



# Owen Hodge Financial Planning



## Market Review 2<sup>nd</sup> Quarter 2007

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## Avoiding the winter chill

Major financial markets have largely shrugged off the cool southern hemisphere winter to post yet another quarter of solid returns. Just as we've been lashed with frosty mornings, storms, floods, and plenty of snow in the mountains, the world's markets have also endured some volatility, most notably a surge in bond yields and the re-emergence of US housing worries. The latter has even caused a few hedge funds to go the way of the Pasha Bulka, beaching themselves on the US sub-prime mortgage market rather than Newcastle's Nobby's Beach.

Helping to warm up the markets over the period was the stellar performance of both resource stocks and commodity currencies. In the domestic equity market, the resources sector posted a stellar gain of 15.5%, while the New Zealand, Australian and Canadian dollars were the best performing currencies over the period. These gains in the equity and currency markets reflected growing confidence in the sustainability of the current commodity cycle.

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

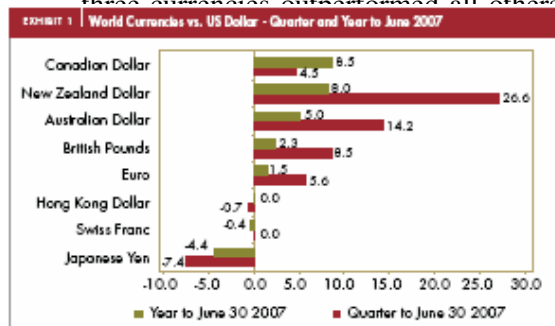
### Snapshot

- **Australian resource stocks rose 15.5%, benefiting from rising energy, oil and coal prices.**
- **Resource-driven currencies, such as the Australian, NZ and Canadian dollars also benefited from growing confidence in the commodity cycle.**
- **Strong GDP growth, muted inflation numbers and continued high commodity prices helped the Australian equity market to rise 5.6% for the quarter.**

### 1. Resources stocks and commodity currencies

The S&P/ASX 300 Resources index posted an outstanding gain of 15.5% during the June quarter, benefiting from rising energy, oil and coal prices. Strength in base metals, in particular copper, also drove the sector higher. The majors (BHP and Rio) were among the star performers, gaining 17.2% and 25.4% respectively, while Fortescue Metals posted a stunning gain of 67.4%. The sector was further supported by global M&A activity, with Alcoa Inc. bidding for Alcan Inc. and speculation emerging over a possible bid for Rio.

Continuing the theme of strong resources prices was the outperformance of the so-called commodity currencies; the Australian, New Zealand and Canadian dollars. This represented a change in market dynamics as prior to the June quarter there had been little evidence of strong commodity prices pushing currencies like the Australian dollar higher. In fact, these commodity currencies had previously risen by broadly the same amount against the US dollar as other floating currencies such as the Euro, Pound, Swiss Franc and Swedish Krona. Over the quarter these three currencies outperformed all others.



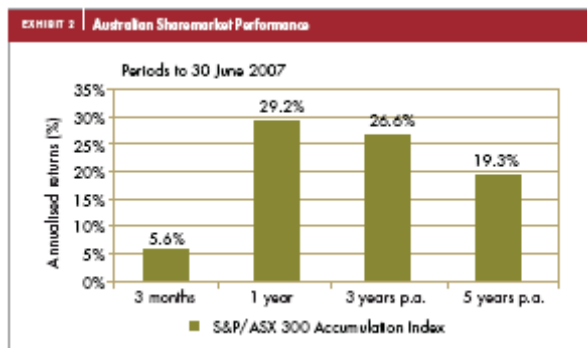
Source: FactSet

### 2. Australian Shares

The Australian equity market continued its rampaging run in the June quarter, rising 5.6% and reaching an all time high towards the end of June. The market was supported by strong GDP growth, muted inflation forecasts, sustained high commodity prices and rising earnings expectations. Small caps dramatically outperformed larger stocks over the quarter, with the Small Ordinaries index rising 10.8%.

The appreciation in the Australian dollar pressured stocks with US dollar revenues, such as News Corp and Cochlear. M&A activity continue to underpin the strong market, with major deals including Ironbridge Capital and Archer Capital bidding for Symbion Health, a proposal (later rejected) to acquire Orica Ltd and Wesfarmers emerging as the only remaining party for Coles. The Resources sector also saw strong M&A activity globally, with Alcoa Inc. bidding for Alcan Inc. and speculation emerging over a possible bid for Rio Tinto.

The strongest performing sectors were Materials and Energy, benefiting from rising oil and coal prices. Strength in base metals and continued M&A activity and speculation drove further supported these sectors. Weak sectoral performers included Transport, Media and LPTs.



Source: Bloomberg

### Snapshot

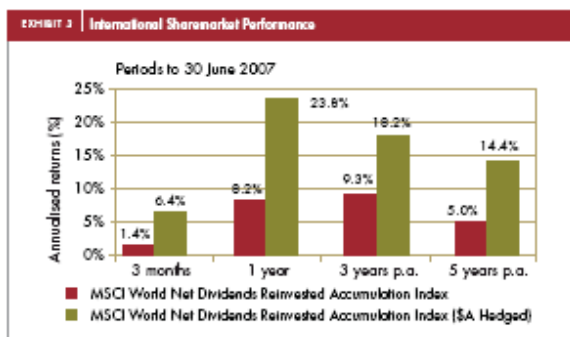
- Global markets rose 5.9% in local currency terms, buoyed by robust growth and continued M&A activity.
- Australian LPTs returned 2.5%, underperforming domestic equities but significantly outperforming global REITs.

### 3. International Shares

Global developed markets fell 3.2% (in \$A terms) in June as concerns mounted regarding the US sub-prime housing market, rising oil prices and a sell-off in the Shanghai stock market. However, strength during April and May led to a 1.4% return for the quarter as developed economies continued to benefit from globalisation and the growth in the emerging markets. In local currency terms, global markets gained 5.9% for the quarter as the US Dollar weakened significantly against the Australian dollar.

Despite concerns about the knock on impact of the US sub-prime sector on the housing market and the wider economy, robust overseas growth and continued M&A activity drove markets higher. Emerging Markets added to their stellar run, significantly outpacing developed markets for the quarter.

Rising oil prices and strong earnings led to a 14.0% return for the energy sector. Despite high valuations, the materials sector gained 11.3% due in part to rising commodity prices. The utilities and health care sectors continued to lag the more cyclical sectors. Growth, as measured by the MSCI World Growth index, returned 7.0% in the second quarter, and in a reversal from previous periods outpaced the MSCI World Value index by 1.0%.

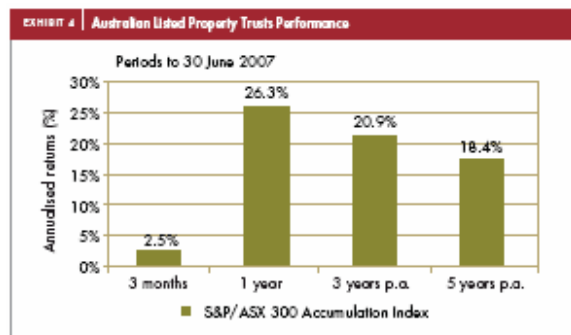


Source: MSCI

### 4. Listed Property Trusts

The Australian LPT sector finished the quarter up 2.5%, lagging behind the broader equity market by 3.1% but outperforming Global REITs significantly by 11.6%. M&A activity provided a boost to the domestic LPT market in April and May. Takeover activities, including Brookfield for Multiplex, ProLogis for Macquarie ProLogis, Morgan Stanley for Investa and rumours surrounding Mirvac triggered a stream of speculative buying across the board in the sector. In June, the sector pulled back amid massive capital raisings, including \$3 billion raised by Westfield and \$1.2 billion raised by Valad, causing the sector to post its worst monthly return since March 1999 of -4.8%. The LPT market was also negatively impacted by rising bond yields both domestically and in the US. Valuations of the US and Japan based trusts continued to be weakened by the strength of AU D against JPY and USD.

Commercial (+16.0%) and Diversified (+4.3%) performed best on the back of the takeover theme while Retail (-1.2%) and Industrial (-0.7%) underperformed. The Leaders were sold off by investors to fund the significant level of stock issuance in June.



Source: Bloomberg

### Snapshot

- **Rising bond yields and rotation away from the sector from general equity investors saw the international property securities market tumble 9.1%.**
- **Australian bonds rose 0.3% as the RBA remained on hold over the period.**

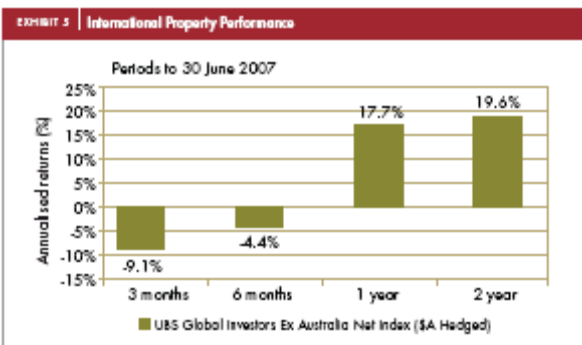
### 5. International Property

The international property securities market fell -9.1% in the second quarter, dramatically underperforming the global equity market by 8.3%. Asia (-2.0% in local currency terms) delivered the strongest returns followed by North America (-9.1%), Continental Europe (-11.1%) and the UK (-14.4%).

Within Europe the Netherlands (-5.4%) was one of the only countries to outperform the global index, while France (-13.8%), Germany (-5.9%) and Sweden (-16.5%) all lagged.

Singapore (+10.7%) posted the best return of all global property markets during the quarter, while Hong Kong and Japan fell 2.6% and 5.4% respectively. Favourable supply/demand fundamentals in Singapore's residential market are maintaining upward pressure on rents, which are expected to grow 25% – 35% over the next two years, according to UBS.

Both Canadian (-6.9%) and US (-9.3%) real estate securities posted negative returns. A confluence of factors contributed to the sharp correction, including higher interest rates, sector rotation by general equity investors and cash outflows from individual investors. Because dividend yields have recently traded at a negative spread to the 10-year Treasury, REIT share prices were more vulnerable to rate increases.



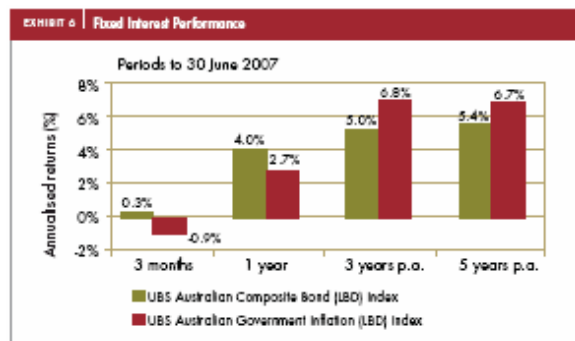
Source: UBS

### 6. Australian Bonds

The Australian bond market was up 0.3%, lower than the return on bank bills at 1.6% although outperforming the international bond market, which fell 0.5%.

The market started the quarter positively before being dragged down by the heavy sell off of global bonds in May and June. Interest rate hikes in New Zealand and Europe, along with strong US economic data which dissipated the hope of policy easing, triggered the fall in global bonds. Domestically the RBA held interest rates unchanged on the back of benign inflation, however employment remains robust and investors have priced a full cash rate hike into the market.

Corporate bonds underperformed “risk free” government bonds as investors continued to reduce their risk appetite. In the US, credit spreads further widened as hedge funds were unwinding collateralised debt obligations to cover losses on sub-prime mortgage exposures. The negative impacts were however mostly contained to the US financial sectors. The Australian corporate and asset backed credit market was only modestly affected.



Source: UBS

### Snapshot

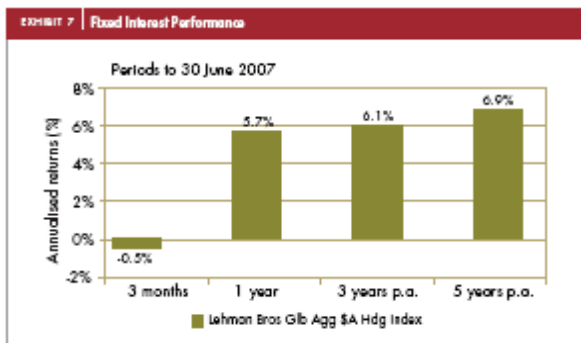
- Improved US data saw bond yields rise and the international bond market fall 0.5%.
- Rising bond yields were observed across the globe, largely driven by rising real yields rather than inflation expectations.

### 7. International Bonds

International bonds had a good start to the quarter but were sold aggressively in late May and early June and finished the quarter down 0.5% in \$A hedged terms.

The sell-off was fuelled by improved US economic data, which prompted investors to reassess their expectations for US interest rates. The data boosted expectations for continuing global economic growth. Towards the end of June, however, weaker than expected US economic data and two Bear Stearns hedge funds reporting heavy losses on their US sub-prime mortgage positions, supported a rally in international bonds. Despite the late June rally global bonds could not finish in positive territory.

Corporate and high yield spreads widened towards the end of June as investors re-priced risk premia over concerns that the US sub-prime problems could spark a significant bout of risk aversion that would impact other higher-yielding fixed income assets. Corporates marginally outperformed governments, while high yield and emerging markets also outperformed despite the flight to quality in mid-quarter.



Source: Lehman Brothers

### 8. Rising bond yields

One of the major factors driving financial markets over the past three months was the sharp increase in global bond yields. For example, yields on 10 year US Treasuries rose from 4.5% in early March to 5.2% in mid-June, before easing back to 5.0% at quarter-end. Rises of similar magnitudes were recorded across all major bond markets, including Europe, the UK and Australia. The current bond market sell-off, however, has been largely driven by rising real yields rather than inflation expectations. Real yields (as measured by US TI Ps), increased by broadly the same amount over the quarter, suggesting inflation expectations remain largely unchanged. The chart below displays the synchronous rise in real and nominal yields over the quarter.

Despite this, the rise in bond yields is perceived by many as the beginning of a change in the way markets are pricing risk. This re-pricing of risk has been observed elsewhere, with a number of Private Equity buy-outs failing and trouble in the CDO and sub-prime housing markets hurting a number of hedge funds. The rise in bond yields was also a key driver of the poor performance of the US REIT market over the period.



Source: Datastream

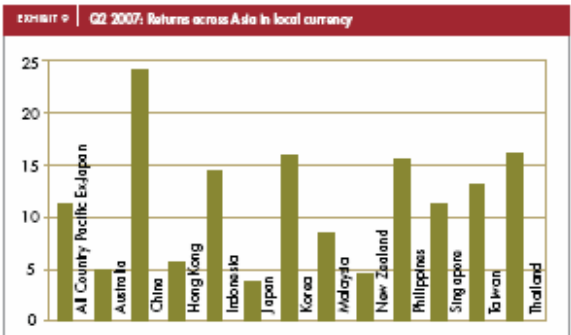
### Snapshot

- **The Asian equity markets continued to perform well, with Asia ex-Japan gaining 11.3%. Japan lagged with a 3.9% return for the period.**
- **Australian small caps left large caps well behind in Q2, rising 10.8%. This pattern was reversed across most other global equity markets.**

### 9. Japan and Asia

Japan's market rose 3.9% over the quarter, a solid return albeit trailing global markets. Better-than-expected employment and manufacturing data in the US, Japan's most important export market, contributed to the positive performance for most of the period. The depreciation of the yen versus the US dollar and a sharp increase in Japan's trade surplus benefited Japanese exporters, helping them to outperform over the period. Bullish data reinforced market expectation that the Bank of Japan will raise interest rates in the next few months. Large cap stocks significantly outperformed small cap and growth companies outperformed value companies.

The MSCI AC Asia Pacific Free ex Japan Index rose 11.3% over the period. Exporters benefited from stronger manufacturing and employment data in the US, the region's major export market. Despite some episodes of volatility, China was the best-performing country in the region after benefiting from strong returns from the local China stocks listed in Shanghai as domestic investors continue to pile into stocks. Korea also performed strongly after being boosted by a free-trade agreement with the US. The defensive Malaysian market, which had outperformed in the previous quarter as China declined, underperformed during the second quarter after a period of profit taking.

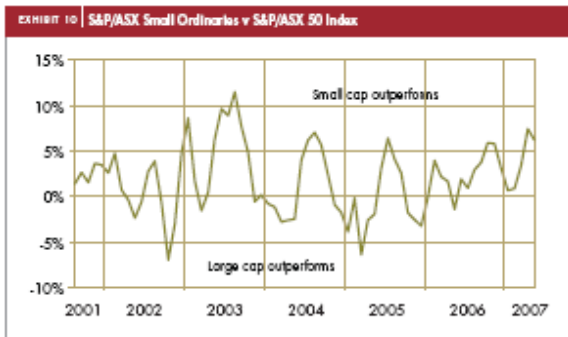


Source: MSCI, FactSet

### 10. Large cap vs. small cap

The domestic small cap sector continued to outpace large caps, with the Small Ordinaries index returning 10.8% during the June quarter, significantly outperforming the large cap S&P/ASX 50 index return of 4.9%. Over the past year, small cap stocks have left their large cap peers well behind, posting an outstanding gain of 44.4% versus a comparatively meagre (but still very respectable) 26.4% return for large caps. The key drivers of the small cap sector over the past quarter and year have been from the resource sector; indeed more than half of the Small Ords' Q2 return was attributable to resource stocks. Most notably, speculative miner Fortescue Metals has achieved returns of 67.4% and 255.8% over the past quarter and year, respectively. This stock now looks set to go the way of Paladin Resources, which was also a key driver of the small cap sector before migrating to the large cap index.

The opposite pattern was observed globally over the quarter, with the MSCI Small Cap index underperforming its large cap equivalent by 1.3%. In the US small caps also underperformed large caps, with the small cap Russell 2000® Index gaining 4.4%, trailing the large cap Russell 1000®, which rose 5.9%.



Source: Bloomberg



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