

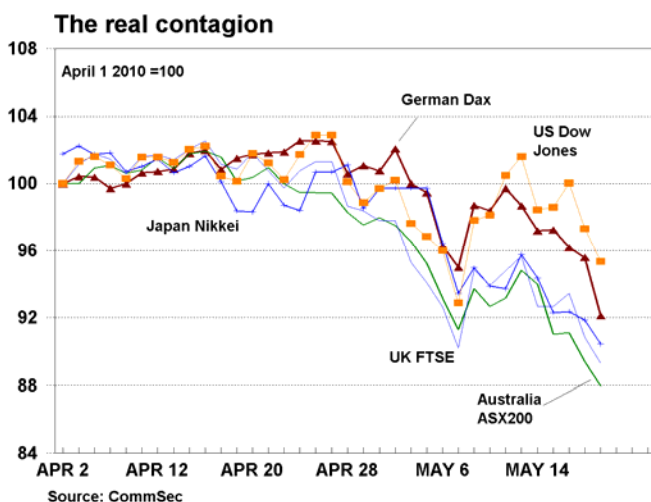
The Panic of 2010

Financial markets

- Just under a fortnight ago we asked whether the “Panic of 2010” had come to an end? The simple answer is no. Despite attempts to address the root cause of the latest problem – the European Debt Crisis – it is clear that investors aren’t convinced.
- The Reserve Bank called the global financial crisis the North Atlantic financial crisis – and that title is much more appropriate.
- The Panic of 2010 has been prompted by a perfect wave of negative influences including the Greek debt crisis, a volcanic ash cloud, a major oil spill and regulatory probes into Goldman Sachs. In Australia, the resource super profits tax has further destabilised, rocking foreign investors.
- It is important to highlight that Asian economies remain rock solid as is the Australian economy. Australia is very much the innocent bystander that, as in the past, has seemed to be hit harder than most.

What is going on?

- Panic events have been common over time, that is periods where there have been runs on banks, falls in sharemarkets and currencies. There is always a trigger but then fear takes over.
- Like it or not human behaviour gravitates between fear and greed – those emotions drive financial markets. And currently fear has taken over.
- Are the fears groundless? Not groundless, but certainly overdone. The current panic began with fears on Greek debt – more precisely whether Greece would default on their repayments. Those fears spread, with worries that Portugal, Spain, Iceland and Ireland would go through previous problems. But the doomsayers then speculated that the Euro could be at risk, and then there were worries about the impact of defaults on the banking system.
- The EU sought to allay fears and on May 10 announced the European Stabilisation Mechanism – a US\$1 trillion support package. The package was seen as “shock and awe”, well above what was expected. And it did soothe



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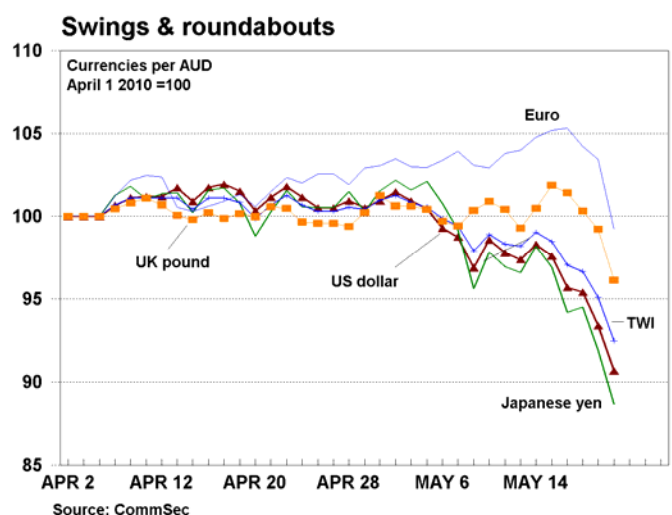
- worries – for a time anyway. But the latest move by Germany to ban naked short-selling prompted further jitters.
- Perhaps if the broader environment were less negative then the panic wouldn't have taken hold to the extent that it has. Simply, there has been a perfect storm of negative events in recent weeks:
 - The Greek debt crisis
 - Rating downgrades for Portugal
 - The volcanic ash cloud across Europe
 - A major oil spill in the Gulf of Mexico
 - Criminal proceedings against Goldman Sachs
 - Political uncertainty in the UK
 - Social unrest in Thailand
 - A resource super profits tax (RSPT) in Australia
 - Fears of a property crash in China
 - If you are an investor you are probably prompted to stay on the sidelines. Other more jittery investors have been prompted to reduce exposure to “risky” assets like equities, commodities and currencies like the Aussie dollar.
 - At face value many of the larger investment banks and hedge funds of the world don't seem to have learnt from past experiences. But then again they probably have. The sad fact is that major financial institutions can benefit from volatility. In fact they may benefit or gain from the fact that currency and equity markets are swinging wildly.

Positives ignored

- There has been a raft of positive fundamental events in recent times as well, but investors have chosen to ignore them. For traders and large institutions it is in their individual interests to ignore the positives, even if the broader implications may end up hurting them.
- What have been the positive events over the past month:
 - Successful bailout deal for Greece
 - Successful completion of the European Stabilisation Mechanism
 - Substantial upgrade of IMF economic forecasts
 - Solid US economic data
 - Data confirming strong Chinese economy
 - Strong economic data across Asia
 - Positive earnings season in the US
- The fundamental influences will eventually hold sway, but markets may have to fall further before the groundswell of smaller investors recognize that markets have fallen too far and embrace the bargains.
- This is effectively a re-run of the US leg of the financial crisis. And those investors that didn't panic just over a year ago in March 2009 and embraced the bargains are sitting pretty today.

Why Australia?

- We don't have a debt problem; our banks are strong; we don't even have a volcanic ash cloud – but Australia is suffering more than most. Our sharemarket and Aussie dollar are targets for jittery investors trimming exposure to “risky assets”.
- The same thing happened in the US financial crisis; the Asian financial crisis; even the technology boom and bust. Unfortunately Australia is the “fair weather friend” – our currency and sharemarket surge in the good times and plummets in the jittery times.
- But certainly the resource super profits tax hasn't helped. It has added to investor uncertainty – especially by foreign investors – at precisely the wrong time. Uncertainty is the killer of financial markets at that has been demonstrated yet again.
- A report yesterday that Australia could face a hung Parliament in the election to be held later this year has added to the jitters of foreign investors. Around 40 per cent of Australian listed securities are held offshore.



Where do we go from here?

- It is up to the Europeans. European political and financial leaders must act forcefully to defend the euro and make a strong show of solidarity to their union and currency. Europe needs to stare down the speculators and state their determination to do what it takes to defend their system.
- Indeed now it has become a global issue and requires US and Asian leaders to also indicate their solidarity to strong defend the financial system. Co-ordinated intervention to drive the Euro and other commodity currencies will be required to prevent currency markets becoming a one-way bet.
- Until there are concrete measures to support financial markets then the Aussie dollar is at risk at falling further. Does it make sense? No panics never make sense. Greece didn't cause financial contagion rather the actions of speculators and other large investors across the globe have seen contagion fears become self-fulfilling.

Stay alert

- The key point for Australians is to stay alert. When markets turn, they will turn with a vengeance. In the US financial crisis the Aussie slumped US30 cents and almost as quickly rebounded. The oil price did similar things. Sharemarkets took longer, but the rebound over 2009 was nothing short of dramatic.
- Just as in 2009, Asia has remained strong in the crisis. China, India as well as economies like Taiwan and Singapore have rebounded sharply – and for the simple reason that they don't suffer from the debt problems in Europe and the US.
- Asia as a whole is bigger than the US. And as a driver of global economic growth, China, India and newly industrialized Asian countries are far more important than Europe, as well as providing a bigger boost to world growth than the US.
- We would hope that the Government can quickly resolve the uncertainty on the resource super profits tax. Simply, if the government restricted the RSPT to new investments and not existing projects then fears of foreign investors would be allayed. And the calculation for the cost of capital needs to change from the government bond rate to either the swap rate or identifiable indicator lending rate. Time will tell what changes are made.
- The ride could get rough, so hold on. But those investors who didn't panic last year and embraced the bargains will tell you that patience will be rewarded. If economic fundamentals weren't so positive in Asia and Australia we would be worried. But they are strong.
- The fall in the Aussie dollar may seem bad – but unless you are an importer or a traveler, the positive spin-off for exporters and tourism is very positive.
- We won't be changing our end year target for the sharemarket at this time. The target of 5,400 is clearly unrealistic as things currently stand but we are still confident of a firmer tone in the second half of 2010.

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