

World financial crisis: Questions & answers

Financial market perspective

- How did we get into this situation and where do we go from here? CommSec examines the key issues.

Is this as bad as 1987?

- The magnitude of the declines is similar but the 1987 experience is still worse than the current period. The drop from peak to trough in late 1987/early 1988 was far quicker as well.
- The Australian sharemarket peaked at 2376.88 on September 21 1987 and fell 49.2 per cent to its low point of 1207.51 on 10 February 1988 – a span of 103 days.
- In the current cycle, the All Ordinaries peaked at 6853.6 on November 1 2007 and has fallen 42.5 per cent to 3939.5 on October 10 2008 – a period of 243 trading days.

How long did recovery take back in 1987?

- The sharemarket hit its lows in February 1988. Four months later the sharemarket had lifted by 36 per cent. A year after the lows, the market had lost some of those gains but was still up 29 per cent on the low point. However full recovery to the previous high took some time. In fact it took just over six years to get close to the previous highs but nine years to decisively push through the previous high. But the period did include a significant recession in 1991 and a slow economic recovery.
- In 1987 the sharemarket was significantly overvalued. In fact the price-earnings ratio hit 21.1, 79 per cent above the previous long-term average of 12.
- In the current cycle the PE ratio stood at 14.25 in November 2007 – below the previous decade average of 16.9 and the 28-year average of 15.2. The current PE ratio stands at 10.

Biggest daily falls for the All Ordinaries index (pct)

1	20-Oct-87	-25.0
2	10-Oct-08	-8.2
3	16-Oct-89	-8.1
4	29-Oct-87	-7.6
5	22-Jan-08	-7.3
6	23-Oct-87	-7.0
7	27-Oct-87	-6.9
8	10-Sep-73	-6.9
9	28-Oct-97	-6.8
10	26-Oct-87	-6.6
11	17-Apr-00	-5.7
12	26-Jun-72	-5.6
13	04-Nov-87	-5.5
14	29-Nov-60	-5.1
15	08-Oct-08	-5.0
16	17-Sep-01	-4.8
17	27-Sep-74	-4.6
18	11-Nov-87	-4.4
19	16-Nov-60	-4.4
20	30-Sep-08	-4.3
21	03-Jun-74	-4.3
22	27-Apr-73	-4.3
23	03-Mar-75	-4.3

Sydney All Ords before 1980

Source: CommSec

Why caused the sharemarket to slide?

- It all began in the US. Bad lending practices led financial institutions to provide loans to people who shouldn't have got loans in the first place – sub-prime borrowers. Those loans were bundled up and turned into investments (securitised). These mortgage securities were also combined with other securities to try and reduce the risk (called collateralised debt obligations) and entice more investors to invest.
- Unfortunately when interest rates rose, sub-prime borrowers started to default. And the house of cards started to come down around the world.
- Financial institutions began to fail, causing banks and other institutions to become more wary about lending. Interbank



Craig James – Chief Equities Economist (Author)
(612) 9312 0265 (work) | craig.james@cba.com.au

Produced by Commonwealth Research based on information available at the time of publishing. We believe that the information in this report is correct and any opinions, conclusions or recommendations are reasonably held or made as at the time of its compilation, but no warranty is made as to accuracy, reliability or completeness. To the extent permitted by law, neither Commonwealth Bank of Australia ABN 48 123 123 124 nor any of its subsidiaries accept liability to any person for loss or damage arising from the use of this report.

The report has been prepared without taking account of the objectives, financial situation or needs of any particular individual. For this reason, any individual should, before acting on the information in this report, consider the appropriateness of the information, having regard to the individual's objectives, financial situation and needs and, if necessary, seek appropriate professional advice. In the case of certain securities Commonwealth Bank of Australia is or may be the only market maker.

This report is approved and distributed in Australia by Commonwealth Securities Limited ABN 60 067 254 399 a wholly owned but not guaranteed subsidiary of Commonwealth Bank of Australia. This report is approved and distributed in the UK by Commonwealth Bank of Australia incorporated in Australia with limited liability. Registered in England No. BR250 and regulated in the UK by the Financial Services Authority (FSA). This report does not purport to be a complete statement or summary. For the purpose of the FSA rules, this report and related services are not intended for private customers and are not available to them.

Commonwealth Bank of Australia and its subsidiaries have effected or may effect transactions for their own account in any investments or related investments referred to in this report.

lending rates rose to reflect the increased risks but still financial institutions were wary about going about normal business.

- At the same time the massive residential construction and borrower defaults led to an oversupply of homes. The downturn in the housing and finance sectors has dragged down the US economy with the reverberations felt across the globe.
- In Australia, some highly geared Australian companies and property firms have been placed under strain by tight global credit conditions. Banks have had to pay more for funding in overseas markets and been forced to pass on some of the higher costs to borrowers.
- Overall, however the Australian economy has remained sound. The Australian banking system has also not suffered the same stresses experienced in the US, UK and Europe. The Australian banking system was recently ranked the second strongest in the world.
- The failure of banks and investment banks in the US, and the need for US, UK and European authorities to bail out other institutions has taken its toll on investor confidence.
- Effectively banks are worried about lending to one another, causing credit markets to fail. And worried investors have withdrawn from the sharemarket. While sharemarkets are now super-cheap across the globe, investors aren't keen to buy.

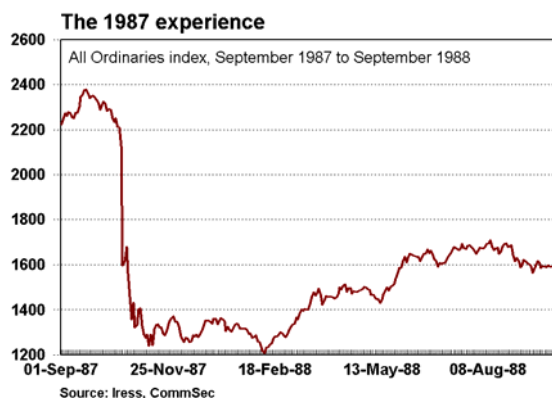
Were other factors involved?

- The sharp rise in the oil price (and commodity prices more generally) over 2008 has put additional pressure on the US economy. At the same time, the rise in oil prices and other commodity prices put upward pressure on global inflation, causing central banks to maintain tight monetary policies.
- Investor confidence was already under pressure from the US housing crisis, and record oil prices didn't help. Between mid March and mid May, the All Ordinaries rose by over 16 per cent with the US Dow Jones up by 9 per cent. But oil prices were also on the march, up 25 per cent, prompting more jitters about the state of the US economy and derailing the sharemarket rally.
- The industrialisation of the Chinese economy has coincided with the US housing shakeout and consequent global financial crisis. These significant events in world history have occurred at the same time, making it more complicated for central banks and regulatory authorities to deal with the clean up process.

The US and UK Government announced rescue packages. Central banks have cut rates.

Why haven't they worked?

- There was much hope when the US rescue package was announced. The problem is that the US House of Representatives failed to approve the deal. While the package was subsequently passed, the initial failure further destabilised investor confidence. However, it is important to recognise that the US plan is a long-term solution and the measures are yet to be implemented.
- The UK Government announced a rescue package but the impact was dulled by the slowness of central banks to announce co-ordinated rate cuts. Australia's Reserve Bank announced a hefty rate cut of 1 percentage point on Tuesday October 7. Other central banks were also expected to slash rates but the co-ordinated rate cuts happened on Wednesday, not Tuesday. The UK Government package was also announced on Wednesday. But it failed to provide guarantees for inter-bank lending – essential to get banks lending to one another again.
- The rate cuts in Europe and the UK also fell well short of the move made in Australia. And that is despite the Australian economy being in a far better position to handle the global financial crisis.
- The UK Government has proposed that major industrial powers guarantee all interbank lending. The US has



indicated they will consider the proposal. Given that banks have no confidence in dealing with each other, this proposal is very positive. It would quickly unfreeze credit markets.

The G7 finance ministers met over the weekend. What did they say?

- There were some fine sounding words but the statement was short on action. The G7 said it would “take all necessary steps to unfreeze credit and money markets” and that it would “take decisive action and use all available tools”. But there were no details on what they will actually do. We will have to wait and see what concrete measures are taken.

What else are countries doing?

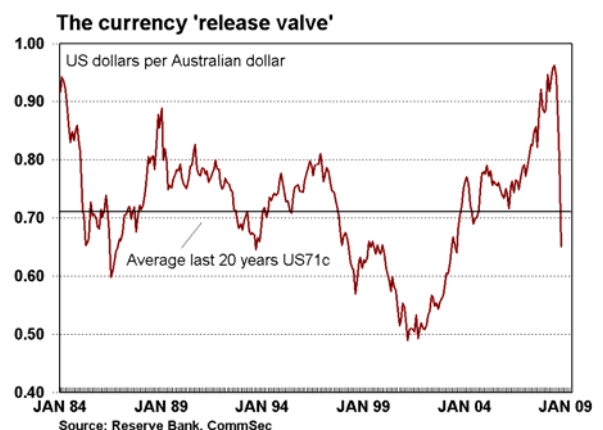
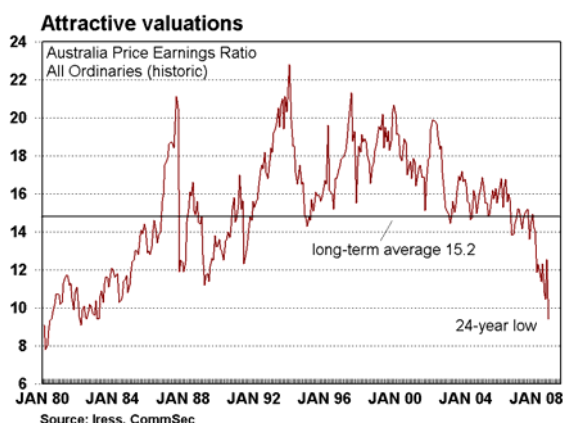
- The UK and US Governments will buy shares (equity stakes) in financial institutions. US Treasury Secretary Hank Paulson hopes to take stakes in a “broad array” of financial institutions “as soon as we can”. It will be the first time since the 1930s that the US Government has bought stakes in banks. In the 1930s the Reconstruction Finance Corporation invested US\$50 billion in over 6,000 companies.
- The move by the US to buy equity stakes in financial institutions follows the lead from the UK in its financial rescue package announced last Wednesday.
- The Russian government proposes to invest 175 billion rubles (US\$6.7 billion) in stocks this year as part of a US\$200 billion rescue package. It proposes to invest a similar sum next year.
- In August 1998 during the Asian Financial Crisis, the Hong Kong government bought shares in companies. In total around HK\$118.1 billion (US\$15 billion) was invested with the Government taking 7.3 per cent of all shares in the 33 companies comprising the Hang Seng index. The intervention was successful and the legacy of the move, the Tracker Fund, still exists today.

And our bank deposits are safe?

- Yes. The Federal Government has guaranteed all bank deposits for three years. It has guaranteed all term wholesale funding of Australian banks operating on international markets. The NZ Government has guaranteed all bank deposits for two years.
- in the US, UK and Europe, governments have been forced to bailout banks that have got into difficulties. Understandably depositors across the world have been worried by this development. In response, the Irish government has pledged to guarantee 100 per cent of bank deposits. The UK Government responded by lifting its guarantee on bank deposits from £50,000 to £100,000. In the US, the guarantee on bank deposits has been lifted from US\$100,000 to US\$250,000.

In 1987, investors shifted from shares to property. Could the same happen?

- Certainly. The Reserve Bank has already slashed the cash rate from 7 per cent to 6 per cent but monetary policy still remains tight. The cash rate could fall to previous lows of 4.25 per cent set in 2001 when the US was last in recession. Clearly inflation is the least of our concerns at the moment.
- If interest rates come down, investors will be attracted to move into the property market. Demand for property is strong but supply hasn't kept pace. As a result rental markets are the tightest in 19 years, rents are rising and so are house prices.
- In response to slowing economic growth unemployment is likely to rise in coming months. However unemployment is lifting from “full employment” – unemployment rates near generational lows.
- People only sell up their homes if they have to. And for the majority of Australians there is no need.



Unemployment is still low, and if you sold up, you would still have to live somewhere. Given the tightness in the rental market, it is hard to find affordable accommodation, let alone in the area you want to live.

- Some analysts are worried about household debt levels. But as the Reserve Bank has been at pains to point out, higher real incomes have caused more Australians to take on debt. And while debt has risen, so have assets.
- The other key factor is rising population growth – the fastest in 18 years, boosted by record immigration. The International Monetary Fund said that migration was the key reason why Australian house prices are not overvalued: “if country-specific factors, particularly the impact of long-term migration on housing demand, are taken into account, the results do not produce evidence of a significant overvaluation of house prices.”

Should I move my investments into cash?

- Moving investments from shares and property into cash is not without its costs and is a short-term decision. It also represents an attempt to “time the market”. And countless studies show that it is near on impossible to time the sharemarket.
- A widely quoted study in the US tracked sharemarket movements from 1963 to 2004. It found that 96 per cent of market gains occurred on only 0.9 per cent of trading days. (Towneley Capital Management study undertaken by Dr H. Nejat Seyhun). The bottom-line being that if you move money out of the sharemarket and then back in, you would have to be either extraordinarily astute or lucky to get the timing right.
- If you are aged below 55, you no doubt will experience more events like we are experiencing at present – although hopefully not as significant. Corrections occur regularly, reflecting the “animal spirits” that underpin investor behaviour. In short, we all get over-confident and over-pessimistic – fear and greed.

How is Australia placed?

- The Australian economy is probably the strongest major developed economy at the current time. Unemployment is just above 33-year lows, the economy hasn't had a recession in 17 years, government debt has been paid off and the budget surplus stands at \$20 billion.
- The Australian banking system is amongst the strongest in the world – ranked equal second by the World Economic Forum behind Canada in a recent survey.
- Australia is more dependent on China rather than the US, UK or Europe for trade and economic growth. And China continues to expand strongly.
- Clearly Australia is not insulated from the world's problems. Our banks need to raise money on global markets and are forced to pay higher interest rates. If the US, UK and European economies slow then they will buy less goods from China and China will demand less raw materials from Australia.
- But Australia's Reserve Bank has plenty of room to move to cut interest rates and stimulate the domestic economy. If the job market were to slow markedly, then the Government would revise down its immigration target.
- The dramatic fall in the Australian dollar – while bad news for overseas travellers, represents good news for Australia's exporters, especially in the farm sector.
- In short, Australia has plenty of options available and plenty of safety valves to shore up growth – something which clearly can't be said for many other developed nations.

Craig James, Chief Equities Economist, CommSec
Work: (612) 9312 0265

RETURNS ON FINANCIAL ASSETS (percent)

Year to	Aust shares	Global shares	Aust property securities	Aust fixed interest	Cash
Jun-89	3.5	17.9	-1.1	5.3	16.0
Jun-90	4.1	1.9	15.2	17.3	18.5
Jun-91	5.9	-1.8	7.7	22.4	13.5
Jun-92	13.0	7.2	14.7	22.0	9.0
Jun-93	8.7	31.3	17.1	13.9	5.9
Jun-94	15.5	0.2	9.8	-1.1	4.9
Jun-95	6.4	14.1	7.9	11.9	7.1
Jun-96	14.3	6.7	3.6	9.5	7.8
Jun-97	26.8	28.5	28.5	16.8	6.8
Jun-98	1.0	41.6	10.0	10.9	5.1
Jun-99	14.1	8.2	4.3	3.3	5.0
Jun-00	18.2	23.7	11.9	6.2	5.6
Jun-01	9.1	-5.8	13.9	7.4	6.1
Jun-02	-4.5	-23.3	14.9	6.2	4.7
Jun-03	-1.6	-18.3	12.1	9.8	5.0
Jun-04	21.7	19.4	17.2	2.3	5.3
Jun-05	26.0	0.6	18.1	7.8	5.6
Jun-06	24.0	20.0	18.0	3.4	5.8
Jun-07	29.2	8.2	25.9	4.0	6.4
Jun-08	-13.7	-21.0	-36.3	4.4	7.3
Annualised over 20yrs	10.5	6.6	9.7	9.0	7.5

Source: Colonial First State

Percentage return over rolling 1 year. UBS Australia Bank Bill Index (91 day Commonwealth Treasury Note Index pre Jan 1989), UBS Australian Composite Bond Index (CBBi All Series pre Oct 1989), S&P/ASX 200 Property Accumulation Index (ASX Property Accumulation Index pre April 2000), S&P/ASX 300 Accumulation Index (ASX All Ordinaries Accumulation Index pre April 2000), MSCI World Net Index (A\$). All dividends reinvested excluding fees and charges.