

Monthly Market Watch – September Issue 2009

MARKET COMMENTS – AUGUST

The Australian equities market recorded its sixth consecutive monthly gain in August, up 6.6% for the month. During the month, investors' attention was fixed on reporting season, particularly over the provision of management guidance on earnings outlook. The overall results have been positive with a large percentage of companies exceeding consensus forecasts. This, combined with a flow of positive economic data releases, saw the market again stage a robust rally.

Under the buoyant market conditions, defensives have again lagged the broader market. Telecommunications fell -3.6% while Utilities were -3.3% weaker. And despite industrial metal prices firming during the month, Materials companies fell modestly to be down -0.5%. In comparison, Financials (including Real Estate) led the market higher with a 12.8% gain. Cyclical industrials, particularly those linked to the construction sector, have also posted solid gains at 11.7%.

Similar themes have emerged in global equities with the market continuing to draw strength from the improvement in economic data in the US. The MSCI World ex-Australia Index returned 2.3% for the month, with approximately one third of the monthly gain lost due to the appreciation of the Australian dollar against other major currencies. In local currency terms, the best performing regions were Europe (5.8%) followed by North America (4.0%). Asia Pacific ex-Japan edged to a slight gain for the month (0.2%) as the broader region was kept subdued by the steep decline in the Chinese equities market.

In the second half of 2009, economic momentum appears to have gathered speed and the former consensus about a 'W' shaped recovery has wavered to be replaced by those arguing the normal 'V' shaped recovery is underway.

Despite this improved outlook central bank and government policy settings are likely to remain at extreme levels, especially in the developed world. Reluctance by governments to withdraw fiscal stimulus is being driven by widespread uncertainty about the strength of the recovery, and in particular, concerns that consumer deleveraging (given high unemployment, weak incomes growth and structurally higher savings)

and low investment will limit the strength of the recovery.

In the short-term, global inflation has fallen substantially, allowing key central banks to cut rates to near zero. It is uncertain if a deflationary environment will persist (as it has in Japan since the early 1990s) or if the massive policy easings by central banks will eventually translate into an inflation problem.

Australia is holding up well compared to other countries as its large budget surpluses have been spent, a 'temporary' budget deficit has been engineered, monetary policy has been eased aggressively and the economy has benefitted from its Asian trade exposure. Economic forecasts have been revised up with the economy now likely to escape recession in 2009. These factors should boost equities further in the short-term.

The Australian cash rate has been held at 3.00% by the RBA as there are signs that previous policy easings are taking effect (e.g. in retail sales data and consumer confidence). The forward interest rate markets have factored in rate hikes to 4.5% by mid-2010 which seem more realistic in view of recent strong data - despite rising unemployment. Nonetheless, the RBA has foreshadowed hikes are possible even while unemployment is at high levels.

STOCKS IN THE NEWS

Telstra Corporation Limited (TLS) - ADD

The government has released its draft legislation for regulatory reform of the Telecommunications sector. Under the draft legislation, Telstra is required to structurally separate its wholesale business voluntarily or face forced separation. It is considered that the announcement has pushed Telstra into a position where its only option is to collaborate. The announcement was in line with market expectations that Telstra would be forced to separate its wholesale business.

Price as at 16 September 2009 \$3.24

STOCKS TO CONSIDER

Billabong International Limited (BBG) - BUY

Billabong possesses a substantial portfolio of quality brands. The company has an achievable medium-term earnings growth target of 15%.

While the long-term outlook is for reasonable organic growth rates, the upside lies in further acquisitions, which Billabong is actively pursuing across all key markets. Billabong has proven its ability as a brand manager and despite earnings pressure, can take advantage of growth opportunities that arise from a protracted slowdown.

The company continues to offer reasonable rates of organic growth coupled with significant scope for growth by acquisition. Despite weakness in the US market, Billabong has experienced only relatively minor earnings downgrades. Until economic news from the US and Europe improves, sentiment will run against the stock. However, this is viewed as an opportunity to acquire a high-quality company at reasonable prices.

Price as at 16 September 2009 \$10.47

Rio Tinto Limited (RIO) - ADD

Rio aims to operate quality long-life, low-cost mining assets, augmented by a pipeline of projects to replenish and grow earnings. The company's management has a proven record of successfully operating and delivering low operating-cost projects.

Rio's board appear to have found a solution to its over-leveraged position following the Alcan deal. The US\$14.8B capital raising and proposed iron ore Joint Venture should put the company back onto a positive footing and better able to handle the ongoing weakness of the commodity cycle.

Price as at 16 September 2009 \$60.18

Ansell Limited (ANN) - ADD

Ansell operates through three divisions. Professional Healthcare manufactures and markets medical, surgical and examination gloves. Occupational Healthcare manufactures and markets occupational health and safety gloves. The Consumer Healthcare group markets condoms and other personal products. The company is positioned number one or two in many of the markets in which it operates.

Ansell is a top three global player in each major business. It has progressively restructured to deal with high latex and oil prices, improved manufacturing efficiency, rolled out innovative

higher margin products, expanded into new markets and dropped unprofitable business.

Ansell has been heavily affected by the global recession, but its restructuring initiatives will help it emerge a stronger company. The company has a conservative gearing structure.

The global economic downturn has severely affected Occupational Healthcare Division's sales and margins. Professional Healthcare Division continues to perform reasonably well, but Consumer Healthcare is struggling. A weakening US\$ will boost US\$-denominated earnings from outside the US, but cause earnings compression when translated back into A\$. Ansell has initiated a major business process re-engineering project, which should stand it in good stead for an upturn in the economy.

Price as at 16 September 2009 \$9.42

James Hardie Industries NV (JHX) - SELL

James Hardie is well positioned in the long run: its differentiated product (fibre cement) allows it to capture a greater share of the value chain and to grow faster than the housing market by winning share from competing products. However, given uncertainty as to the timing and size of recovery in the US housing market, there is not a great margin of safety.

Although James Hardie can handle industry slowdowns better than many competitors, caution remains in the short term, especially as the bulk of its business is in the US. At this point in the cycle, present price levels look a little steep.

Price as at 16 September 2009 \$7.28

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