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What lies ahead ?

2008 has been the most difficult year for investors in memory. The international credit crisis has left the banking system in tatters, markets down around 50% from their peaks, and many investors wondering if 2009 will bring recovery or further difficult times.

Firstly let me reiterate that we have no crystal ball, no divine insight, and no inside knowledge. We have however applied our understanding of economics and stockmarkets, our research skills, and some critical thinking, to enable us to advise you in 2009.

It is important to understand that no amount of logic or critical thinking will identify all the issues. Mr Madoff's $50 billion Ponzi scheme, and the spate of government intervention in markets are events that are random but very significant. Without knowledge of these we are looking for trends and analysing risks in forming our recommendations.

In our minds there is little doubt that 2009 will see the major world economies in recession including Australia. The possible exception to this is China which may remain in a growth phase albeit significantly slower than it has been. As a consequence we believe that company profits will fall generally in 2009, and that unemployment will increase significantly from current levels in the Australian and US economies, with similar experiences across Europe.

The biggest challenge to any sharemarket recovery will be the lack of capital available for business. The banks have increased their reserves, absorbing available funding without an associated increase in lending. Many companies are required to renew their financing arrangements in the next year and face the prospect of not being able to obtain funding. It is likely we will see a period of "debt rationing" as banks lend to only the most appealing customers. Traditionally large firms could issue debt on the corporate bond market but there is simply no interest in corporate debt currently and firms face the reality that they cannot raise capital from this source at all. This leaves only equity markets as a viable source in the near term. As more and more companies introduce capital raisings it is likely that equity markets will remain stretched with limited liquidity being directed to share issues, rather than pushing prices up, limiting their traditional rally after a major correction.

If companies need to raise capital via the sharemarket it is likely that they will do so at a significant discount to their current share price, adding to the difficulties in achieving any sort of sharemarket rally. Consequently it is hard to see a major sharemarket rally whilst credit remains so constrained.

The bond market, a typical defensive asset, also remains fraught with danger. When interest rates fall, bonds increase in value, and when interest rates rise, bonds fall in value. A bond investor therefore is looking to invest in a falling interest rate environment. Despite a fall in government interest rates, the cost of corporate debt has actually increased and this has resulted in bond investors losing value in a falling interest rate environment.

Property has also suffered significantly as it is closely linked with the availability and cost of money. Listed property investments around the world have fallen dramatically over the last 12 months. Unlisted property in Australia has seemingly outperformed but we are now seeing assets frozen as managers acknowledge their valuations are too high and that they cannot sell assets to meet redemptions. It is our expectation that unlisted property will decrease significantly to bring valuations roughly into line with listed property. We expect redemption freezes to be an ongoing issue with unlisted property trusts in 2009.

Finally the “hidden crash” of 2008 has been the interest rates on deposits. Term deposit and cash rates have halved over the year and will likely fall further in the first half of 2009. Whilst this is good news for borrowers it holds no appeal for investors with cash.

Predictions for 2009

These are our expectations for 2009 and are based on our understanding and interpretation of events. We fully expect to get some right and some wrong, but expect that by planning appropriately we can ensure that clients achieve an acceptable outcome, and that risk is sensibly managed.

Cash – We expect cash to average returns of 2% to 4% for calendar 2009. Higher rates will be available in regional banks although those banks may not see 2010 (We expect them to be taken over or sold). The government guarantee will provide reassurance to those looking for higher returns from these banks. Ultimately cash will become unviable for most investors as rates continue to fall.

Bonds – Our expectations are that this market will at best be erratic as we see official interest rates decrease, but possibly corporate rates increase. Over the next 5 years it is likely that bonds will perform poorly as interest rates either remain flat or start to rise. Zero or negative returns may well be the final insult for defensive bond investors and we advise clients to steer clear of bonds in their portfolios at this point.

Residential Property – We expect falls in this market in 2009 but interestingly rents should hold up. With reduced interest rates (for those that can actually borrow), there may be buying opportunities in 2009 that will provide great 5 year returns. Good selection will be important in maximizing returns.

Commercial Property – Once again this sector follows its boom/bust cycle. After some amazingly good years we are now seeing a very different environment. Vacancy rates are rising towards the long term average, and a reduction in business demand, and new supply will very quickly push this higher. There are likely to be good buying opportunities in 2010 and 2011 for long term investors.

Shares – 2009 looks to be another challenging year as a lack of liquidity will likely cap any potential recovery in markets. We expect many companies to reduce dividends to retain capital, and whilst this is logical many investors may not respond positively to dividend reductions. New shares are likely to be issued at significant discounts to encourage further investment, which will present opportunities for cashed up investors to buy in cheaply. We have reduced our expectations for 2009 and expect markets locally and overseas to be flat to mildly positive.

Currency –In retrospect almost any forecast between 60c and 99c against the US dollar would have been right at some point during this year, but unless investors acted at exactly the right time the knowledge has not proved useful. We have absolutely no idea what the Australian dollar might do in 2009 and retain our view that investors should hedge out their currency exposure, leaving them with one less risk to manage.

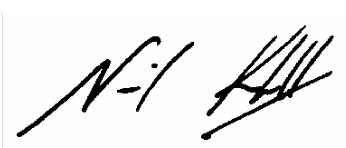
Risks – There are many risks to our outlook. Most significant in our view is that further government intervention produces increased volatility and unpredictability. The “rogue trader” issues are hopefully out in the open as most of these are exposed in extreme circumstances but there are no guarantees that there are not more “Mr Madoffs” out there.

Our strategy will be to remain conservative, at least early in the year, and the risk remains that markets do recover more quickly than we expect and you miss higher returns from equity markets. The risk in holding cash is that there will, for many people, be some capital erosion as interest rates fall and capital is required for living expenses. This may still be the best outcome available.

Other predictions –

- Hedge funds will continue to freeze redemptions and their managers, the self confessed “best and brightest”, will be laid off in the thousands.
- The big 4 Australian banks will continue to thrive and their competition will weaken in the flight to quality.
- Resource stocks will recover more slowly than other sectors.
- The China story will continue to look relatively attractive.
- The US will not invade another country in 2009.

Despite the rather uninspiring view of 2009, mankind will continue to innovate and adapt and we will have a much healthier financial system by the end of 2009, and a foundation for strong growth over the following 5 years. I expect that many people will be surprised at the strength of the recovery when it comes and it is important not to become too focused on the short term challenges.



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