

Spotlight now on the economy

What a dreadful month. October is now officially jinxed. Starting in late September, the liquidity crisis morphed into a full blown bank solvency crisis, forcing Governments across the globe to respond with massive, unprecedented action.

The good news...

Thanks to the coordinated global effort, bank balance sheets have been strengthened (through capital injections) and many bank deposits have been given government guarantees. As a result, panic surrounding the integrity of our financial system appears to be over and there is a growing feeling that the low point (in sharemarkets) may now be behind us. Brave words I know.

The bad news...

It's safe to say that most economies, especially the US and Europe, will face tougher times over the next year or so as slower economic growth takes a toll on household and business confidence. This will inevitably spread to Asia and Australia, although probably to a lesser extent.

In short, the focus has now shifted from the uncertainties surrounding the credit crisis to the economy and the risks of recession. This is actually an important change in thinking.

As we are all affected by the optimism or pessimism of others it is important not to underestimate **sentiment** as a driver of market movements. In the present climate, sentiment swings wildly from day to day, often making little or no sense. As unnerving as this is in the short term, it does illustrate that anxieties are high as rational investors wait on the sidelines. This, of course, underscores the importance of staying calm, buying on weakness (if possible) and taking the long-term view.

Delayed redemptions

There has been a fair amount of media attention surrounding the issue of delayed or frozen managed fund redemptions in recent days. While, in practice, this does not generally pose much of a problem for the vast majority of investors, there does appear to be some confusion on the subject.

Who?

The temporary redemption delays (which can be up to 12 months) only impact on mortgage style and some property funds, **not all managed funds**. In other words, share, cash and balanced managed funds have not been affected by the delays.

Why?

Following the Federal Government's recent decision to provide an unlimited guarantee on bank deposits, many investors in mortgage style funds began to redeem their funds en masse (up to 20 times more than usual) in favour of Government guaranteed deposit accounts.

Mortgage funds, like most managed funds, are designed to invest in specific sectors (like mortgages, shares and property) for the long-term benefit of their investors. When a fund suddenly experiences a large level of redemptions, the manager is often forced into selling quality investments to support the high volume of withdrawals, generally to the detriment of longer-term investors. So to avoid inequity between investors, a fund manager will often temporarily suspend withdrawals.

This is not the first time we've seen this measure adopted, nor is it a sign that a fund manager is in financial trouble. Of course, in the current climate, any hint of disruption merely adds to the 'laundry list' of fears and concerns out there in the general community – a sign of the times.

The Government's Deposit Guarantee

Following the example of Britain and several other European countries, the Rudd Government quickly announced (on 12 October 2008) that it would guarantee deposits in Australian owned banks, locally incorporated subsidiaries of foreign banks, credit unions and building societies for a period of three years.

As other government's had all ready made similar guarantees, the decision was effectively a fait accompli. Imagine where the Australian dollar would be now if there was no guarantee - fund outflows from Australian banks would be similar to, but on a much larger scale than, those being experienced by mortgage funds, which fall just outside the guarantee.

Still a work in progress, the Government has decided that a threshold of \$1 million be implemented, over which a fee will be charged to receive the benefits of the deposit guarantee. The fee will be based on the eligible institutions' credit rating, with AA-rated institutions paying 70 basis points (or 0.7%), A-rated institutions paying 100 basis points (1%) and BBB-rated and unrated institutions paying 150 basis points (1.5%).

The fee will apply from 28 November 2008. Up until that date all deposits eligible for the guarantee arrangements will be guaranteed without charge. After that date, deposits over \$1 million will only be guaranteed if the relevant fee is paid.

It is likely that the fee will take the form of a lower interest rate and will apply to the total of all bank guaranteed deposits. Government officials are yet to clarify how this will be monitored.

Treasury officials are also working on options to extend the Government's guarantee to some cash management funds, depending on the quality of their assets.

In the media today...

- **Dow up 889**– up all session – hovered up about 200 points most of the day until a 700 odd point run in the last 2 hours. This is the Dow's second biggest rally ever (the largest was two weeks ago) despite negative news consumer confidence and housing data.
- **Asian markets up** – Japan's Nikkei up 6.4% (reversing a 7.5% fall). Hong Kong's Hang Seng up 14.4% (reversing a 12% fall the day before).
- **Currency experts** say it might take years for the Aussie dollar to regain the 25-year high of US98.49c in reached in July.
- **Qantas** will pay the second-biggest price-fixing fine (\$20m) in Australian history for its part in an international freight cartel.
- **Economists** expect the Reserve Bank of Australia to cut official interest rates by at least 50bps at its next meeting.
- **Fortescue Metals** said there could be potential delays to its \$2bn WA iron ore expansion.
- **Suncorp-Metway** has left the door open for a potential sale of its banking operations after hinting it might cut its dividend to improve its capital position.
- **Crown** chief executive Rowen Craigie told shareholders at yesterday's AGM that there could be "some dislocation" in some businesses over the next 18 months. The stock closed down at \$6.30, more than half the \$14.30 it was trading at when James Packer spilt the gaming and media company.
- **The government is pressuring the major banks** to provide liquidity to besieged mortgage funds – also the Future Fund chairman asked banks to buy mortgage fund assets to free up liquidity. The government has said mortgage funds, who have frozen redemptions amidst the run on funds to the safety of the government guaranteed banks, should consider shifting their businesses to come in under the shelter of APRA regulated institutions and the guarantee net.
- **Standard and Poor** downgraded RIO's BBB credit rating to "developing" from "positive."
- **Speculation that Packer is preparing to buy PBL Media back** – having stepped down from the board so as he's not an insider. A rumour from 2-weeks ago suggested Packer had offered to buy out PBL Media debt holders for \$2bn.

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