Investment Market Turbulence

October 2007

I thought it may be useful to summarise some of the reasons for the considerable turbulence we have experienced in global stock markets since the beginning of July. The recent volatility was initially triggered by concerns in the credit and sub-prime markets in America and latterly; the knock-on effect that this has had to other financial markets.

A long period of low interest rates in the US encouraged Banks to provide high levels of mortgage lending to low income borrowers and those with poor credit history. As the US economy improved, there were real concerns for future inflation and this was countered by a series of rate increases. This resulted in many of these borrowers unable to meet the increased mortgage repayments. There has also been some reduction in property values which has exacerbated the situation. In February, a spate of failures of sub-prime mortgage lenders triggered mild concern. More recently, this has grown as the extent of the number of financial institutions affected by this has been realised. It has become apparent that this sub-prime lending was partially financed by US Banks packaging loans together and selling them to yield-hungry financial institutions, largely banks, around the world. Many banks in the western world have some exposure to this. The problem is compounded by the difficulties in identifying and quantifying the potential losses in these packaged loans.

Markets do not like uncertainty and the extent to which other financial institutions are exposed is still not known in its entirety, consequently global markets have become volatile. However, some fund managers are seeing this as an opportunity to buy good company shares at low values, which they believe will stimulate higher fund growth in the future.

The intervention by the Federal Reserve in decreasing its discount rate (the rate at which banks can borrow overnight in an emergency situation), was viewed positively by the market, increasing the chance of cuts by the Federal Reserve and other central banks in the main lending rates, thus injecting liquidity and restoring confidence.
This turmoil has to be put into perspective against the generally positive scenario of good corporate earnings with controlled inflation and relatively high levels of employment.

A well diversified portfolio still provides the best opportunity to both cope with increase market volatility and benefit from a return to less volatile markets which will undoubtedly happen. History does show that the key to successful financial management is to ride out short term uncertainties and remain with a balanced portfolio in quality shares and funds that will benefit from the upturn in due course.

Source: City Quilter; M&E Network – Research & Technical Dept.
Past performance is not a guide to future performance. The value of investments and the income from them can go down as well as up, and it may be effected by exchange rate fluctuation and the investor may not get back the amount invested.

This letter is meant to provide a general overview of the investment markets and economic climate and does not constitute advice.