



## It's been a big week on Wall Street

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Dirk Morris is the CEO of BT Investment Management and has more than 20 years experience in the finance industry. Here he takes a closer look at this week's developments in the US.

### At a glance

- ◆ We are experiencing a very difficult investment environment, with almost all asset classes except cash in negative territory in 2008
- ◆ From a valuation perspective, market declines are bringing most asset classes back to attractive levels
- ◆ There are opportunities to add selectively to a diversified portfolio, including value in larger international companies, high quality credit markets, the larger Australian diversified miners, selected industrials and emerging value in the financial sector

The ongoing problems in US financial markets has seen a second wave hit global financial markets, with almost unprecedented volatility shocking investment markets to their core. This latest wave is primarily a crisis of confidence resulting from ongoing credit market problems in the US; financial market participants have refused to extend credit to each other after the Federal Reserve signaled its unwillingness to 'bail-out' any more investment banks (after being forced to take on the debts of the two big US government lenders Fannie Mae and Freddie Mac).

### What does this mean and how should investors react?

Without access to short-term funding, US Investment Bank Lehman Brothers was forced to close this week and Merrill Lynch was forced to find a buyer in the form of Bank of America. The markets have now begun to focus on who might be next. While no one can predict the final outcome, we believe the US authorities are likely to respond in a way that prevents an economic meltdown and restores financial market confidence over time. Failures like Lehman are an important part of ensuring the long-run health of global markets, as excessively risky and unproductive business practices should not always be paid for by public money. Now that message has been sent clearly to US markets, it is likely that further policy reactions will be more directed at ensuring financial and economic stability.

### An easing of interest rates?

Most importantly the US Fed (and central banks globally) will now be more inclined to reduce interest rates on signs of further economic weakness. This is already being priced into longer-term interest rates; a trend that is also being reinforced by sharp falls in commodity prices, particularly oil. As it turns out, while the US housing market has deteriorated further in the past six months, the overall economy has continued to grow.

### Oil, interest rates and inflation to dim recession

While the current financial shocks will likely slow global growth somewhat, we would expect lower oil prices and interest rates to prevent a sustained recession from taking hold. Outside of the US, growth will also be impacted by the most recent financial shocks, but there is ample room for fiscal and monetary stimulus to prevent a negative spiral developing. With the exception of China, there are no signs of entrenched core inflation being a problem, indeed it seems likely headline and core inflation will fall rapidly as we move into 2009. In China, perhaps the most important driver of global growth, the authorities are looking through current inflation, with a view to keeping growth in an 8 to 10% zone. This week's Chinese interest rate cut again confirms global central banks are moving to a pro-growth bias.

### Careful steps for Australian investors

For Australian investors, this remains a very difficult investment environment, with almost all asset classes now in negative territory apart from cash this year. From BTIM's viewpoint, the market declines are now bringing most asset classes back to being attractive from a valuation perspective. However, valuation alone is not always enough to justify owning (or buying more) growth assets, especially when the outlook is uncertain. If our view on the likely global policy response to the current crisis is broadly correct, then the current dips in equity and credit markets should be used as opportunities to add selectively to a diversified portfolio.

We see strongest value in large international companies and high quality credit markets and we are increasing our portfolio holdings in these areas. We are still conservative in our view of Australian equities and listed property, but do see strong value in some parts of the Australian market – the larger diversified miners, selected industrials and some emerging value in the financial sector. While more unsettling news is likely in coming weeks, sticking to our long-term investment strategies in these times of crisis is still our preferred approach.

### Dirk Morris

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