

Monthly Market Watch – August Issue 2008

MARKET COMMENTS – JULY

Market developments during July and early August included:

- Global developed markets equities continued to struggle in July, falling 1.7% for the month. This was tempered somewhat by the pull back in the Australian dollar, with the return in dollar terms being -0.7%.
- Australian equities fell by 4.7%. Banks had a mixed month with ANZ and NAB performing poorly while Westpac held up well. BHP, Woodside Petroleum and Fortescue all had negative months. Australian Listed Property Trusts (LPTs) also fell with the broader market. While questions remain over valuations and the structuring of many LPTs, investors are starting to find the yields of some stocks attractive.
- The RBA left rates steady at 7.25% in August. However, it indicated that rates may be cut in the coming months should indicators continue to suggest a significant slowdown in demand. The RBA currently forecasts underlying inflation to be back in the 2%-3% target range by early 2010 (excluding the impact of the government's proposed carbon emissions scheme).
- The A\$ fell 1.7% in July, as investors see the US Federal Reserve moving into a tightening phase. Since the end of July, and the RBA's comments regarding a possible monetary easing in Australia, the A\$ has fallen dramatically to be below US89c by mid August.
- Global growth is expected to slow significantly in 2008 to around 3.5% as the US economy enters recession. The outlook does not look much better in 2009.

The sell-off in global credit, as a result of the weakness in the US subprime housing sector, has been worse than expected. This has been due to the high degree of leverage in credit derivatives markets and holdings in hedge funds and other financial firms. Write downs have affected earnings results of major US banks.

Forward indicators for Australian growth (such as consumer and business sentiment) are particularly weak especially when combined with the impact of high oil prices and interest rates. The RBA now expects non-farm GDP to slow dramatically (from 3.6% year-ended March

quarter 2008 to just 1.5% over the year to the December quarter 2008) which is likely to lead to the unemployment rate rising towards 5%.

The June quarter 2008 CPI data was again stronger than expected with core inflation running around 4%. Underlying inflation is likely to persist above 3% given upward wages pressure, low productivity and limited capacity. Domestic sourced inflation is running at 5.6% which highlights the problems faced by the RBA in containing inflation pressures into its 2% to 3% target range over its policy time horizon (to 2010).

A high A\$ is still required to offset domestic inflation pressures from higher rents, food prices etc. Nonetheless, leading economic indicators have been so weak that the RBA has changed to an easing bias (priced in by markets as early as September). The A\$ corrected below US\$ 0.90 as the market factored in rate cuts, weaker commodity prices and a surge in the US\$.

STOCKS TO CONSIDER

Leighton Holdings Limited (LEI) - BUY

Leighton Holdings is the parent company of Australia's largest project development and contracting group. Major divisions include Thiess, Leighton Contractors, Leighton Asia, John Holland, Leighton Properties and Technical Resources.

Leighton has, for many years, been a key player in the Australasian contracting market. The company's good balance sheet leaves it well placed to finance future growth. Leighton's increased presence in Asia and the Gulf opens the door to a more geographically diverse revenue base over coming years. Leighton is periodically troubled by "rogue" contracts, such as the Darajet geothermal power station, which act as reminders of the risks attached to its business activities.

Leighton is supported by a strong pipeline of work and significant growth prospects underpinning the company's expansion strategy into India and the Middle East. The outlook remains positive, with sustained healthy earnings guidance. The company's diversification strategy by sector and geographies has merit, while continued uncertainty over the

commitment of major shareholder Hochtief remains.

Price as at 14 August 2008 \$42.36

United Group Limited (UGL) - BUY

United Group is a well-run contractor focusing on property services, locomotive/rolling stock design, facilities management, labour outsourcing and engineering construction work. The work is spread across six sectors: property, rail, water, power, resource and defence. Growth potential is aided by a pursuit of increased recurring revenue streams, plus still healthy infrastructure and resource sectors. To date, United Group's acquisition strategy has delivered and remains active.

The 2008/09 outlook is promising, underpinned by confidence that the infrastructure sector will remain buoyant, which opens the door to an even larger contract book over the next year or so. Even if signs emerge that the resource and infrastructure sectors are levelling out, the company's push into services, helped by its PREMAS, Equis and UNICCO purchases, should help allay cyclical concerns.

Price as at 14 August 2008 \$13.24

Telstra Corporation Limited (TLS) - BUY

Telstra is the incumbent carrier in Australia and, like others, suffers the ignominy of core margins under pressure, heightened competition and unsympathetic regulators. However, management has undertaken a transformation strategy to lower the company's cost base and enhance its product offering. Telstra is delivering on its milestones and is continuing to deliver growth in other areas, while slowing the decline in the public network.

The company's transformation strategy should be positive and should better position it to respond to changing market dynamics. Its transformation has surpassed some significant milestones, but there are still many challenges ahead, notably the rationalisation of its IT platforms. Nevertheless, Telstra's legacy telecom business is delivering encouraging results, and it is expected that Telstra will continue to focus on organic growth and improving cost efficiencies in its current markets.

Price as at 14 August 2008 \$4.26

Worley Parsons Limited (WOR) - BUY

WorleyParsons is a leading provider of professional services to the energy, resource and complex process industries. The merger in late 2004 with Parsons E&C gave the company

an entree into Europe, bolstered its presence in the Americas and also built on its Australasian, SE Asian and Middle Eastern operations. The recent acquisition of Colt Companies has increased the company's exposure to Hydrocarbons in Canada.

WorleyParsons has a growing stable of businesses and is increasing market share by acquisition. The company is leveraged to the strongly performing hydrocarbons sector plus has the diversification benefits to the buoyant commodity and infrastructure industries. Given the continued success in securing new contracts and, evidently successful, Colt acquisition, a positive 12-month view is held on the stock.

Price as at 14 August 2008 \$34.15

BHP Limited (BHP) - BUY

BHP has a good portfolio of long-life, low-cost assets and a string of major projects in petroleum, base metals, coal and iron ore that will add to the company's underlying value and production base over the next five years. Investors are reminded that BHP has a proven track record in being able to deliver successful expansionary projects, and its project development plans exceed US\$10B over a five-year period. BHP is viewed as an attractive investment opportunity.

Record iron ore and coal contract prices along with strong oil and base metals prices underpin the excellent earnings outlook for BHP. It is well positioned to benefit from an extended cycle driven by Chinese and Asian demand generally. Recently margins have contracted slightly as the result of industry wide cost inflation.

Price as at 14 August 2008 \$38.70

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