

Investment Update

December 2008

What's happening with investments?

2008 will go down as one of the worst years in investment markets on record. There have been unprecedented falls in the value of nearly all major asset classes, reflecting the downturn in developed economies around the world. This downturn will undoubtedly cause further pain as unemployment grows. But investment markets have already felt most of the pain: they fell before economies began to decline and they will also rise before the economy does. Analysts expect that this will make 2009 a much better year for investors who hold their nerve through the economic turmoil.

How did the trouble start?

The trouble was set off in the United States, where mortgage brokers had been granting mortgages to people who could not otherwise qualify for a loan or afford to buy houses. Mortgage brokers were paid commissions on the loans they established – they were not concerned about whether the loans could be repaid. Banks then sold these poor, or sub-prime, loans to investment banks, who packaged them into investment products and sold them in **tranches** to investors. The top **tranches** were supposed to be secure and so they were highly rated by credit agencies. When home-buyers started to default on the loans, investment banks could not pay returns to investors and the financial crisis began to emerge.

Credit dries up

Investment banks had been forced to hold on to the riskiest loan **tranches**, because they could not get them rated highly enough to sell to investors. This meant that the investment banks started losing huge amounts of money and they struggled to survive. In September 2008 Lehman Brothers, one of the largest investment banks in the United States, collapsed after losing US\$3.9 billion in the quarter to 31 August 2008 compared to a profit of US\$887 million in the quarter to 31 August 2007. Afraid that another big bank might collapse, banks would not even lend money to each other. It became even harder for companies and individuals to borrow money. Economies across the world were affected – without finance from banks it is difficult for businesses to operate. And that affects both jobs and consumers.

What governments are doing

Governments realised that conditions were like those that had led to other significant economic downturns, such as the Great Depression of the 1930s. They acted quickly and with unprecedented co-ordination to



reduce the cost of borrowing and to guarantee bank deposits, to avoid the crisis of confidence spreading to consumers. The US government approved an unprecedented finance package of US\$700 billion in order to rid the system of the loans that had caused the problem. In Australia the government also provided \$10.4 billion to pensioners and families to try to avoid an economic downturn.

What will the new year bring?

Economists expect a significant downturn in the Australian economy and potentially a recession in 2009. Many developed economies have already experienced recessions, with the downturn commencing in the United States at the end of 2007, but spreading to Europe and Japan, which fell into recession in 2008. Emerging economies have also slowed significantly, but China is very unlikely to fall into a recession, with its recent history of extraordinary growth. Around the world governments have made unprecedented moves to stimulate their economies, and it is expected that some signs of recovery will emerge in 2009.

Analysts expect that this investment will lead to improved returns on investment markets well before we see any recovery in the wider economy. Many commentators have said that it is,