

## Monthly Market Watch – August Issue 2009

### MARKET COMMENTS – JULY

Australian equities rallied strongly in July, gaining 7.3% as measured by the S&P/ASX 300 Accumulation Index. Better than expected economic data, both locally and in the US, helped lifted the market higher, as did improving investor sentiment at the prospect of an eventual economic recovery. The local market in July was also buoyed by better than expected earnings results from US companies, mostly notably in the financial sector.

Cyclicals and more heavily discounted securities continued to enjoy the strongest support, while defensives such as Health Care (-3.3%) have significantly lagged the market. Metal and mining companies were generally stronger amid a broadbased rally in base metal prices. Financials outperformed and recorded an 8.5% gain for the month.

Despite the strong market sentiment, the outlook for corporate earnings remains subdued. Companies including ABB Grain, Cochlear and Paperlinx have issued earnings guidance downgrades ahead of the reporting season. However, investors are seemingly looking beyond the shorter term earnings results and focusing on the medium-term earnings recovery. The latest reporting season is likely to provide some key information on the corporate earnings outlook.

Global equities also posted strong gains last month (5.5%), despite unfavourable movement in the Australian dollar. Growing confidence that the decline in the US economy is bottoming out and edging toward a recovery has propelled the strong rally across global equity markets. In local currency terms, the S&P 500 gained 7.4%, the DAX was up 10.9% while the Nikkei ended the month 4.0% higher. Emerging market equities extended their strong rally since March and were up 9.8% for the month. Similar to Australian equities, the global equities rally was led by cyclicals which are best positioned to benefit from a recovery in economic activity. One exception was the energy sector, which has underperformed along with the flat performance for crude oil last month.

Global economic forecasts project a contraction in world GDP (by around 1%). This would represent the first contraction in world GDP since World War II. The consensus has factored in this forecast and there is now a more widespread belief that the shape of the recovery

will be a “W” rather than the normal “V” given the structural problems remaining in the global economy. This outlook is likely to trigger a reversal in equity markets at some stage later this year.

Progress has been made in adding liquidity to the global financial system but problems remain in capitalizing banks, dealing with ‘toxic assets’ and giving consumers spending power through fiscal packages as they are reluctant to spend given ongoing large scale job losses.

In the short-term, global inflation has fallen substantially, allowing key central banks to cut rates to near zero. It is uncertain if a deflationary environment will persist (as it has in Japan since the early 1990s) or if the massive policy easings by central banks will eventually translate into an inflation problem.

Australia is holding up well compared to other countries as its large budget surpluses have been spent, a ‘temporary’ budget deficit has been engineered, monetary policy has been eased aggressively and the economy has benefitted from its Asian trade exposure. Economic forecasts have been revised up with the economy now likely to escape recession in 2009. These factors should boost equities further in the short-term.

The Australian cash rate has been held at 3.00% by the RBA as there are signs that previous policy easings are taking effect (e.g. in retail sales data and consumer confidence). The forward interest rate markets have factored in rate increases but this would seem unlikely until 2010 given that the RBA anticipates underlying inflation falling from 3.75% currently to 2% by the end of 2010. Nonetheless, the RBA has foreshadowed that increases are possible even while unemployment is at high levels.

### STOCKS TO CONSIDER

#### **Rio Tinto Limited (RIO) - ADD**

Rio aims to operate quality long-life, low-cost mining assets, augmented by a pipeline of projects to replenish and grow earnings. The management has a proven record of successfully operating and delivering low operating-cost projects. The board appears to have found a solution to its over-leveraged position following the Alcan deal. The US\$15.2B capital raising and proposed iron ore Joint Venture should put the

company back onto a positive footing and better able to handle the ongoing weakness of the commodity cycle.

*Price as at 14 August 2009 \$59.72*

### **Australian Infrastructure Fund Limited (AIX) – BUY (for yield)**

The company's portfolio of airports ranges from the stable, mature Melbourne Airport to high-growth prospects such as Perth and Gold Coast. Despite criticisms about the company's tendency to take minority stakes and for conservatism, these factors have served the company well in recent times. Given that medium-term funding for Perth and Gold Coast airports are now secure, and the strong yield and long-term margin growth of most of their airports, the long-term outlook on the company is favourable.

The company retains a strong portfolio of reliable cash-generating assets, with significant growth potential through increased passenger throughput and retail and property development. The traffic outlook for its Australian airports has been resilient and this is evidenced by the latest traffic statistics with the company's airports significantly outperforming respective geographical counterparts and industry.

*Price as at 14 August 2009 \$1.53*

### **CSL Limited (CSL) - ADD**

CSL has a global footprint in the recession-resistant plasma business, which enjoys strong organic growth from population increases, spreading health insurance and greater government spending on healthcare. Industry dynamics in the US are broadly favourable as Baxter and CSL dominate a "rational oligopoly" structure, although there is some threat from new entrants. Merck's HPV vaccine GARDASIL will deliver CSL years of solid royalties. CSL is becoming a major global vaccine player.

Plasma market fundamentals remain favourable. Increasing take-up of CSL's new higher-margin liquid IVIG product will deliver further yield and margin gains. Despite the defeat on Talecris, CSL' has a recession-resistant business in the prevailing environment with healthy growth prospects.

*Price as at 14 August 2009 \$33.00*

### **Wesfarmers Limited (WES) - REDUCE**

Whilst two hurdles have been overcome by the January equity raising thereby avoiding an S&P downgrade and refinancing risk, there remain worries about its long-term plan for Kmart and

the cyclical nature of the company's earnings. The long-term earnings outlook for a turnaround in the Coles Supermarkets is good, but questions arise about how the return stacks up for the massive investment.

Wesfarmers still must overcome a large earnings decline from coal price negotiations and tangible evidence is still to be seen that the Coles supermarkets are being turned around from a profitability point of view. Whilst strong performance is expected from Bunnings and Target, its other retail businesses are expected to lag its competitors.

*Price as at 14 August \$25.66*

### **Computershare Limited (CPU) – ADD**

Computershare offers exposure to a growth-oriented share registry provider to the global securities industry. Computershare's long-term growth is underpinned by the strategy of diversifying from the low-margin registry business into the higher-margin investor relations area. The company is expected to achieve continued earnings growth over the medium to long term.

Computershare is expected to benefit from a recovery in investment markets during 2009/10, with stronger transactional revenues across its business lines. This is likely to be partly offset by lower interest income on client balances due to lower dividends and interest rates.

*Price as at 14 August 2009 10.18*

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