

# New Year hangover – a painful recovery!

2008 came in with a bang. Equity markets joined the bond markets 'doom and gloom costume party'. The equity guys came well and truly drunk on the punch provided by Bernanke in the U.S.

The recent downturn, supposedly triggered by large losses by a rogue junior trader at a French Bank, brought the global equity market to its knees in January. Equity markets suffered until 'Helicopter Ben' hit the panic button and cut the Fed's target rate by 75bps intra-meeting, only 8 days before the regularly scheduled meeting. But the markets smelled blood and demanded more, causing the Fed to cut again by 50bps on January 30th. This brings the total rate cuts by the Fed in this cycle to 225bps in a short span of 6-7 months.

The fiscal taps were opened as well. President Bush announced a fiscal stimulus package of \$150 billion to help boost the flagging economy. With the U.S. fiscal deficit at \$400 billion, and the war in Iraq termed a \$1 trillion war, is \$150 billion really going to have a significant impact?

These actions indicate that financial market-driven central bankers and government officials are quite happy pouring drinks from the fountain of market excesses to keep the party going. Unfortunately, more drugs may just prolong the pain.

Key questions remain:

1. Is there a decoupling between the US and Asia, in particular Australia? Or, is economic integration and globalisation a more rational model for the current reality?
2. Should Australia continue to raise rates as the other central banks cut?
3. Should global central bankers cut rates in a rising inflationary environment, abandoning inflation targets in favour of encouraging growth?
4. Is the US just postponing its longer term structural problems and avoiding the inevitable – a downgrade in their rating? (high inflation, housing problems, current account deficit, fiscal deficit, low interest rate – If you were a third world country, what should your rating be?)

The answers to these questions will only be known over time. However, when we look in our crystal ball a few things are very clear:

1. Europe and UK have to come to the party. We expect rate cuts and a more pronounced sell-off in equities. This translates to a bearish European stocks/Euro (€) and bullish European curve view.
2. The US yield curve has to be steeper. Investors will demand a higher risk premium to hold US 10yr debt. Not only for term premium, but also for an inflation and credit premium.
3. The financial sector has been taken to the cleaners. The message is loud and clear: 'Get the filth out and use extra starch on my shirts'. US financials and investment banks have lost on average 50% of their equity value, and short of additional writing downs/losses are beginning to look like good value.
4. The U.S./Australia rate spread will widen in the short-term. When the US eventually starts hiking rates, Australia will be most likely cutting rates. But, in the short end, the spread will be a whopping 5%.
5. Cash at 7% looks like a good place to be in Australia. Safe and stable returns with no volatility. No other asset class can say the same.

**Break out the Panadol. The market will go through a painful recovery to get rid of this hangover!!**