Recent market volatility has begun to raise concerns of another global financial crisis.

I thought you may be interested in what has caused recent market movements, and what this may mean for Australian financial markets going forward.

US Debt Ceiling Debate – A Quick Fix, But Not For The Long Term

After weeks of uncertainty surrounding whether the US government would find a way to raise the debt ceiling and reduce the budget deficit in future years, a deal was negotiated.

The debt limit was raised by $US2.1 trillion and agreement was made to reduce debt by $2.4 trillion over 10 years. It was generally expected (as they had little other choice) that this action would be taken. However there are likely to be some longer term impacts, as we have seen with last week's downgrade of their long standing AAA credit rating to AA+ by Standard & Poors (S&P), as well as a slowing of their economic growth.

This is only one out of the three major ratings agencies however, with both Moody's and Fitch affirming the AAA rating post the increase in the debt ceiling.

How much trouble is the US economy in?

If you do the maths, you will realise that $2 Trillion in proposed spending cuts over 10 years is NOT equal to $2 Trillion in debt increases every year or so. The US cannot continue to borrow to pay 40% of its expenses each year.

The agreed budget cuts are a step in the right direction, and the raising of the debt ceiling has removed the immediate risk of default, however the US economy still faces a number of headwinds.

Recent economic data confirmed that the US economy is struggling to recover further, with the pace of economic growth coming in at a modest 1.3% in the second quarter of this year. Weak consumer spending, slower manufacturing activity and a general lack of confidence, have seen growth prospects weaken.

Since the announcement of the debt ceiling increase, there has been concern that the US economy will grow at a pace slower than that assumed in the budget forecasts, and that the spending cuts in the budget could further slow the pace of economic growth in the years ahead.

Cuts in the growth of an economy, mean reductions in government revenue. This is particularly concerning where government revenue already falls far short of its expenditure.

How will this affect Australia?

The US economy and sharemarket continues to be the key barometer for global confidence, and a winding back of growth expectations has already had an impact on markets around the world.

Although the Australian economy is still in a better position than most other developed economies, financial markets in Australia and around the world are likely to remain volatile in the near term. It appears that investors are beginning to reassess expectations for global growth in the current environment, and as emotions run high, volatility is an inherent result.

Falls in recent weeks have been severe, with investors becoming concerned we could be entering another global financial crisis. Markets have begun to react by moving out of risk assets.

Importantly to date, there has not been a freezing up in credit and bank funding markets as was the case during the global financial crisis. This will be important to watch going forward, especially given that financial markets are now operating in unprecedented times post the downgrade by S&P to the US AAA credit rating

Is this another global financial crisis?

The reality is that very little has changed in the last week or so. Markets have reacted, but the fundamentals remain largely unchanged in the short term. It is my view that the markets have in many cases ignored a number of these important fundamentals for quite some time, and are now responding having been prompted, triggering the reactions we have witnessed.

It is important to remember that financial market participants, (including central banks and bank regulators) are much more prepared for financial market dislocation compared to the depths of the GFC – when it actually caught them by surprise. Lessons have been learnt, although it is impossible to say another crisis won't happen.

It is clear from market volatility seen in the last few weeks that financial markets are lowering their growth expectations for the global economy. For the US, major challenges still lie ahead. But if the political will is present (and it is not at this stage), there is hope the US could change its ways, reduce spending, and refocus on lowering government debt. This would serve to build confidence back into the US economy (and world financial markets).

If you have any concerns about this recent market volatility and the impact it may have on you, please feel free to contact us.

Our Business Update for the month of August 2011 is also attached for your information.