Q&A – current market situation

by Edmund Brandt
Investment Director
JPMorgan Asset Management

1. What are the reasons for the current market crisis?

A sharp increase in mortgage borrowing costs in the US combined with large areas of negative equity (e.g. in Florida condominiums) has meant that lenders to the US mortgage market have been hit by a dramatic rise in mortgage defaults.

In the past, this might have been a local problem. But today's global markets mean financial institutions around the world have been able to buy up the loan books of lenders to the US mortgage markets, meaning that the effects of defaults are felt across the globe.

As one part of a bank's investment portfolio suffers, its willingness to take risk in other parts of its business falls sharply. So it demands a higher rate of return for making new loans across the board.

2. What is happening in the credit markets?

It may be that financial institutions simply refuse to lend money because they are unwilling to take on more risk in this uncertain climate. But this can cause severe problems to those dependent on short-term borrowing in order to finance long-term positions.

An illustration:

You have taken on the purchase of a house on a two-year fixed rate mortgage. You envisage remortgaging every two years to get the best rate for the duration of the 25 years you anticipate it will take to repay the loan.

However, at the end of the two-year fixed rate term you find that you are either having to remortgage at much higher levels than expected, or, if the asset (your house) is perceived to be a risk asset (e.g. a house suffering from subsidence) you may find it almost or completely impossible to remortgage. You may then be forced to take up your lender's extremely expensive variable rate or, if the bank considers its exposure to be too great and demands foreclosure, you may be forced to sell your asset.

As you and others become forced sellers, the market for the asset weakens further, making it harder for others with the same type of asset to remortgage.

This is a very simple analogy to explain what is currently happening in the debt and credit markets. Risk appetite has been greatly reduced, and the rate of return demanded by lenders has significantly increased as they demand greater compensation for the risk they are taking on. Companies seeking to refinance their debt are finding that the costs of borrowing have risen dramatically, and in some cases there is simply no willing lender.

3. Why is this affecting my equity holdings?

Equity markets are responding directly to two themes:

1. They rely on market confidence. If one part of the financial market suffers, the willingness of investors to take on risk in other areas is curtailed. Indeed, high-quality liquid stocks may be sold to cover losses elsewhere.
2. In the leveraged buy-out (LBO) debt markets, interest rates demanded by purchasers have risen dramatically in recent weeks. Lenders financing private equity buy-outs are extremely nervous of not being able to get the debt onto the secondary market and instead having to hold it themselves. This has effectively halted new deals and put under the spotlights existing deals in the pipeline. Hence, any company that had been a potential target for a private equity buyout has fallen particularly sharply as the bid premium has unwound.

4. What is the current outlook?

Equity market investors who can see the current market through may be best placed in the long-term. The cost of switching and the difficulty of correctly timing a re-entry into equities mitigate any potential benefit of a short-term switch into cash.

Furthermore, while no one can predict the bottom of the current falls, it is clear that many securities have been pushed well below fair value. Selling at these levels may mean taking needless losses - those investors that have the ability to ride out the current volatility may be rewarded in the long term.

Bonds are likely to benefit from the current situation. Further interest rate rises appear to be fully priced in, so bonds represent a safe haven. However, it is JPMAM's view that a short-term move would be unwarranted due to the cost of switching and the difficulty of timing of re-entry into equities, as mentioned above.

The investment views expressed in this document are those held by JPMorgan Asset Management at the time of writing and are not a recommendation to buy or sell. JPMorgan Asset Management (UK) Limited is authorised and regulated in the UK by the Financial Services Authority.

LV – JPM1501

08/07