

## Monthly Market Watch – October Issue 2008

### MARKET COMMENTS – SEPTEMBER

Global economic forecasts project world GDP growth to slump in 2009 to under 2%. This pessimistic outlook (the IMF forecasts 3%) reflects the view that advanced economies will only grow at 0.3% as the impact of the global financial crisis hits consumer spending and business confidence. Developing economies will also be dragged down, though some forecasters (including the IMF) argue that they (especially China) 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 the coordinated global 0.50% rate cut and range of significant measures by central banks, more needs to be done to provide global bank solvency and avoid a global depression. This was affirmed by the G7 and G20 meetings on 10-12 October 2008. The US has announced direct capital injections into the banking system which is positive. Most commentators see these moves as significant steps in the right direction but more needs to be done.

The Australian cash rate was slashed by 1.00% to 6.00% in October, as the RBA has acted to try and ward off recession. However, bond markets continue to foreshadow further significant rate cuts. Although some of this move reflects a "risk aversion trade", it is clear that there is scope to cut the cash rate to around 4.75% as growth may slump to 0.7% in 2009 resulting in unemployment rising over 5% (reaching almost 7% by 2010). 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.

Market developments during September included:

- Australian equities fell heavily in September and October as the deterioration of the financial crisis was threatening to cripple some of the largest global financial firms, potentially further de-stabilising the global financial system. Fear aversion saw equities

driven substantially lower during the month with global developed equities down -10.8% in local currency terms. Australian equities have also suffered sharp losses to be down -9.9%. The resources sector has been particularly hard hit. Investors are becoming increasingly concerned that a severe global economic slowdown would drastically dampen the demand for commodities.

- Government bonds rallied strongly in September. The demand for risk free asset soared during the month as uncertainty intensified over the development of the financial crisis and the level of government's commitment to stymie the worsening of the crisis. Credit risk premium have widened across all sectors of the credit markets, from investment grade to sub investment grade, contributing to the sector's significant negative performance for the month.
- Despite the relatively defensive nature of the sector, listed property and infrastructure have suffered heavy losses in September. The sector has continued to struggle on concerns over the debt level of selective companies and the ability of some to refinance their debt or raise capital to support their business.

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### STOCKS TO CONSIDER

#### **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. The company continues to grow via an active acquisition program and is well placed to continue delivering superior long-term returns.

QBE has delivered good underlying earnings growth despite tougher insurance market conditions and it is expected the solid dividend growth of the past few years to continue. QBE is the preferred general insurer.

*Price as at 17 October 2008 \$25.68*

### **Woolworths Limited (WOW) - BUY**

The company's retail format is considered to be superior and changes 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 believe 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 should ensure the company's earnings will be well insulated to a slowing economy and its share price will follow.

*Price as at 17 October 2008 \$26.46*

### **Downer EDI Limited (DOW) - BUY**

Downer EDI provides infrastructure and engineering services across several sectors, including water, rail, power and mining. Given buoyant resource and infrastructure sectors, it is forecast the company will perform successfully across all its businesses over the medium term.

Management's renewed focus on risk management and the improved performance of the Mining division should be positive for the company. From an underlying business point of view, the company's strong position, although recently marred by operational shortcomings.

*Price as at 17 October 2008 \$4.98*

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

Toll's recent acquisitions have enabled the company to gain a foothold in Asia and as these businesses integrate, strong long-term growth is forecast. The continued growth of multi national companies will make total supply chain solutions essential in order to be competitive, especially end-to-end logistics with the rise of China and India and their importance to world trade. Analyst's are positive about Toll's long-term outlook, with the VBA separation expected to bolster Toll's growth ambitions.

While smaller acquisitions may become available, a major acquisition is not expected in the short-term. The separation of the Virgin Blue is positive for Toll, as it removes considerable uncertainty and enables a more transparent valuation of the company's assets. Toll is a quality company and the current share price does not reflect its underlying value.

*Price as at 17 October 2008 \$6.48*

### **Australian Infrastructure Fund Limited (AIX) - BUY**

Australian Infrastructure is a diversified infrastructure fund, with investments in airports, ports, toll roads and light rail. Its strategy is to maximise both income and capital returns.

Australian Infrastructure Fund's portfolio of airports ranges from the stable, mature Melbourne Airport to high-growth prospects such as Perth and Gold Coast. There is some criticisms about Australian Infrastructure's tendency to take minority stakes and for conservatism, however at present it is considered that the former is fully factored into the security price and the latter is a healthy strategy in the current environment.

Australian Infrastructure retains a strong portfolio of reliable cash-generating assets, with significant growth potential through increased passenger throughput, and retail and property development. It is considered that there is significant upside within its airport assets.

Despite the fact that soft traffic growth is forecast this year, the security presents a solid short-term buying opportunity based on the security price discount to fundamental valuation.

*Price as at 17 October 2008 \$2.09*

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