

Markets – like that student driver – are stuck in the parking lot of risk!

Market Returns – Performance, performance, performance

The equity markets in Australia had their worst year in performance for more than a quarter of a century. The ASX 200 fell 27% in the 2009 financial year after falling 15.5% in 2008. Increase in investor appetite for risky assets underpinned a powerful rally over the last quarter on hopes that the massive fiscal stimulus and low rates will bolster economic growth. Has Armageddon been avoided for now?

Meanwhile in the land of bonds: the UBS composite posted a positive return of nearly 11% for the financial year. However, since 2000, both Australian bonds and equities have provided similar returns, approximately 6% annualised. In hindsight, a prudent investor would have taken the 6% return with less volatility – bonds!

A trip down memory lane: June 08 – June 09

Oil was trading around USD\$147 in June 2008. By August and September 2008, equity markets were starting to worry about the problems the bond markets had been concerned about for months. The RBA had left rates unchanged at 7.25%, Lehman brothers had declared bankruptcy, and Merrill Lynch had been hitched to Bank of America. Thus began the financial year 2008!

October, November, and December 2008 saw equity markets plummet and the RBA cutting interest rates by a total of 275bps. Central bankers were forced to bail out Citigroup, followed quickly by Freddie Mac and Fannie Mae. January brought Barack Obama as president of the United States, and Prime Minister Kevin Rudd announced a \$75 billion fiscal rescue package in Australia. So much for decoupling!

February, March and April 2009: the equity markets reached their low (March 6th), followed by 'green shoots' sprouting around the world. Armageddon had been avoided, risk-taking was back, the hangover over, and it was time to revisit the pub once again. Short-selling bans were eventually lifted in May, and the equity markets finally managed to claw back some gains in the months of April, May and June 2009. The late stage rally notwithstanding, 2009 was one of the most volatile financial years on record and ended with a total loss of \$330 billion in market capitalisation.

Thus ended the financial year 2009 – a year that most investors would love to forget.

Some shattered records –

- Australian three-month bank bills ended they year at 3% after plummeting from nearly 8%.
- Share markets fell 42% from the highs – the biggest fall in 21 years.
- There were only five months of positive equity returns in 2008, with four of those coming in the immediate past four months.
- The Australian dollar fell from nearly 95 cents to 61 cents in the middle of the crisis, only to close around 82 cents. A fall of nearly 23.6% for the year.
- Bank and government bond issuance soared.
- Oil prices fell 49%.

What is ahead?

Central bankers and government authorities have done everything they can to reduce systemic risk. The risk has largely been transferred from the private sector to the public sector. Public sector balance sheets have deteriorated significantly as authorities had to increase spending quickly and revenues fell off a cliff. Central bankers will have less of a role in the next 12 months, as they have very little policy latitude with rates as low as they are in most countries. The question now is: has the systemic risk disappeared? Transferring risk from the private sector to the public sector has only reduced the risk; it has not made the risk disappear.

Given the fiscal burden many countries are taking on as a result of fiscal stimulus packages and falling revenues, the bond vigilantes have started to demand a higher premium to fund deficits. This partially explains recent increases in rates by about 150bps. Government borrowings will continue to be large for many years to come (even ignoring the possibility of any reversals of quantitative easing). This is true both on the federal and the state level.

Like most solutions, there are positive and negative consequences of recent actions by authorities in response to the financial crisis. The positive consequence of the enormous stimulus provided could be that Armageddon has been avoided for now. The negative consequences are plenty, the exit strategy for some of which can be very messy. The aim of policy-makers to date has been to stop the Titanic from sinking, not to worry about the mess they made of the deck chairs. Inflation is a huge risk in the medium- to long-term, and the US dollar faces challenges as the US depends on the rest of the world to finance its deficit.

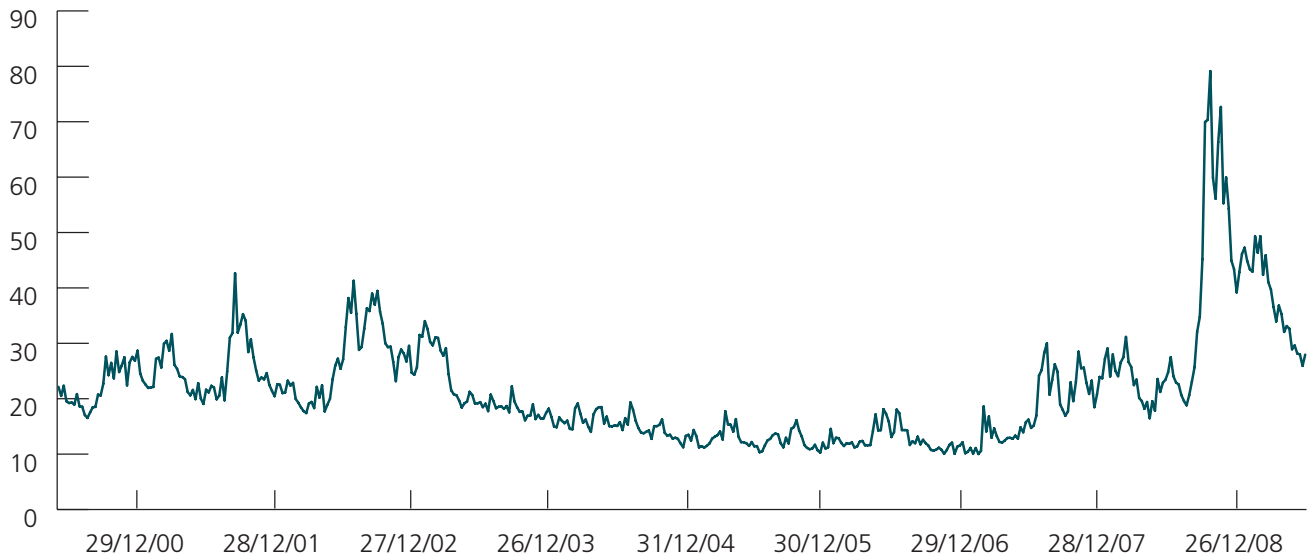
Can Asia, particularly China and India, bail out the system this time around? As the world moves towards an even more interconnected global economy, the challenges are enormous. Authorities in China need to do whatever is necessary to keep growth robust and stop unemployment from rising. Consumption for world growth needs to come from the younger population in India and China. One would assume that much of the initial wealth creation in either country should first be saved (to fund medical and retirement benefits that are currently unavailable) before spending occurs. So potentially there is no quick solution to replace the Western consumer.

The market has reversed the losses of the 1st quarter 2009 in the 2nd quarter to sit somewhere around zero returns for the year in both equity and bond markets. This could be the new norm on return expectations for many years to come until the mess gets sorted out. The current government policies will place the burden on future generations of taxpayers to fix the system. Complex and toxic securities that were levered up will be hard to unwind in a short time frame. It is not over yet.

Parking lot of risk and volatility

The VIX or 'fear index' that measures volatility hit an intra-day high of 89.5 in October 2008. This was at the height of the crisis when the market was staring at the abyss. Today it seems a lot more reasonable around 26 points. Has the fear subsided forever? Are we back to a 'normal' environment on risk, especially given the problem has not been solved but the hot potato just been transferred from private to public sector? History will be the judge of that.

The VIX index



Recovery

There is a growing belief that the global economy is slowly rebounding and recovering. This has been highlighted as share markets have rallied, commodity prices have experienced a bounce and the general level of risk-taking has increased as volatility has fallen. But the road is likely to be bumpy, given the potholes left behind. We should anticipate a period of slower growth in the years to come as we learn to live within our means. While fund managers have swarmed towards beaten down stocks that have offered cheap value, their conviction will be tested by the economic data that is yet to be published, followed by earnings announcements of major corporations.

For the bond fund manager, it would seem prudent in this environment to own assets that are higher up in the capital structure and provide a good solid income.

While dealing with uncharted territory of untested policy measures, there are two things investors can be certain for the future:

1. Low nominal returns and
2. Increased volatility of returns.

The student driver can be expected to remain on their 'L' plates for long time to come!