

## Monthly Market Watch – December Issue 2008

### MARKET COMMENTS – NOVEMBER

Over the month of November, the best performing sectors were Australian and global government bonds.

Equities suffered another month of heavy falls in November with Australian and global equities returning -6.3% and -5.2% respectively for the month. Australian equities experienced another volatile month in November, falling sharply initially before rallying strongly in the final week of the month. The broader market index finished 6.3% lower, extending its losses for 2008 to -38.8%. Sectors which suffered the heaviest falls included Information Technology (-18%), Consumer Discretionary (-14.5%), Industrials (-11.3%) and Financials (-8.1%). Mining and energy sectors also fell amid declining commodities prices and a weakening outlook on the demand for commodities. The withdrawal of BHP from its proposed takeover for Rio Tinto triggered heavy selling on Rio Tinto and sent its share prices back to a level last seen in 2001.

Global economic forecasts project world GDP growth slumping in 2009 to around 1.5% (with downside risk). This pessimistic outlook (the IMF now forecasts 2.2%) reflects the view that advanced economies contract on a full year basis in 2009 (the first time post World War II) as the impact of the global financial crisis hits consumer spending and business confidence.

Developing economies will also be dragged down, though some forecasters (eg the IMF) argue that they (especially China which has announced a massive fiscal stimulus) will be relatively insulated. If developing economies hold up, this may limit the fall in commodity prices and volumes.

In the short-term, global inflation is likely to fall substantially allowing scope for more global rate cuts. The longer term outlook could be deflationary if a full-blown recession develops but the more likely risk is a surge in inflation as the system is flooded with liquidity. This should benefit real assets.

Despite co-ordinated deep global interest rate cuts and other actions by central banks (the US Federal Reserve balance sheet has expanded to 15% of GDP), more will need to be done to provide global bank solvency and avoid a deep global recession. President-elect Obama has foreshadowed a sizeable fiscal stimulus package

(over US\$500B) and a bail-out of the auto industry.

The Australian cash rate has been aggressively reduced to 4.25% in December, as the Reserve Bank desperately tries to avert a recession. However, bond markets continue to anticipate further significant rate cuts. It is clear that there is scope to cut the cash rate to 3% to 3.5% as growth may slump to zero (or even negative) in 2009 resulting in unemployment rising significantly (to at least 7%). The Federal government has already announced an A\$10.4B fiscal stimulus package which is estimated by market economists to add around 0.8% to GDP in 2008/09 (with most impact in December 2009). However, State Governments are being forced to adopt contractionary policies as revenues fall.

### STOCKS IN THE NEWS

BHP has withdrawn its 3.4 shares for 1 share takeover offer for Rio Tinto. BHP cited deterioration of global economic conditions and the lack of any certainty as to when conditions would improve for its decision.

#### **BHP Billiton Limited (BHP) – BUY**

BHP holds a 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. BHP has a proven track record in being able to successfully deliver low operating cost projects. A strong financial position will enable BHP to maintain the current momentum it has in exploration and development.

Weak commodity demand, causing soft commodity prices across BHP's product groups, is placing pressure on near term earnings. Rising costs are expected to moderate but will continue to bite into margins. BHP continues to be well positioned to benefit from any upswing in commodity demand driven by the developing economies especially China and India.

*Price as at 12 December 2008 \$28.82*

#### **Rio Tinto Limited (RIO) – BUY**

Rio Tinto aims to operate quality long-life and low cost mining assets. Augmented by a pipeline of projects that should, over the coming years

replenish and grow Rio's commodity base and hence earnings. Importantly, Rio's management has a proven record in successfully operating and delivering low operating cost projects. The company's financial position is constrained at the moment, as exception market circumstances buffet its balance sheet and cash flow.

Weak global demand is causing commodity prices to fall, placing pressure on Rio's near term earnings. Expectations are costs will moderate but will remain as a major drain on margins. Rio's debt position may restrain short-term opportunities and add additional costs, especially while the company is positioning itself to weather the current cyclical weakness.

*Price as at 12 December 2008 \$36.21*

## **STOCKS TO CONSIDER**

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### **Leighton Holdings Limited (LEI) - BUY**

For many years Leighton has been a key player in the Australasian contracting market. Leighton's good balance sheet and active capital planning leaves it well placed to finance future growth. The company's increased presence in Asia and the Middle East opens the door to a more geographically diverse revenue base. Leighton is periodically troubled by "rogue" contracts 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 2008/09 earnings outlook remains positive, with sustained healthy earnings guidance underpinned by a strong order book. 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 12 December 2008 \$23.00*

### **WorleyParsons Limited (WOR) - BUY**

WorleyParsons is a leading provider of professional services to the energy, resource and complex process industries. WorleyParson's exposure to large-scale projects through its diversified blue-chip client base positions the company well to weather short-term commodity price weaknesses. The company has a strong presence in regional energy and resource 'hot spots' such as the Americas, Australasia and the Middle East. The company is also well positioned to benefit from the long-term growth outlook in renewable energy.

WorleyParson is leveraged to the lucrative hydrocarbons sector and has the diversification benefits of the commodity and infrastructure

industries. They are also continuing to expand into the alternative and renewable energy sectors, which provide ample growth prospects.

*Price as at 12 December 2008 \$13.13*

### **Metcash Limited (MTS) - BUY**

Metcash is considered well placed, as it has created its own niche and generally operates outside areas occupied by Coles and Woolworths. Ultimately the company's success is based on the performance of its dominant IGA business, and given its staple nature its cash flow is considered reliable. A price war and a strong comeback from Coles is considered unlikely. This will allow Metcash to further establish its businesses. The fully franked dividends are attractive.

*Price as at 12 December 2008 \$4.17*

### **Asiano Group Limited (AIO) - BUY (Speculative only)**

Although the company is highly leveraged, it has a strong operating cash flow, market leading position in ports and rail, high leverage to commodities, the high barriers to entry in its business segments, large customers underpinned by long-term contracts and mature and irreproducible assets.

Asiano reported strong 2007/08 results from its underlying operations and has continued that momentum into the first quarter. It has cut its distribution forecast to preserve capital and management is willing to take a partner in its assets. Despite this, pending asset sales and heavy gearing concern us and we have an analyst discount in AIO's price target to account for this uncertainty. Nonetheless our fundamental outlook is positive.

*Price as at 12 December 2008 \$1.23*

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