



Owen Hodge Financial Planning



Market Review 4th Quarter 2007

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Stumbling across the finish line

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Equity markets around the world stumbled in the closing months of 2007. The fourth quarter continued on from the pessimism that started during the August sub-prime meltdown, causing most major equity markets to dip into negative territory.

For global equities, the fall in the December quarter lead to a calendar year return of 6.2% for hedged investors, although the strength of the Australian dollar (rising 11.4% for the year against the US dollar) resulted in an unhedged return of -2.1%.

Despite declining over the quarter, Australian equities were once again the standout performer in 2007, rising 16.2% for the year, driven primarily by the Materials and Energy sectors.

Traditionally defensive assets classes such as Australian Listed Property Trusts and Global Property Securities were hit hard by the sub-prime fallout, declining 8.4% and 17.8% over the year respectively.

Australian and International Bonds withstood the barrage to both finish the year in positive territory, although investors with excess exposure to global credit markets felt the full force of the credit crunch.

In this edition of the Market Review, we discuss the performance of the investment markets over the fourth quarter of 2007, along with the major economic trends affecting them.

Snapshot

■ Despite the severe impact on financial institutions, the sub-prime virus has not yet infected the rest of the US economy.

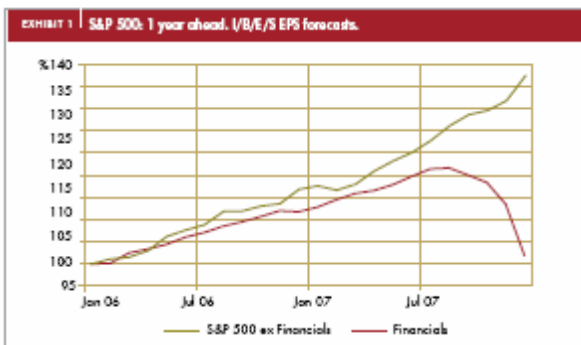
■ An initial \$100 investment in Centro Properties Group on 30 November 2007 was worth just \$11.57 on 15 January 2008.

1. Sub-prime rampages financials

The sub-prime crisis continued to plague credit markets and investor sentiment during the fourth quarter. Estimates of potential sub-prime losses range as high as US\$400 billion, which has prompted fears of a world wide credit crunch.

Globally, financials was by far the hardest hit sector, falling 8.1% over the quarter as global giants such as Merrill Lynch (-23.7%), Morgan Stanley (-14.7%) and Citigroup (-35.5%) began announcing billions in sub-prime losses. Goldman Sachs (+0.2%) avoided most of the drama, while Australia's major banks were also largely immune, falling just 0.8% due to their lower exposure to global credit markets and more conservative lending practices. Indeed, some commentators are even suggesting Australian banks will benefit from the sub-prime fallout as non-bank competitors (eg. RAMS) fall by the wayside.

Despite the severe impact on US financial institutions, the sub-prime virus has not yet infected the rest of the US economy. The chart below shows the latest I/B/E/S consensus EPS growth forecasts for the US S&P 500 Financials and S&P 500 Ex Financials. Earnings for the S&P 500 Ex Financials is expected to grow by 14% over the next year, which contrasts to the sharp fall in expected earnings for the financial sector.



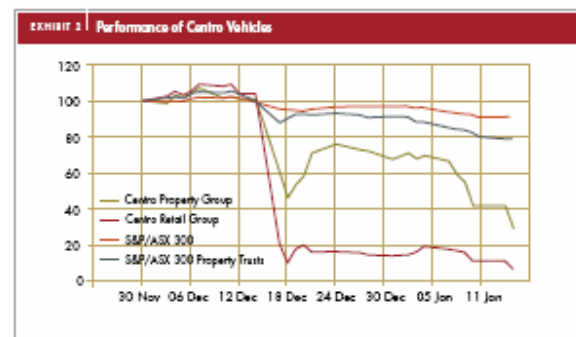
Source: I/B/E/S, Russell calculations

2. Centro – a property trust tragedy

It's not every day that a large cap stock falls by almost 80%, especially when it comes from what has traditionally been considered a 'defensive' sector. On Monday 17th December Centro Properties Group (CN P), the (then) eighth largest property trust in the Australian market, fell 76.1% (versus the S&P/ASX 300 which fell 3.5%), while the related Centro Retail Group (CE R) fell 40.4%.

CNP is a property fund manager that, at June 2007, managed approximately A\$26.6bn of assets in wholesale funds, a listed vehicle (CE R), and 39 syndicates. The assets in these funds primarily include US and Australian shopping centres. On 17 December, CN P downgraded its earnings guidance by 13.6% from 47cps to 40.6cps and suspended distributions for the December 2007 half. The downgrade was primarily caused by rising interest costs due to the global credit crunch and subsequent difficulties refinancing its debt obligations. These factors combined with the group's complex structure to cause a complete collapse in confidence.

Other stocks with similar characteristics, such as Goodman Group, which fell -28.0% for the quarter, were also sold off heavily. By contrast, LPTs with less gearing and more traditional structures, such as Westfield Group, were much less affected.



Source: Bloomberg

Snapshot

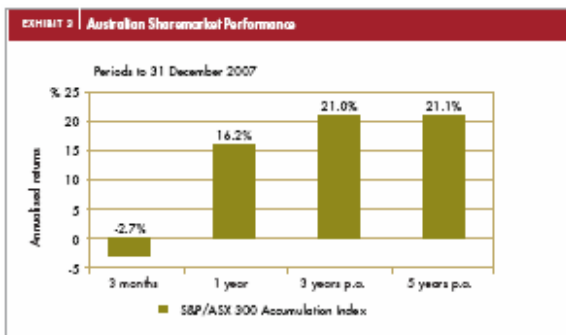
- **The Australian equity market took a bath in Q4 after solid falls in November and December. It remained, however, the standout performer for year, rising 16.2% in 2007.**
- **Global equity markets fell 1.7% in the December quarter, dragged down by the Financials sector and its exposure to US sub-prime lending.**

3. Australian shares

The Australian equity market declined 2.7% in the fourth quarter, despite closing at record highs earlier in the period. The brunt of the subsequent falls in November and December was felt by US-exposed vehicles and interest rate sensitive stocks and sectors, which were hammered amidst revamped sub-prime related fears, another 25bps RBA rate hike and speculation of a US recession.

Notably, the dramatic nose-dive of Centro Properties Group (falling 86.3% for the quarter) after announcing difficulties refinancing its debts shook market confidence, causing other major property trusts to plummet and prompting further falls in other interest rate sensitive sectors, such as utilities, infrastructure and the rest of the financials sector. The Australian currency remained strong (despite falling marginally against the USD), causing widespread earnings downgrades by overseas earners. On a more positive note, upgraded earnings, takeover speculation and a general retreat to defensive stocks saw ResMed (+21.4%) perform strongly.

M&A activity was also weaker due to tightening credit markets, with the exception of Wesfarmers completing its takeover of Coles and the much speculated bid by BHP for Rio Tinto. This sent Rio Tinto (+23.8%) skyrocketing, helping to mask falls in the rest of the market.



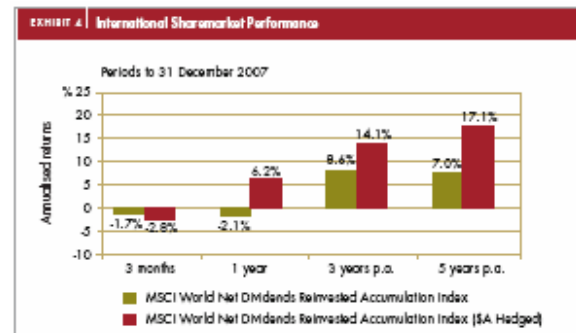
Source: Bloomberg

4. International Shares

Global markets lost 1.7% in Australian dollar terms in the fourth quarter. The gain for 2007 was 4.7% in local currency terms, although with the Australian dollar rising 11.4% against the USD the Australian dollar return was actually negative, falling 2.1%. Over the fourth quarter, growth continued to gain momentum, outperforming value by 4.6%. Large caps also continued trends from the third quarter, outperforming their smaller cap counterparts.

Financials was the worst-performing sector, falling 8.1% (in AUD terms). This was mainly due to the sector's exposure to US sub-prime lending. The utilities sector was the best performer, gaining 8.5% as investors fled to companies with stable earnings and higher yields. Strong oil prices boosted the Energy sector, which rose 5.3%.

Regional performance trends favoured European countries, notably Spain which finished the quarter up 9.1%, partly due to the resilience of its financial system. Japanese stocks were again laggards in 2007 posting a 5.3% loss for the quarter, leaving the country 14.0% behind for the year. As investors fled riskier assets, the carry trade unwound further, leading to Yen appreciation versus the U.S. Dollar, which hurt the prospects of Japanese exporters.



Source: MSCI

Snapshot

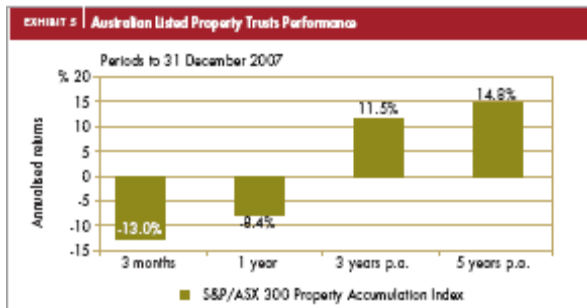
- The Australian listed property sector closed 2007 looking sore and sorry, falling 13.0% for the fourth quarter and 8.4% for the year.
- The international property securities market plummeted 12.3% in the December quarter, feeling the full brunt of a slowing US housing market and tighter credit markets.

5. Listed Property Trusts

Australian LPTs plummeted 13.0% in the December quarter, dramatically underperforming the broader equity market and marginally underperforming Global Property Securities, which fell 12.3%.

The most notable event for the quarter was clearly Centro Properties Group's spectacular fall from grace (-86.3%), after it announced difficulties re-financing its short term debt obligations and cancelled its December half dividend. The stock plummeted from \$5.70 to as low as \$0.42 before ending December at \$1.01. The revelation of Centro's financial instability had a significant flow on effect as other LPTs with high levels of gearing or maturing short term debt were re-valued. Westfield (-3.2%) largely defied the trend as investors saw its low gearing and higher asset quality as signs of stability.

The best performing sector was Diversified, supported by Mirvac which rose 11.6% to be one of the only positive performers for the quarter, and Stockland, which fell 4.0% but still significantly outperformed the index. The Industrial sector was the weakest, dragged down by the underperformance of Goodman Group (-28.0%) after it was hit by similar (albeit less serious) forces to those that shook Centro.



Source: Bloomberg

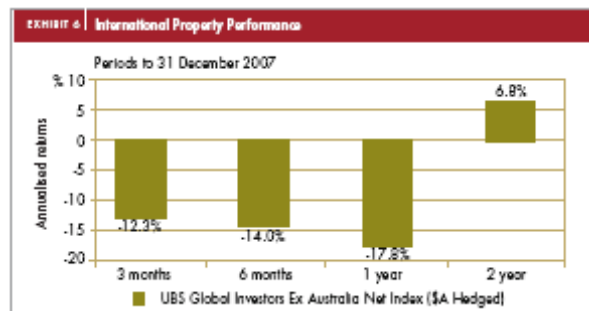
6. International Property

The international property securities market fell -12.3% for the fourth quarter, underperforming the global equity market by 9.5%. Asia (-5.4% in local currency terms) topped the index, followed by North America (-12.9%), Continental Europe (-11.5%) and the UK (-4.9%).

In Continental Europe the Netherlands (-6.0%) led the way, followed by Sweden (-9.1%), Germany (-9.9%) and France (-15.3%). The UK experienced a significant pull-back, particularly in November when a number of companies reported declines in Net Asset Values.

The strength of the commercial real estate market and strong economy, coupled with the liquidity of the Chinese stock market, continues to buoy the market in Hong Kong, which rose 4.4%. Japan (-8.2%) and Singapore (-13.1%) lagged behind. Developer companies in Japan were particularly hit hard during the quarter as economic conditions weakened.

Canadian (-12.6%) and US (-13.0%) real estate securities underperformed the global index. In 2007 US REI Ts broke their seven-year record of outperformance versus the broader equity market. REI Ts suffered along with the stocks in the broader financial sector as concerns about a weaker economy and tightening credit put upward pressure on dividend yields and contributed to higher capitalisation rates and discount rates being used to value underlying properties.



Source: UBS

Snapshot

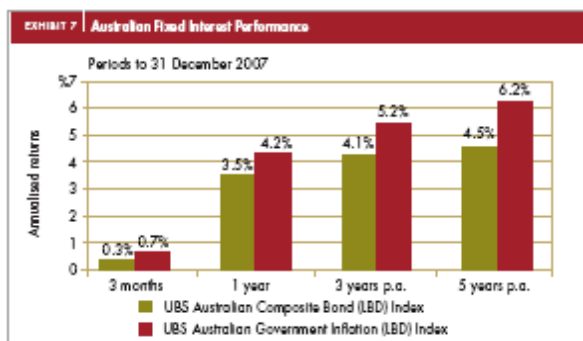
- **Australian bonds rose 0.3% as the economy continued to grow strongly, with the risk of higher inflation the main focus of policy makers.**
- **The global “flight to quality” theme, which commenced in Q3, continued during the quarter with investors preferring the safety of government bonds.**

7. Australian Bonds

The Australian bond market gained 0.3%, underperforming bank bills at 1.8% and lagging behind the international bond markets which advanced 2.6%.

In contrast to slowing global economies, the Australian economy continued to grow strongly with the risk of higher inflation the main focus of domestic policy makers. The RBA raised the official cash rate to 6.75% in November and the market is expecting another monetary tightening in early 2008. US housing market weakness spread to other sectors of the economy, prompting the US Federal Reserve to lower its official rate twice during the quarter from 4.75% to 4.25%. US bond yields, particularly US Treasuries, fell substantially as a result of these monetary easings.

In Australia, corporate and swap spreads continued to widen in a thin market. The financial sector suffered the most while entities that rely on short term debt funding were also hit hard on concerns about their ability to secure credit in an illiquid market. Government bonds substantially outperformed non-governments even as government bond yields rallied to their highest level since early 2002.



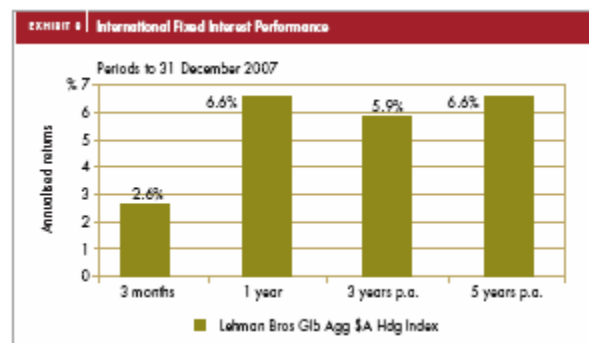
Source: UB S

8. International Bonds

International bonds returned 2.6% over the quarter in A\$ Hedged terms, a period in which risk aversion and the weakness of the US dollar were the main drivers of returns. The Federal Reserve (Fed) lowered interest rates in October to 4.5% and hinted at further rate cuts. However, continued financial sector losses coupled with the Fed’s uncertain economic outlook caused November’s corporate spreads to widen to their highest levels since the WorldCom and Enron scandals in 2002.

The global “flight to quality” theme, which commenced in Q3, continued during the quarter with investors preferring the safety of government bonds. The direct impact of the US mortgage sub-prime fallout continued as more financial institutions, including Morgan Stanley and Citigroup, admitted greater exposures to sub-prime loans. More significantly, investors and lenders became increasingly risk averse, dramatically reducing the liquidity in fixed interest markets around the world.

In December, after the Fed cut rates by another 0.25% to 4.25%, a combined global effort of some of the world’s major central banks prompted a rally in riskier assets. Financials, high yield and emerging markets underperformed over the quarter although they recovered some lost ground in December.



Source: Lehman Brothers

Snapshot

- Australian dollar was one of the strongest currencies in 2007, rising 11.4% against the US dollar after reaching a 23 year high of 94 cents in early November.
- One of the most striking themes to emerge from the sub-prime fallout has been the amazing resilience of the Asian (ex Japan) equity markets.

9. Australian dollar falls in Q4 but still a strong year

The Australian dollar was weaker against most major currencies over the December quarter, falling 0.8% against the US dollar, 1.5% versus the Canadian Dollar, 5.9% versus the Japanese Yen and 4.8% against the Euro. However, the domestic currency did finish up 0.8% versus the British Pound. During periods of uncertainty the Australian dollar tends to co-vary with investor attitudes towards risk, rising when risk appetite is high and falling when investors become more risk averse. The Australian dollar has followed this pattern since the start of the sub-prime crisis in July, so it was not surprising to see it fall slightly in a quarter where risk aversion was high.

For the full year, however, the Australian dollar was one of the strongest currencies, rising 11.4% against the US dollar after reaching a 23 year high of 94 cents in early November. The key drivers of the Australian dollar have been the falling US dollar, driven by its large current account deficit, and a widening interest rate differential between Australia and the US. Continued strength in commodity prices was also supportive of commodity currencies such as the Australian, New Zealand and Canadian dollars over the year.



Source: FactSet

10. Emerging Markets

While the rest of the world's equity markets were haemorrhaging, Emerging Markets continued to soar in Q4, gaining 4.5% in AUD terms. India was the best-performing major country after rising 24.3% as investors continued to seek visible, sustainable growth opportunities in this market, in part due to its more attractive valuations relative to China. China (-2.9%) underperformed after the market saw profit taking opportunities on concerns the economy was overheating. Argentina (-10.1%) was the worst-performing country, partly due to investor concerns regarding the credibility of the Argentinean central bank and, in particular, its policy towards managing inflation.

One of the most striking themes to emerge from the US sub-prime fallout has been the amazing resilience of the Asian (ex Japan) equity markets, driven in particular by growth in China and India, which gained 49.2% and 55.4% respectively for the full year of 2007. The chart below shows the performance of some of the major international indices since the beginning of the sub-prime sell-off in July. While developed markets such as Australia and the US have lagged, Asia and other emerging markets have risen substantially, thanks partly to their limited exposure to US sub prime lending.



Source: Datastream (*market peak prior to subprime sell-off)



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