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QUOTE

"There is only one thing more painful than learning from experience and that is not learning from experience."

- Archibald McLeish

Financial Quote

"Sales of both new and existing homes have dropped sharply from their peak... the inventory of unsold homes has risen substantially since 2006"

- Ben Bernanke Chairman (Fed Reserve)

Market Statistics

Official Cash Rate: 6.50% U.S. Fed. Funds: 5.25% 90-Day Bill Rate: 6.90% 5 Year Bond Rate: 6.13% \$AUD (US cents): 82.39 All Ordinaries (Aus): 6297.1

As at 4 September 2007

trading of Index futures during the middle part of the trading day. The All Ordinaries Index then shot up a lazy two hundred points as announcements indicated that funds were available to meet the needs of their stakeholders.

Less than ten trading sessions later the Index was almost at pre US sub-prime levels (refer below), set aside by the plethora of record profits in the midst of the reporting season, and as confidence was injected into markets by a 0.50% rate cut (institutional lending rate) by the Federal Reserve in the US.

Shares such as ASX, JB Hi-Fi, QANTAS, Seven, QBE, Bluescope

Steel, BHP, Babcock & Brown and Caltex announced robust profits which aided market confidence. Surprisingly, even James Hardie, which is involved heavily in the US building industry, posted a year on year increase in interim profit, citing a higher profit margin as a primary driver (revenues had fallen slightly).

But it must be remembered that the Australian share market has a high correlation with the US market. It may take only one announcement and the Australian share market could face further weakness. For example, a US lender/fund manager may announce bankruptcy, or the Federal Reserve may not decide to cut their Federal



INTEREST RATES, FINANCIAL MARKETS AND THE ECONOMY

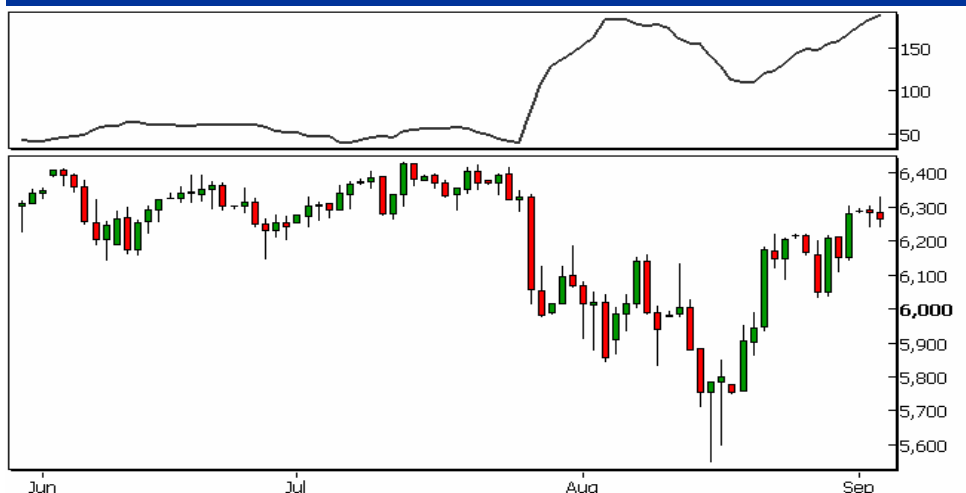
The Australian Economy: What Lies Ahead?

The one thing you cannot accuse our sharemarket of is being dull.

For example, the All Ordinaries Index had fallen by over 300 points during intraday trading on Thursday 16 August 2007 as institutional investors sold stocks amid fears of a "lack of liquidity/money", not only in the American money market due to the sub-prime mortgage crisis, but also within Australian financial firms.

It was hinted that a large Australian broking house and Rams Home Loans had limited access to funds which exacerbated already difficult sharemarket conditions and sparked panic selling. As the rumour spread institutional investors sold large orders of stock holdings, which forced the SFE (Sydney Futures Exchange) to take radical action and prohibit the

ASX 200 Index with Volatility (Standard Deviation)



ASX200: The ASX200 Index has been volatile since late July following US sub-prime lending concerns, as denoted by standard deviation (top).

Funds rate for instance. If this occurs confidence and resource prices may suffer, and drag our shares down with it.

The next few months will be interesting, particularly with the US under pressure due to the sub-prime situation and with much work to do, especially policy wise, to restore sound and efficient lending conditions. Moving forward it may take much longer for the US economy to fully recover from sub-prime related problems.



## EQUIPMENT LEASES

### WHAT IS AN EQUIPMENT LEASE?

An equipment lease is a contract between an equipment owner and a person wanting temporary enjoyment and use of the equipment, in exchange for paying rent to the equipment owner.

It is an agreement that specifies the rights and obligations between a lessor (one who owns equipment) and a lessee (to whom the lease gives certain rights to possess and use the equipment).

### HOW DOES IT OPERATE?

A lease on equipment is a means of financing the purchase of cars, plant and office equipment. The leased equipment is still owned by the bank or finance company, until the expiry of the lease term, at which stage the lessee may be able to purchase the asset by payment of the residual value decided on in the terms of the lease agreement.

### TERM?

Lease terms can be for up to any period of time as long as all parties agree and it is stipulated in the agreement.

### TYPES OF LEASE?

There are two main types of equipment lease. These are known as operating leases and finance leases.

**1. Operating Leases** – The equipment is either purchased by a financier on your behalf or is leased directly from the supplier. The lessor

then makes periodic rental payments during the lease period and the financier or supplier as lessor retains ownership of the equipment.

Once the lease expires the equipment can be returned. At times the lessor may allow you to extend the lease.

**2. Finance Leases** - A financier purchases the equipment you require on your behalf. The finance lease will require you to make rental repayments and will also show a residual value which enables you to make an offer to purchase the equipment at the end of the lease term for that residual value.

**3. Hire Purchase** - Hire purchase operates in a similar method to finance leases. It usually requires the hirer to pay a deposit at the outset of the agreement when the equipment you require is purchased for you by the financier.

### PURCHASING?

If you choose to buy rather than lease the equipment you would normally borrow from a financier and make loan repayments.

Buying the equipment gives you ownership of the equipment from the outset but the financier would normally take a chattel mortgage over the equipment as part of its financing requirements.

Purchasing the equipment may be a viable option where the equipment has a long life and also some resale value if you later chose to sell.

### GUARANTEES

It is often a requirement of lessors and financiers that directors of the business provide personal guarantees to support the repayment obligations under the lease or loan. Specific legal advice should be obtained prior to signing any such guarantee.

### SECURITY DEPOSIT

A lessor may request a security deposit. Security deposits held by lessors must be held in an interest bearing account.

### REPAIRS

The lease document will govern who is responsible for repairs and maintenance of equipment.

## ASSIGNMENT

Generally, a lessee needs the consent of the lessor to assign the lease. Further, the assignor is usually required to guarantee the performance of the assignee during the current Lease.

## DISPUTE RESOLUTION CLAUSES IN THE LEASE

A Lease should contain a clause dealing with methods of dispute resolution. Generally, parties should opt for mediation or another alternative dispute resolution prior to commencing legal proceedings.

### MCP LEGAL - SUPER FUNDS AND FAMILY TRUST DEEDS

Recently we have updated Super Funds and Family Trust Deeds in one go, for all clients of certain accounting firms that are older than say 12 months, to ensure their currency with legislative changes and practical tax requirements.

For example current Super Funds should have provisions around flagging and splitting for family law purposes, and Discretionary Trusts should have adequate provisions for income streaming.

If you are interested in either or both updates we can provide you with an example letter to your clients setting out the reasons for updating, and an excel spreadsheet with the detail we need from you to prepare such updates.

For these bulk orders we are charging \$200 plus GST per update (3 bound copies).

Please let us know if you see this as something you wish to arrange for your clients.



## US SUB-PRIME MARKET AND STOCK MARKET VOLATILITY

As noted on the cover page there has been significant volatility within global financial markets in the last month caused largely by the "sub-prime"

mortgage market. The article which follows explains the "sub-prime" issue and also how MCP Financial manages client portfolios to reduce the impact of market volatility.

The "sub-prime" market represent loans made to persons with a poor credit history and/ or low income and asset levels. In other words highly risky lending. It has become apparent that lenders in the US have not been diligent enough in screening their loan applicants and a high number of defaults have occurred as a result. As a result a high level of defaults on repayment of debts in the US "sub-prime" debt market has occurred.



**Stop or Go?** Our equity market has been extremely volatile due to the US sub-prime mortgage market fiasco.

Sub-prime debt has been parceled up and on sold to investors with seemingly attractive rates of interest. Hedge funds and other investment groups have purchased the debt. However with the high level of defaults the debt the investors own is now worth a lot less than they paid for it. This has led to some hedge funds and other investors losing a significant amount of funds.

In turn this has fed into the general market and fears over the increased cost of credit has led to significant market volatility.

Market corrections are a normal part of investing in equities and while the timing of the correction is nearly always a surprise the fact that it happens in the first place should not be viewed as anything other than a normal occurrence of investing in assets that are traded every working day by people with conflicting emotions of greed and fear.

MCP Financial manages portfolios

with the expectation of corrections occurring although of course it is impossible to forecast with any accuracy the exact timing of a market correction.

However we manage portfolios in the following ways to reduce the impact of a correction on your portfolio. We adopt a "diversified focused" investment strategy approach which has, at its core, the protection of capital and the generation of compound investment returns over the long-term.

Portfolios are managed in accordance with a client's risk profile and therefore preferred asset allocation. Importantly we actively sell down on asset classes that have outperformed to invest in others that have not been performing as well. Over the last two years we have been reducing exposure to Australian equities and increasing exposure to international equities and fixed interest.

It should be noted that over the last month the Australian dollar has dropped significantly which has offset the falls experienced in international equities.

Investment markets will most probably remain volatile in the short term. However fundamentally little has changed to the Australian economy and we do not see a reason to alter portfolios significantly.

Should you have any queries with regard to your portfolio please contact John Ross or David Mac Manus of MCP Financial.

### SIGNIFICANT PENSION OPPORTUNITY

A hugely significant change to the pension assets test occurs on the 20th September this year.

There is the possibility for many more retirees to be entitled to an aged pension and you may be surprised at the level of assets you may have and still retain entitlement to an age pension. The assets test cut off from 20 September is as follows:

#### Single

Homeowner: \$520,750  
Non-Homeowner: \$641,750

#### Couple

Homeowner: \$824,500  
Non-Homeowner: \$946,500

It is important to note that both an

assets and an income test applies for age pension entitlement. Whichever results in the lower payment is the test that applies. So it is possible that even though you satisfy the above assets test requirements you may still not receive the age pension.

The other significant change from the 20 September 2007 is that the 50% exemption from complying annuities and term allocated pensions (TAPS) is eliminated. However for existing annuities the 50% exemption is maintained.

There is therefore an opportunity to purchase the annuities and create an exempt asset before the 20 September 2007.

However as time is limited you need to act now if you believe you will benefit. Please contact John Ross or David Mac Manus of MCP Financial.



### A FOCUS ON US SUB-PRIME LENDING

#### What is a sub-prime loan?

Generally, a sub-prime loan is made to borrowers who, due to their credit history, asset position or prospective loan to value ratio, do not qualify for a regular standard rate mortgage.

In the US, lenders like to see borrowers with a credit rating of above 700 to qualify for standard rate mortgages, as they are considered a low risk lend. Borrowers with credit scores between 600 and 700 are offered favourable credit terms, while applicants with a credit score below 600 find it hard to gain credit. These borrowers often seek finance under sub-prime mortgage conditions and, due to their perception of being a riskier borrower, pay a significant premium to the standard mortgage rate to reflect the additional risk assumed by the lending institution.

#### How do their rates work?

There are several permutations of the sub-prime loan. One of the most common sub-prime lending instruments is the 2/28 mortgage. As its name suggests, the loan is fixed at a

low rate for the first two years, then reverts to a floating variable rate thereafter. Other products allow a borrower to pay interest only for the first 2-5 years, or make a low set repayment for the first two years, reverting to a floating repayment thereafter.

The problem with sub-prime lending is the jump in repayments and the lag effect of many 2/28 loan rates coming into their third year (especially considering how far the Federal Funds rate has appreciated since 2005). Sub-prime mortgages are prone to offer a low initial rate, let's say 4%, and increase markedly thereafter to reflect the underlying risk of the borrower. The increase in rates could end up being many percentage points higher (e.g. 6%) than a floating rate benchmark such as the Federal Funds Rate/LIBOR in the third year.

Put simply, after an introductory period repayments jump up to a phenomenal rate, and this has caught many off guard. We will not know the outcome, or the full extent of the sub-prime lending crisis until these loans' introductory period expires, which may take several more months.

#### What are the current problems with sub-prime lending?

We've already seen the short-term implications as a result of the sub-prime mortgage crisis; these being a decrease in the liquidity of global money markets, plummeting share prices, spiraling consumer and producer confidence, a historically low level of housing sales, decreases in forecasted US company profits and the re-rating of mortgage bonds (which has, in turn, decreased their value, leading investment depreciation).

Additionally, there has been a decrease in the number of US financial firms providing sub-prime mortgage products, as businesses decide to shift resources to more profitable revenue streams or are forced to close their doors due to unsustainable losses.

#### What will happen in the medium to long-term?

The lackadaisical sub-prime lending policy in the US is going to have substantial economic repercussions and regulatory implications. Sub-prime mortgages could lead to the following

possible economic outcomes:

- ◆ Tightening of credit assessment guidelines for mortgage loans;
- ◆ Increase the level of foreclosures on properties and personal bankruptcies;
- ◆ Decrease retail expenditure, therefore decreasing the level of projected US profits;
- ◆ Mitigate share price growth in worldwide markets due to the correlation of international financial markets with the US;
- ◆ Increase credit levels as consumers scramble to pay mortgages;
- ◆ Further decrease the value of selected US property due to additional supply as homes are foreclosed, and a decrease in demand as borrowers find it increasingly difficult to gain finance approval; and
- ◆ It may decrease resource prices as world growth is adjusted downwards.

An interest cut has been earmarked as a possible reaction to the sub-prime lending crisis, with some financial writers believing that this may elevate investor confidence and spending alike, particularly in the short-run as sentiment is restored. But, conceptually, it seems unlikely that this will resolve the fundamental economic problems that have arisen



**Global growth:** Resource prices decreased as a result of the US sub-prime crisis, after fears that global economic growth may stall.

due these (sub-prime) loans. A 0.25% cut may have little impact when sub-prime mortgagors are paying very high interest rates. It is likely that many more Americans will lose their houses, and that the economy could be stunted for many years to come as a minority of borrowers foreclose their properties or reduce retail expenditure as they battle with higher

repayments.

Other avenues include the initiation of financial programs to allow the flexible repayment of sub-prime loans or government concessions/grants.

#### Conclusion

Sub-prime lending has accounted for 25% of all mortgage loans in the US in recent years, but only a few percent of the total mortgage market. It will take time to feel the full extent, and complexity of problems caused by the sub-prime mortgage market – only time will tell with how well the US and global economy copes.

### FINANCIER NEWS

#### Westpac Bank

Effective immediately Westpac are no longer granting further variable discounts beyond 0.70% where combined lending (new and existing) does not exceed \$600,000. As a rule of thumb expected pricing discount guidelines for are as follows:

- \$150,000 - <\$250,000:** Up to 0.6%
- \$250,000 - <\$600,000:** Up to 0.7%
- \$600,000 - <\$800,000:** Up to 0.75%.
- \$800,000 - \$1m:** Up to 0.8%
- \$1m-plus:** Pricing in excess of 0.8% can be negotiated.

#### ING Bank

ING are now offering an additional 0.06% discount on new Mortgage Simplifier loans where combined ING borrowings exceed \$300,000 under their "Smart Pack" option. For the Mortgage Simplifier the Variable Rate of 7.65% p.a. is discount to 7.59% p.a. when this extra discount is factored in. The application fee is \$499 under the "Smart Pack" option. No ongoing fees apply.

#### First Home Owners Grant

A new First Home Owner's Grant application form is now being used by the State Revenue Office. Please contact MCP for the updated form if you have been distributing any previous version to your clients. For a short period, the State Revenue Office will accept either form, although we advise the use of most recent version.