

## Monthly Market Watch – March Issue 2008

### MARKET COMMENTS – FEBRUARY

The Reserve Bank of Australia (RBA) has forecast that the Australian economy will slow from 4.5% growth in September 2007 to just 2.75% by June 2008. The RBA also increased the official cash rate from 7.00% to 7.25% in March due to inflation concerns.

With unemployment down to 4.1%, strong demand for goods and services is flowing into higher prices. The economy does not appear to have the capacity to lift production in order to meet demand.

After the Australian sharemarket's 11.3% plunge in January, February was a month of volatility. The S&P/ASX All Ordinaries index fell just 0.4% in the month but movements in excess of 1.0% occurred on over half the trading days. Volatility is associated with high levels of uncertainty.

Driving the market during the month were the RBA's moves on interest rates and its outlook for the economy. At the same time, the profit reporting season was in full swing.

Profits for the six months to December 2007, across companies in the S&P/ASX 300, had risen just under 5% compared with the same period the previous year. Within this figure there was considerable variation.

Resource companies saw earnings fall 3.1%; banks lifted profits 4.1% while the broad non-resources or industrial sector reported a 12.8% lift in profits.

Among companies to post strong results were JB Hi-Fi which lifted earnings 60% on strong sales of iPods, computers and games. Qantas profits rose 101% on passenger growth while the profits of ASX limited rose 50% due to high levels of share trading in the past six months. Woolworths lifted earnings 28% as it cut costs and lifted market share.

On the other side of the ledger, companies whose profits slipped included Bluescope Steel, Santos and Boral. Bluescope Steel faced write-downs on its businesses in China and Vietnam; Santos had lower than expected oil and gas production and higher costs while Boral was hurt by the weakness in the US housing market.

While in the longer run share prices are determined by the profitability of companies, in the shorter term a good profit result does not guarantee a rising share price. Qantas shares

were down 5.8% for the month, JB Hi-Fi fell 19.7% and ASX was down 9.0%. Woolworths posted a gain of 0.7%.

In terms of total return over the month, the best performing larger companies included Alumina (+25.4%), Woodside Petroleum (+24.2%), Telstra (+12.2%) and Rio Tinto (+12.1%). Alumina benefited from stronger aluminium prices, Rio benefited from a 65% lift in the contract price for iron ore and the rise in oil prices helped Woodside Petroleum. Telstra's strong cash flows have attracted investors.

Weaker performers included Allco Finance (-74.0%) which faced debt financing issues; ABC Learning (-51.5%) whose profits fell 42.0% and Cochlear (-21.7%) as sales to ear-implants in China were below market expectations.

Major global sharemarkets were either weak or flat during February. The MSCI World index, a broad measure of global shares, fell 0.7% in USD but was down 4.8% when measured in AUD. Over 12 months global shares were down 2.3% in USD terms but fell 17.7% in AUD terms.

Unlike last month, US markets were among the weakest of the major markets. The Dow fell 3.0% in February, the S&P500 was down 3.5%, and the NASDAQ fell 5.0%.

Reporting season in the US was mixed. While earnings in the fourth quarter of 2007 were down almost 23% on the same period last year, the bulk of the pain was felt by the financial sector. Stripping out the financials saw other companies lift earnings some 18%.

The extent of the US slowdown remains a major issue facing global sharemarkets. Lower US interest rates would help as would clarity surrounding its credit markets and the price of debt facing corporate borrowers.

### STOCKS TO CONSIDER

#### **JB Hi-Fi Limited (JBH) - BUY**

JB Hi-Fi is successfully developing a strong retail brand and is well positioned to achieve medium- to long-term earnings growth through store roll-outs and expanded product lines. Downside share price risk comes from any potential slowdown in the overall market. There's upside to the forecast should consumer spending

remain strong for a prolonged period or if JB Hi-Fi participates in industry consolidation.

After delivering a booming 1<sup>st</sup> half result, JB Hi-Fi has projected 2008/09 NPAT to grow by 41%-49%. Although the stock currently trades at a premium to market and sector PE ratios, this is justified, given the strong near-term growth outlook. Caution is expressed that the premium rating does suggest that the market would react very harshly to any disappointment. The recent pull back in JB Hi-Fi's share price is seen as an opportunity.

*Price as at 12 March 2008 \$9.91*

### **Toll Holdings Limited (TOL) - BUY**

Toll generates strong cash flow and its balance sheet is solid. While long-term growth is contingent on finding earnings-accretive acquisitions, in the medium to long term, the strategy in Asia will provide for moderate growth. Longer-term strategies such as selling Virgin Blue would provide upside.

Toll is expected to pursue an aggressive acquisition strategy to focus on expanding its existing logistics businesses, particularly in Asia. Its current operations will drive growth at the revenue and profit lines in 2008/09 alone. Given its past record of accomplishment of successful acquisitions, its strong balance sheet and business skill are expected to drive earnings in the near term.

*Price as at 12 March 2008 \$9.48*

### **ASX Limited (ASX) - BUY**

ASX provides direct exposure to the rapidly expanding equity and derivative markets with leverage to trading volume activity. Over the medium to long term, it is expected that strong growth in ASX's core markets, with equities volumes helped by growth in superannuation. The merged ASX/SFE is also a cost-efficient business. With a strong balance sheet and an expanding footprint, ASX is well placed to compete in further global exchange consolidation.

While the earnings outlook for ASX is partly dependent on continued short- to medium-term market growth, it now has a more diversified business following the merger with SFE and earnings are less sensitive to a downturn in any one market. With volumes continuing to grow and the full benefit of merger synergies yet to be reflected in earnings, another good year is expected in 2008/09.

*Price as at 12 March 2008 36.64*

### **ANZ Limited (ANZ) - BUY**

ANZ has built a strong track record of delivering on its targets. It has traditionally had the weakest retail franchise of the major Australian banks, but is making significant progress in growing this business. Following the acquisition of NBNZ, ANZ has the leading banking franchise in New Zealand. There is confidence that ANZ will be able to achieve solid earnings growth over the medium to long term and have a positive long-term view of the stock.

ANZ's growth strategy, particularly its initiative to grow the retail franchise, is starting to generate solid revenue growth and, despite new investments in the business, cost growth remains below revenue growth. The steep increase in bad debt provisions will reduce short term EPS growth, however the bank is expected to move back to double digit EPS growth by 2009/10.

*Price as at 12 March 2008 \$21.86*

### **Australian Worldwide Exploration Limited (AWE) - BUY**

AWE has made the transition from an explorer to an oil and gas producer. The Casino gas 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%), offshore New Zealand, also came on-stream in mid-2007. The company's focus will now return to exploration as it seeks additional reserves to extend its production profile.

AWE's two-year growth outlook is very strong. Earnings will continue to build through 2008 as projects ramp up and there will be a major step change now that the Tui Area Project is operational. The Price Earnings ratio is expected to improve significantly over the next two years as multiple revenue streams are established.

*Price as at 12 March 2008 \$3.09*

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