



Holding on to our hats

Markets in the United States and in Europe have fallen sharply over recent trading sessions and investors from Wall Street to Trafalgar Square, Collins Street to the Champs Elysees, all have the same question on their lips: What should I do? Do I sit tight, or should I sell up?

As the table shows, share prices were battered across the globe, especially in the last week.

Index	Per cent Change		
	Week	Month	Year
Dow Jones Industries - USA	- 5.75	- 9.36	+ 8.73
FTSE 100 - Britain	- 9.77	- 12.90	- 2.21
DAX - Germany	- 12.89	- 16.17	- 1.54
All Ordinaries - Australia	- 7.35	- 10.46	- 9.06
Nikkei 225 - Japan	- 5.42	- 6.74	- 3.67
FTSE Italia - Italy	- 12.61	- 20.28	- 23.13

Source: Data at market close, 5 Aug 2011, Thomson Reuters

Dealing with the fear

The headlines scream of billions lost and fear seems to have permeated the major stock markets of London and New York. Given the Australian market represents only 3 per cent of the world market, like all small players we've been swept along with the crowd.

But wait a moment? What has changed, particularly here in Australia? Did the bottom fall out of coal and iron ore prices? Did trade cease with China? Has unemployment moved from 5 per cent to match the 9–10 per cent in the US and Europe? Is our debt-to-GDP ratio anywhere near the 120 per cent Italy 'enjoys' or the looming 100 per cent facing the USA? Are our banks underfunded or failing stress tests? Is our credit rating facing a downgrade from AAA which the US has been hit with?

Snapshots



The answer to all these questions is a resounding No. So what has changed to bring about this event, and the air of fear and panic?

What's new?

Commentators struggle to put this sudden drop down to one big issue. Unlike big falls in markets in the past there has been no single event this time. At a macro level the issues of European and US debt have been around for some time. At a more micro level, data like purchasing indices in China, Europe, UK, and the US have disappointed, along with industrial production in the UK, and European and Australian retail sales figures, but none of them account for the market's response.

There's certainly concern that European policy makers may be short of options to address their debt and banking problems, given existing low growth and interest rates. When the major British bank RBS booked large losses last week against their exposure to Greece, it raised the spectre of higher losses to more banks if Spain and Italy come under increased pressure.

Similarly, an apparent stalemate in the US political system raises doubts the US can summon the political will to address their debt levels, exposing fears that growth will slow further and the world's economic powerhouse will fall back into recession. This fear was only compounded when Standard and Poors decided on 5 August to lower the US government's credit rating from AAA to AA+.

Surveying the local scene

Coincidentally, the Australian Reserve Bank's (RBA) quarterly report was also released on 5 August and it shows our future is more intertwined with Asia's than with the faltering US economy.¹

The RBA report shows Australians have a renewed interest in saving and paying down private debt. In the March quarter, the household saving ratio reached

11.5 per cent of disposable income, a level not seen since the mid 1980s. This sense of caution is also reflected in the way we have slowed our use of credit cards.²

At the same time, in the June quarter our terms of trade, or international buying power, was the highest it has been on record.³ And recent figures seem to indicate that the drop in vehicle sales in previous months was mainly down to supply issues following the Japanese earthquake, as sales increased 12 per cent in July.⁴

Back to basics

Which brings us back to the question of how to respond to this market turmoil.

When in doubt, it is a good time to go back to first principles. There may certainly be things we don't know at the moment, especially about what is around the next corner. However, markets do tend to rise before an economic recession ends because market prices reflect the expectation of future growth.

While it is impossible to accurately pick the time a recovery will start, getting the timing wrong may cause you to miss out on a significant amount of growth because the biggest market gains have often been concentrated into very short periods. We know that past performance is no guarantee of future performance, but from January 2000 to June 2006, the 20 best days on the ASX delivered 48 per cent of total returns in that period.⁵

So hang on to your hat; and don't take your eyes off where you want to be and what you want to achieve. If you would like to discuss your portfolio and this current market volatility, please don't hesitate to call us.

¹ Reserve Bank of Australia, *Statement on Monetary Policy*, 5 Aug 2011

² Reserve Bank of Australia, *Domestic Economic Conditions*, 5 Aug 2011

³ Reserve Bank of Australia, *Economic Outlook*, 5 Aug 2011

⁴ Quoted by Ross Gittens, 'So are we talking ourselves into a recession?', *SMH*, 6 Aug 2011.

⁵ Source: ASX.



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