic growth in the US.

Continued...

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It is important to remember that the current financial crisis in the US will take time to work through and likely dampen growth for some time. The good news is that authorities are working hard to resolve the issues.

The Australian market

The recent events in the US will have a flow on effect on the Australian sharemarket. Investors are nervous with emotion and uncertainty currently driving reactions.

On the banking side of things, we would do well to remember that our banking system in Australia is not faced with the same issues as the US banking system. Our housing sector remains firm and we have not seen the pickup of mortgage default rates that started this financial crisis in the US. Our banks are well capitalised and well supervised and should withstand the current problems, albeit with some volatility experienced in share prices.

Financial markets are now expecting the Reserve Bank of Australia to cut interest rates several times between now and Christmas. This, along with falling oil prices, would be good news for the sharemarkets and commercial property (but not great for 'cash deposits').

Another positive sign for Australia was that the recent profit season (just gone) showed profits were growing and that Australia is still benefiting from the resources boom.

As always, feel free to call me if you'd like to review your investments or strategy.

Kind regards,

Rick Maggi
Managing Director