

Monthly Market Watch – February Issue 2008

MARKET COMMENTS – JANUARY

There is understandable concern about the recent volatility in investment markets. So this update is provided to cover possible questions such as:

- **What has caused some share prices to fall so sharply?**
- **Is another drop in markets likely?**
- **What should you do in these times?**

Since peaking in November 2007, the Australian sharemarket has fallen more than 20%. In 2008 to date the market is down 15.2% wiping away most of the gains achieved during 2007. The primary cause of the market's weakness and its volatility is the health of the US economy. There are concerns that the US will slip into recession during 2008, indeed some think it's already there.

US economic growth has been hurt by its sub-prime mortgage problem. Loans were made to people who simply couldn't afford it. Eventually the borrowers defaulted and some US banks and other financial institutions reported very large losses. At the same time, the US home building sector has been shrinking and acting as a drag on the economy.

Even though the US Federal Reserve has reduced its official cash rate, borrowing costs for businesses in the US have risen. This is also hurting the economy and business profits. Lenders are simply charging higher interest rates to customers with lower credit ratings. In the past they had been charging too little but the sub-prime problem has made all lenders more conservative. In some cases, financial institutions are unwilling to lend at any interest rate. This is called a credit crunch or liquidity crisis.

When the economy slows, profit growth slows. When the economy goes into recession profits tend to go backwards. Given that earnings drive sharemarkets, the thought of falling profits unsettled the markets. When large US banks reported actual losses and when economic indicators pointed to a slowing economy, US investors decided it was time to sell and Australians followed suit.

Despite the fact that the Australian economy is strong and growing, investors became nervous. Would a US recession hurt our resources boom? Are our banks also going to report losses? Would higher interest rates in Australia hurt Australian

companies? Would higher mortgage rates hurt the building sector?

There were too many uncertainties for investors to cope with and January saw 12 consecutive days in which the Australian sharemarket fell. Australia is not alone in experiencing market weakness. Since the start of the year, the US Dow Jones Industrial share price index has fallen 7.5%. In the United Kingdom the FTSE 100 index is down 13.1% while in Japan the Nikkei is down 16.2%.

There will be further volatility. However over time, the sharemarket will grow with the Australian economy and the outlook for the Australian economy is positive. In fact, at present the Australian economy is growing so rapidly, the Reserve Bank is lifting cash rates to slow the economy down.

The weakness of the sharemarket, in light of the strength of the Australian economy, can be frustrating. But markets are affected by sentiment in the short-term and, so far in 2008, sentiment has been negative.

In the short-term there will be periods of weakness and periods of strength. The problems associated with the US sub-prime market are not over. The slower US economic growth will hold back global economic growth. The bad news out of the US, Europe and Asia will hurt sentiment from time to time. However, central banks around the world are cutting interest rates to ease the pressure on businesses and consumers.

The forthcoming Australian profit reporting season should show that profits in Australia are growing with the economy and the demand for Australian resources remains strong. However, share prices will continue to be driven by negative sentiment in the short term.

Despite the recent falls in the sharemarket, share prices are still up 11% since early 2006 and up 75% since early 2003, so it's important to put these falls into context and remember what your long-term goals are. If you are thinking of making changes to your investments, it's important to consider all the implications of this. If you switch or withdraw from your existing investment, the possibility of the investment recovering is lost forever. So, it's important that you weigh up the chances of an investment recovering and that you talk to your financial adviser as they will have a better understanding of your personal financial situation.

STOCKS TO CONSIDER

Woolworths Limited (WOW) - BUY

The company's retail format is considered to be superior. It is believed that Stage III of Project Refresh, which is currently being implemented, will help to deliver above-average Earnings Per Share growth, although increased pressure from a revamped Coles Group (now owned by Wesfarmers) could potentially stifle long-term sales growth. It is recognised that the company trades at a high forward earnings multiple, but it is believed that this is justified.

Woolworth's position as market leader in the supermarkets business should ensure the company has an effective platform to leverage its expertise into businesses outside its core competencies. The defensive nature of its assets and its market position supports the view that the company's earnings will be well insulated to a slowing economy and its share price will follow. Potential capital management will also buoy the share price.

Price as at 8 February 2008 \$28.99

National Australia Bank Limited (NAB) - BUY

NAB has a very strong banking franchise in Australia and New Zealand, but remains sub-scale in the UK despite owning some strong regional bank brands and expanding its presence into the south of England. Margins are also under pressure in the UK. NAB has a strong wealth management brand in MLC.

NAB has demonstrated that it has now clearly turned the corner and the outlook is for further growth going forward. It is considered there are further opportunities for NAB to achieve improvements in its business and this, combined with a favourable banking and wealth management environment, should see NAB achieve double-digit earnings growth over the next few years.

Price as at 8 February 2008 \$33.43

Brambles Limited (BXB) - BUY

Bramble's principal activities are pallet pooling and information management. The company's principal asset is CHEP, which operates a near-global monopoly in pallet pooling, with primary market penetration rates of 80% in Australia and the UK, 35% in Europe and 40% in the US.

As CHEP continues to grow its pallet pools around the world and continuously seeks to drive greater efficiencies from the business, Brambles can sustain double-digit earnings growth. Beyond its core developed country markets, growth is also seen in Latin America,

eastern Europe and, to a lesser extent, Asia. The company's resilient characteristics important to long-term growth include its market leading position, robust balance sheet and strong cash flow.

CHEP's near-monopoly position in many of its markets, strong cash generation characteristics and large markets suggest that Brambles should remain a core holding for investors. Management is looking to pursue an exciting growth strategy around the world and has alluded to potential 'business related' acquisitions. Its attractiveness to other suitors in the transport sector is also noted.

Price as at 8 February 2008 \$10.09

Babcock & Brown Limited (BNB) - BUY

Babcock & Brown is a global investment and advisory business with operations in most major international business centres. The company offers exposure to a well-run and diversified investment and advisory firm with a very strong long-term growth profile. Although subject to market cycles, the company's business and geographic diversity and proactive approach to deal sourcing and risk management should see it continue to generate a strong flow of new and profitable deals. Its strong level of business activity will underpin medium- to long-term earnings growth.

Babcock & Brown is expected to continue to deliver strong growth over the short to medium term as the company works its balance sheet and generates increasingly reliable recurring income streams. The company continues to take advantage of new deals and significant investments, underpinning short- to medium-term earnings growth. Babcock & Brown is well positioned to leverage the rapid increase in its deal flow and are forecasting strong Earnings Per Share growth.

Price as at 8 February 2008 \$18.53

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