

Market Comment

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Update on credit crisis



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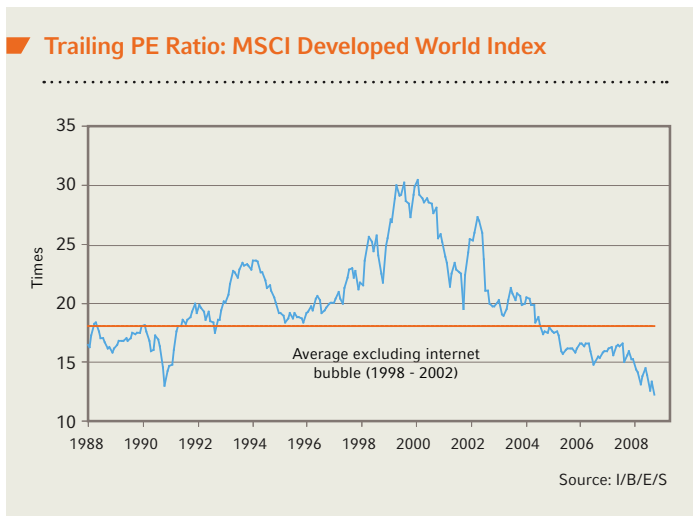
As you know, on Monday U.S. financial services firm Lehman Brothers filed for bankruptcy protection as the fallout from the U.S. housing collapse and global credit crunch continues to intensify. In this *Market Comment* Russell's Investment Strategist Andrew Pease provides some insights into this latest financial crisis.

Darkest before the dawn?

The financial crisis is unrelenting. Two once venerable investment banks, Bear-Stearns and Lehman Brothers have collapsed. The Bank of America has taken over Merrill Lynch in an emergency operation. Financial markets are in turmoil around the globe amid fears that the crisis might spread to high profile insurance companies.

Predicting when markets will bottom is a futile exercise. Market cycles of boom and bust typically have more to do with euphoria and panic than with the underlying fundamentals.

The emotional response generated by dramatic market events is the greatest danger for long-term investors. Our psychological hard wiring ensures that we are over-confident during market booms and ready to capitulate during market busts. One way to counter this is to step back from the market turmoil and attempt to look dispassionately at how the market is processing this information.



It's all about profits

Ultimately, company profits matter most. Profits (and economic growth) underpin the income streams that investors receive. Profits ultimately determine the value of companies and share-markets. A good question to ask therefore is what profit outlook is priced into global share-markets?

The chart shows the price-earnings ratio for the MSCI developed world index based on profits for the last 12 months. The ratio of 12.2 times is the lowest in the 20-year history of the index. Excluding the Internet bubble from 1998 -2002, this PE ratio has averaged 18 times. At current share-market levels, profits (earnings-per-share) would need to fall by a third to lift the PE ratio to its long-term average. In other words, global developed share-markets are effectively pricing in a one-third decline in profits.

A profit decline of this magnitude would exceed the declines experienced in the last two recessions.

Is a global recession now inevitable?

The economies of Europe and Japan contracted in the June quarter and the UK economy was stagnant. The US economy, however, expanded at a 2% annualised pace over the first half of the year. The global economy is weak this year, but has not yet entered recession.

The financial crisis could tip the global economy into recession through its effects on consumer and business confidence, and if banks become unable or reluctant to continue lending. The distinction between investment banks and commercial banks is important. So far, the crisis has centred on investment banks. Commercial banks, which do the majority of intermediated lending that is important for most household and business borrowing, have been relatively unaffected. Commercial banks would need to be caught up in the crisis for it to have a severe impact on the global economy.

Furthermore, with the inflation threat from high energy prices now dissipating, central banks around the globe are now able to lower interest rates and provide monetary stimulus. Monetary policy operates with a lag and may be unable to prevent a global recession over the next few months. Central bank action, however, should ensure an eventual economic recovery.

In short, even if the world does slide into recession, there is no reason to think it will be more severe than the scenario currently priced into global equities.

No direct link to Australia

US investment banks are at the centre of the crisis. Australia's commercial banks have reported only small exposure to the institutions under pressure. Aside from the rise in global funding costs and more cautious attitudes towards risk, there is no reason to expect a local credit crunch. The impact on the local economy should be through exports and confidence effects.

We've been here before

As dramatic and painful as the current episode is, investors need to remember that crises are a regular feature of the market landscape. They have occurred at a regular 6-7 year frequency over at least the past twenty years. There was the 1987 share market crash. The early 1990s saw the US savings and loan crisis. 1998 witnessed the triple whammy of the collapse of Long-Term Capital Management, the Asian economic crisis and the Russian bond crisis. There was the bursting of the Internet bubble and the corporate accounting scandals in 2002 and 2003. Equity markets have risen over time, despite these setbacks.

It is impossible to predict whether global markets have reached a bottom – this requires an understanding of psychology as much as finance and economics. To paraphrase John Maynard Keynes, *investing is often about anticipating the anticipations of others*.

An emotional response to the market drama is the greatest danger for long-term investors.

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