

## WHAT IS GOING ON IN THE WORLD MARKETS?

I am just back from holiday and am writing to explain the turbulence in the markets this month. We have seen most of the world's stock markets fall by around 15% in the first half of this month. Fortunately, most markets have regained a third to a half of this loss in the past week.

## SUB-PRIME MORTGAGES

As you have probably read, the main trigger for this was the sub-prime mortgage market in America. With the rapidly rising property prices and very low interest rates in the past years, there has been a massive amount of lending to un-creditworthy people. There was even some fraud amongst borrowers which was undetected until now as mortgage lending criteria became too relaxed. Now that interest rates have risen and property prices dropped, many cannot afford their repayments and when the properties are reposed, there is a shortfall in the loan.

## SO WHY HAS POOR MORTGAGE LENDING AFFECTED WORLD MARKETS?

The mortgage companies sold the loans on to companies that collateralised them and sold them to banks and hedge funds as collateralised debt obligations (CDOs). The rating agencies helped structure these so that a broad mix of loans were combined together on the basis that they would not all default. They were then given an AAA rating and sold as a CDO.

The problem is that these CDOs have been sold and sometimes repackaged into other instruments and sold on again. Banks and hedge funds around them have bought them as low risk instruments with supposed good returns. Now they are not achieving the returns and defaults are high, banks are having to write off some of the value. Also, because the content of these had a high level of weak or sub-prime loans, their rating has been downgraded and as they are no longer investment grade bond, they have to sell them. However there are no buyers at present, making them difficult to value.

## WHAT HAPPENED?

Fear took over. Because it is still not possible to measure the extent of the problem and nobody is sure who is holding all the liabilities, there was near panic in the credit markets. The banks stopped lending, even to each other. Central banks had to step in to lend to the banks as they could not borrow from each other. \$billions was made available to banks to provide liquidity.

Many large hedge funds borrow money to invest in world markets. The banks called in these loans which caused the hedge funds to dump investments that were perfectly good. Some major banks, notably Bear Stearns & BNP Paribas announced temporary and permanent closure of their hedge funds as they could not value them. These factors caused panic in the equity markets and funds that use computers to determine when to buy and sell kicked off a round of automated selling. BNP have just re-opened their funds.

## OTHER FACTORS

As well as the deleveraging, the crisis has caused a substantial reduction in the risk appetite of many large institutional funds which affected the emerging markets more than the more established ones. The other factor is that the USA is leading a slowdown in consumer spending and after a long run up in markets, a correction was likely.

This latest bout of equity market weakness is the third in the last 18 months. The previous episodes were caused by worries about US inflation (May/June 2006) and about rising defaults in US sub-prime mortgages (February/March 2007). Both proved short-lived.

## WHAT IS THE WIDER ECONOMIC REAL WORLD IMPACT?

Growth in the rest of the world is still fairly robust and inflation has fallen sharply in the last month. The economic fundamentals remain supportive of equities for now: strong global growth, especially outside the US, reasonable valuations (though small Asian markets look relatively expensive), healthy earnings growth and strong corporate balance sheets. Even with a very weak US economy, global growth and earnings can still be reasonable. In addition, companies have never been stronger, gearing is still low and free cash flow yields are high.

However, it is expected that sentiment will continue to be volatile as equity markets are likely to remain worried about the fall-out from weakness in credit markets. The problem is that investors do not – and cannot – know

exactly where the exposure to US sub-prime mortgages lies, how much leverage exists and which banks, investment vehicles etc. face possible financing crises. Only time will reveal the answers to these questions. So recovery in equity markets may be slower than after the last two weak periods. But a recovery is likely, unless financial market weakness leads to economic weakness. There are two worries on this front: the US consumer and a general credit crunch.

US consumer spending has continued to grow at a healthy rate but the housing market is in little better shape than a year ago. The cumulative effects of falling home prices and equity market turmoil might yet cause it to slow sharply.

Liquidity problems in financial markets could eventually damage banks' balance sheets and cause cutbacks in lending to credit-worthy households/businesses – a credit crunch. If both these happen, the USA would go into recession.

## **INVESTMENT STRATEGY**

At present, the majority of fund managers and economists seem to be assuming that these economic problems will not materialise and that equity markets will recover their recent losses. Therefore we are not generally suggesting any immediate changes to your portfolio as timing markets is difficult and we have already seen a strong partial recovery last week. It is expected that we will continue to see high volatility until things settle down and September is statistically the worst month of the year for equity markets. In fact, it is a good time to be making investments while markets are down, from a medium term standpoint.

For those invested in the Lanson funds, you will be pleased to know that they had a high cash holding before the crisis and no exposure to the US market and so have taken smaller losses (around 5%) than other funds. Also, direct property funds have not been affected, but property funds that invest in equities of property companies have been affected.

If you would like a review or I can be of further help please let me know.

*Best wishes*

*Clive A Ward*

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