

Monthly Market Watch – June Issue 2008

MARKET COMMENTS – MAY

Market developments during May and early June included:

- **International emerging markets** had a strong month, rising by 1.9% in local currency terms. However, this was dampened by the strength of the Australian dollar, which brought returns back to 0.5%.
- **Global developed markets** also performed well, returning 1.6% for the month. Again the Australian dollar pulled back the gains with international equities rising just 0.2% in A\$ terms.
- **Australian equities** returned 1.7% for the month, led by the energy sector which rose 19.7%. Financials such as Westpac, Commonwealth and Macquarie, but with the notable exclusion of takeover target St George, had a poor month. Listed Property Trusts severely underperformed the broader market, falling 8.9% for the month over concerns about interest rates and the quality of earnings.
- **Australian fixed interest** was up just 0.1% over the month, with higher inflation expectations continuing to push interest rate expectations higher.

Global economic and inflation forecasts project world GDP growth slowing significantly over 2008 and 2009 to around 3.0% - 3.5%. This reflects the impact of US growth at under 1% (with two flat to negative quarters likely) due to flow-on effects from sub-prime mortgage and global liquidity issues. Inflation is expected to persist at around 3.8%, given high labour cost growth and oil prices over US\$130/bbl. Steady productivity growth and low labour costs in Asia remain moderating factors, although Chinese inflation appears to be structurally increasing.

There is concern as to whether central banks (led by the US Federal Reserve) have taken sufficient policy action to resolve the global financial system crisis. This means that equity markets are likely to remain under pressure, particularly financial stocks. Investors are likely to remain overweight cash and bonds.

Despite the likelihood of Australian inflation running well above the Reserve Bank's (RBA) 2% to 3% target range for a considerable period, the Australian cash rate appears to be peaking at 7.25%. Forward indicators of growth (business and consumer sentiment) have

weakened sharply and the RBA seems to have moved to a more neutral policy stance but is leaving its options open, according to public statements by officials. Also, the Federal Budget met market expectations. Overall, there is still a risk of a further rate hike to 7.50% but an easing phase beginning in early 2009 appears realistic unless the economy weakens more rapidly than projected by the RBA (that is, to 2.25% at end December 2008).

Core inflation data in the US, Australia and now in China has helped to support the long held view that the current period could be characterised as one of a transition to a moderate inflation period following 20 years of disinflation.

Tight labour markets and falling productivity in key economies are expected to lead to a trend of increased labour costs. An environment of slowing growth (beyond 2008) and rising interest rates (as bond market inflationary expectations rise) is likely to result in lower corporate profit growth rates. This outlook is reflected in ten year forecasts, where long-term equity returns are projected to be at or less than 10%. The performance of markets in 2008 appears to confirm that the equity bull market which commenced in 2003 is over.

STOCKS TO CONSIDER

BHP Billiton 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. The company's project development and expansion plans exceed US\$10B over a five-year period. The increasing production profile makes BHP 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. BHP is in a better position to cope with margin contraction than its smaller competitors.

Price as at 12 June 2008 \$41.80

Worley Parsons Limited (WOR) - BUY

Worley Parsons provides engineering design, project services plus maintenance and reliability support services across a range of industrial segments. It is also involved in the development and commercialisation of technological innovation in areas such as communications, energy, commerce and system integration.

Worley Parsons 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 the European Union, 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.

Worley Parsons 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.

Price as at 12 June 2008 \$36.35

QBE Insurance Group Limited (QBE) - BUY

QBE is a well-managed Australian general insurer with a significant global presence and a conservative approach to risk management. It has a long-established history of delivering above-average returns, with a minor hiccup following the events of September 2001. The company continues to grow via an active acquisition program and is considered to be well placed to continue delivering superior long-term returns.

QBE has delivered good earnings growth despite tougher insurance market conditions and it is expected that the strong dividend growth of the past few years to continue. QBE is regarded to be the preferred general insurer exposure.

Price as at 12 June 2008 \$23.42

Woolworths Limited (WOW) - BUY

The company's retail format is considered to be superior and it is believed that the renewal project, 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 this is considered to be 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 should insulate the company's earnings to a slowing economy.

Price as at 12 June 2008 \$26.25

Australian Worldwide Exploration Limited (AWE) – BUY (Speculative)

AWE listed in 1997 with assets in Argentina and the Kipper gas field. Following several asset trades and a build up of cash, commercial opportunities were identified at BassGas and Casino gas, while exploration skills identified oil discoveries at Cliff Head, offshore Perth and the Tui Area offshore New Zealand. These projects have now been brought into production. AWE has now embarked on another phase of exploration to grow the company.

The Casino field (25% AWE), the Cliff Head oil project (27.5%) and the BassGas project (30%) are in production and will provide steady long-term cash flows. The Tui Area Oil Project (42.5%) is producing above expectations and is generating a very strong cash flow. AWE will return to focus on exploration as it seeks additional reserves to extend its production profile.

AWE's two-year earnings outlook is very strong. Earnings will continue to flow through 2008 from BassGas, Casino and Tui. Production from Tui is more likely than not to surprise on the upside. Exploration programs are planned in Indonesia, the Perth Basin and New Zealand. AWE is seeking its next phase of expansion and development through new discoveries.

Price as at 12 June 2008 \$4.06

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