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Market Review 3rd Quarter 2007

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Don't blink – you might miss it!

If you'd gone on holiday through the third quarter and were viewing the headline numbers for major financial markets, you could be forgiven for thinking it was a pretty uneventful quarter. Nothing could be further from the truth – although most markets closed the period higher than they started, it was one of the most eventful quarters in recent memory.

What started with increasing default rates of US subprime mortgages quickly spread to institutions investing in mortgage backed securities. The resulting credit crunch led to higher credit spreads and a decline in corporate activity. Equity markets sold off heavily, while significant deleveraging from hedge funds and quantitative investment managers sparked concerns for those invested in these strategies. Towards the end of the quarter, the US Fed dropped the Fed Funds rate by 50 basis points – more than most participants expected – which resulted in a sharp rally in equity markets.

If you blinked you missed it, as this rally in equity markets resulted in most around the globe posting positive returns for the quarter, masking the intraquarter gyrations. In this edition of Market Review, we discuss the performance of the investment markets over the third quarter of 2007, along with the major economic trends affecting them.

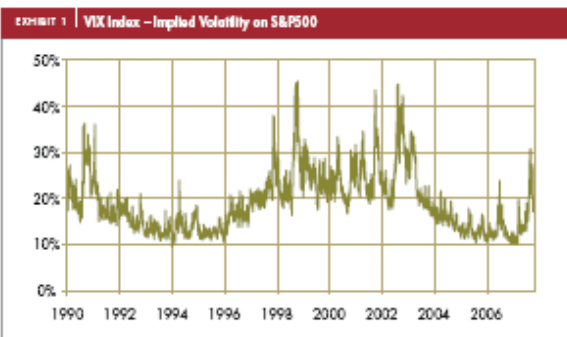
Snapshot

- Volatility ticked up considerably over the quarter, with the VIX index more than doubling between mid July and mid August.
- Problems in the US subprime mortgage market spilled over into major debt and equity markets. Banks remain cautious lending to one another; the spread between bank bills and the cash rate indicates that a degree of risk aversion is still present.

1. Volatility – back at last

The fallout from the US sub-prime crisis has led to a significant increase in volatility after what has been a prolonged low volatility environment. The VIX index, which is calculated from the implied volatility on options on the S&P 500 index, shows that the market's expectations of future volatility more than doubled over the quarter, rising from 15.2% in mid July to a high of 30.8% in mid August. These levels are the highest seen since March 2003, although they are still well below the high points reached in 1998 after the Long Term Capital Management collapse and the Russian debt crisis, and in the early 2000s towards the end of the tech boom.

Cross sectional volatility, a measure of return dispersion across stocks in a market, also ticked up over the quarter. The increase was most pronounced in global equities, although similar patterns were observed across most major global equity markets, including Australia. Again these new levels of higher volatility are still somewhat below those observed in the early 2000s, although they represent a significant shift away from the low volatility environment of the past four years.

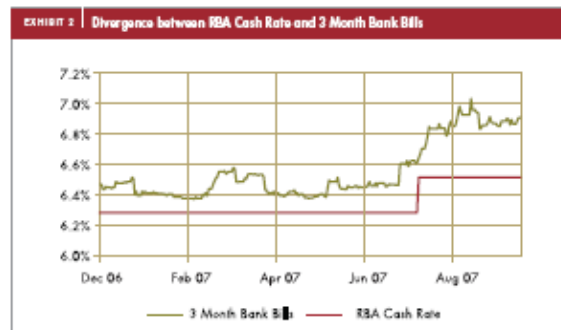


Source: Bloomberg

2. Sub-prime contagion

The volatility that gripped financial markets in the September quarter had its roots in the US sub-prime lending crisis. Several years of strong competition had led to a reduction in lending standards and as interest rates rose and teaser rates rolled off, many borrowers were unable to meet their repayments. As investors in mortgage backed securities realised losses, the fallout spread to broader credit markets, leading to a liquidity crunch, rising spreads and a virtual shut down of the CDO market. Equity markets also sold off heavily before recovering following the Fed's 50bp easing.

The Australian market was not immune to fallout. For example, firms such as RAMS that relied on short term debt to fund their long term lending were unable to roll their funding book, which saw the company's stock plummet 65% post IPO. Further, as banks have become more wary of lending to one another, the three month bank bill rate has diverged from materially from underlying cash rate, reaching a peak of 56bp in mid September. The spread is still high at 43bp, showing that although the equity markets have seemingly forgotten the August volatility, the money markets have not.



Source: Bloomberg

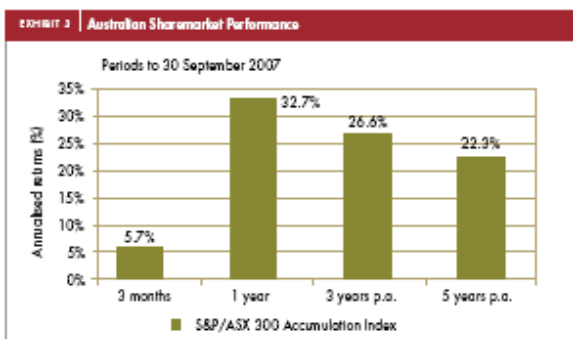
Snapshot

- What market correction? Australian equities rebounded strongly to post yet another solid return of 5.7% for the quarter.
- International equities also recovered strongly from the August sell off, closing the quarter steady. Unhedged investors suffered from the strong Australian dollar.

3. Australian shares

The Australian equity market posted a stellar point-to-point return of 5.7%, masking significant intra-quarter volatility. The S&P/ASX 300 Accumulation Index fell by almost 10% from the end of June to mid-August in the midst of growing concern over the US sub-prime fallout, before rallying strongly in September to close the quarter at record highs. After the July weakness became more severe in August, the US Federal Reserve reduced the discount rate window by 50bp, and later followed up with a larger than expected 50bp cut in the Fed funds rate. These actions saw global markets rebound strongly, while negative net equity issuance and continued strong demand from superannuation saw the Australian market rebound even more sharply.

M&A speculation continued unabated, with Sims, ANZ, Orica and Leighton all making offshore acquisitions. Rio Tinto made a splash with the approval of its \$38bn Alcan takeover, the Wesfarmers/Coles takeover neared completion and Adelaide and Bendigo Banks announced a \$4bn merger. The Metals and Mining sector again performed strongly, benefiting from continued high oil and coal prices. Poorer performing sectors included Information Technology and Telecommunications.

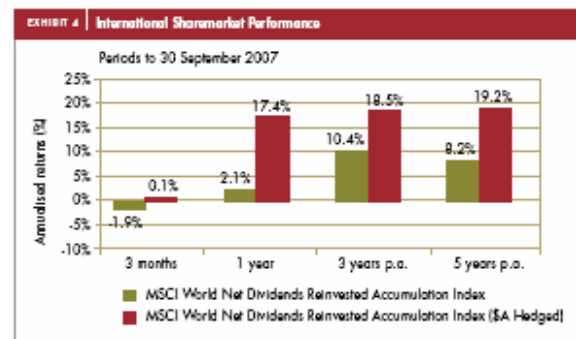


Source: Bloomberg

4. International Shares

Global equity markets were broadly flat (in local currency terms) over the period. Equity markets initially succumbed to the tremendous volatility and turmoil within credit markets as investors worried about the potential for subprime problems to spill over into the real economy. However, the decision by the US Fed to lower the Federal Funds Rate by 50bp led to a sharp recovery. Commodity prices continued to soar with gold reaching 27 year highs and oil reaching a record \$US83 dollars a barrel. With commodities on the rise, the Materials sector posted the strongest gains during the quarter. The Consumer Discretionary and Financials sectors continued to lag as the effects of sub-prime lending in the US spread to other global markets including Germany and the UK.

The Pacific ex Japan region was by far the best performing area of the market, buoyed by continued strong performances in Emerging Markets. Chinese H-Shares were particularly strong, jumping 42% for the quarter and over 72% for the year to date. Japan on the other hand has continued to lag, falling 0.9% for the quarter. Growth stocks outperformed their value counterparts, while large caps outperformed small caps.



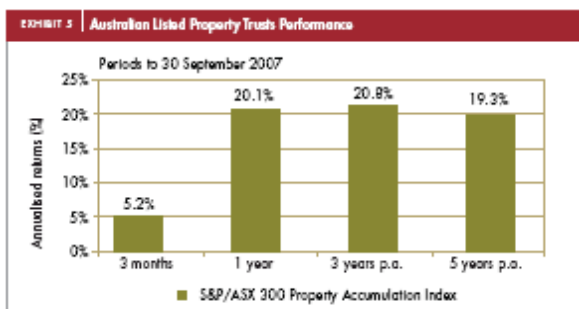
Source: MSCI

Snapshot

- LPTs performed well, gaining 5.2% after benefiting from a switch into defensives during August and then maintaining their form through September.
- International property fell 1.94%, driven primarily by poor performances in the UK and Continental Europe. The US market held up reasonably well, returning 2.0%.

5. Listed Property Trusts

The Australian LPT sector finished the quarter up 5.2%. All but one sub-sector outperformed the broader equity market, with Office Trusts underperforming by -0.1%, which dragged the LPT benchmark into underperformance against the ASX300. Large LPTs with quality portfolios received a significant boost this quarter as investors sought refuge in the relatively lower risk giants like Westfield (+11.5%) and Stockland Group (+10.4%). Volatility in the Australian dollar also had a large impact on firms with unhedged overseas exposures. ING Industrial Fund (+22.8%) was the best performer following speculation of a possible takeover from Goodman Group after it acquired a 9.4% stake. Other M&A activities did not receive as favourable responses from the market with Centro Shopping America's (-12.0%) merger proposal with Centro Retail Trust shunned for its disappointing terms. Other major sales include LaSalle's purchase of Westfield Doncaster from Westfield Group, with investors reacting positively as these funds will be channelled to Westfield Group's other development projects.



Source: Bloomberg

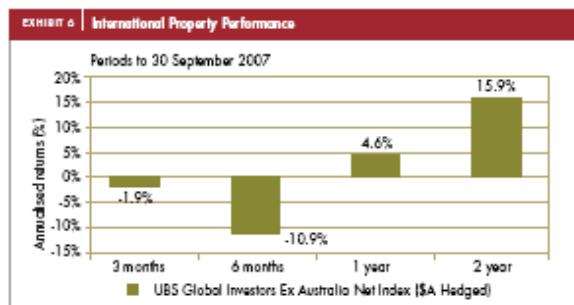
6. International Property

The international property securities market returned -1.94%, underperforming global equities by 2.03%. North America (+1.9% in local currency terms) was the only region to deliver a positive return over the quarter, followed by Asia (-4.8%), Continental Europe (-8.2%) and the UK (-10.2%).

Sweden (-3.1%) and France (-4.0%) were the best of a poor bunch in Continental Europe, followed by the Netherlands (-6.1%) and Germany (-9.1%). The UK market posted disappointing returns on the back of speculation that NA Vs are poised to fall.

Hong Kong (+1.5%) headed up the Asian index, led by the developer companies as a result of their efforts in mainland China. Singapore (-5.3%) and Japan (-7.7%) fell behind and underperformed the broader index.

In North America, US (+2.0%) and Canadian (-0.5%) real estate securities outperformed the index. The heightened market volatility over the past three months appears to have removed the speculative valuation premiums that had been applied to REITs due to the robust merger and acquisition activity over the last several years. Concerns about a weaker economy and more stringent mortgage lending standards amidst an overall tightening of credit has put the focus back on real estate fundamentals and the specific growth prospects of each company.



Source: UBS

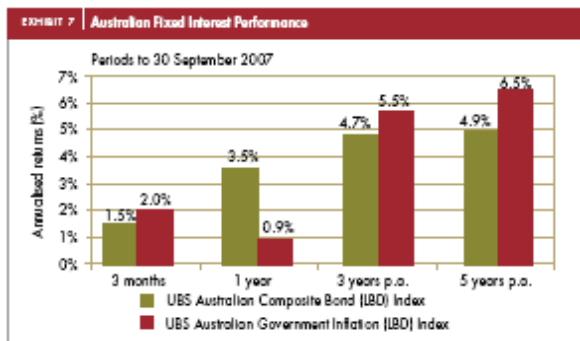
Snapshot

- Australian bonds showed their defensive character, gaining 1.5% in a quarter that saw the RBA raise rates by 25bp.
- It was a solid month for international bonds, buoyed by a flight to quality in the wake of widespread sub-prime losses.

7. Australian Bonds

The Australian bond market rallied 1.5%, outperforming bank bills at 1.1% but lagging behind the international bond markets which advanced 2.9%.

Following the global market trend, the Australian bond market started the quarter strongly as investors returned to the relative safety of government bonds following the fallout US sub-prime crisis. The market stabilised in September after the Fed cut rates to avert growing contagion. Domestically, the RBA retains its tightening bias and raised interest rates by 0.25% in August, a widely anticipated move that was already priced into the market. The slope of the yield curve was less inverted with short term bond yields falling more than longer term yields, reflecting expectations of a tightening cycle on hold until the turmoil in the credit market settled. Corporate bonds underperformed government bonds. The dramatic repricing of risk across all sectors of the credit market, including high quality investment grade bonds, saw credit spread and swap spread widen significantly during the quarter. In particular, diversified financial sectors and bank senior and subordinated debt were hit hardest.

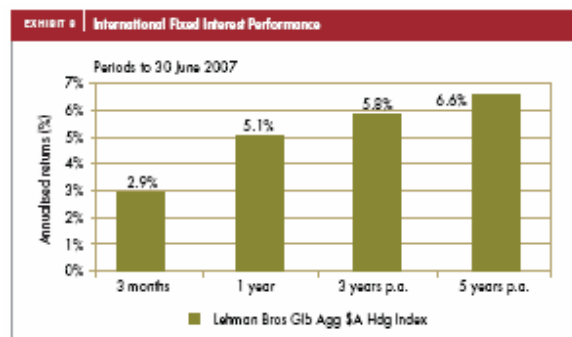


Source: UB S

8. International Bonds

The Lehman Brothers Global Aggregate Index rose by 2.9% in \$A Hedged terms. Gains in the index were buoyed by a flight to quality following widespread sub-prime losses among financial institutions and adverse credit sector conditions. In early August, central banks led by the European Central Bank and the Federal Reserve (Fed) flooded the markets with liquidity in an attempt to help financial institutions overcome tight credit conditions in the money markets. In addition, the Fed later cut its lending rate to commercial banks by 50 basis points to 5.75%, before also cutting the Fed Funds rate by 50bp towards the end of the quarter. It also issued a statement signaling that it would be willing to take additional measures if economic conditions deteriorated markedly. Fixed income investors reacted positively and moved to price in a series of rate cuts in the US for the rest of the year.

In terms of sectors, credit and high yield underperformed governments due to the flight to quality. Risk aversion impacted currencies as investors unwound their carry trade positions prompting a sharp yen rally. The US dollar initially rose against the major currencies as it benefited from its safe haven status, before closing the quarter weaker after the Fed rate cut.



Source: Lehman Brothers

Snapshot

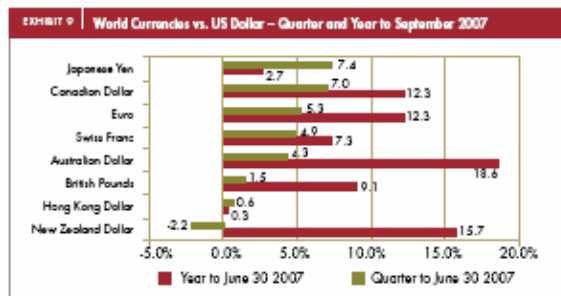
- **The US dollar again fell against major currencies, however this end result masked significant volatility that momentarily saw the US rally against major currencies in August.**
- **Demand/supply dynamics helped push the Australian equity market higher as inflows from superannuation and the Future Fund met reduced supply due to the completion of major takeovers.**

9. Currency – weak US dollar drives Australian dollar higher

The September quarter was an interesting period for currency movements. After weakening for most of the year, the US dollar actually strengthened markedly against most major currencies during the turmoil that hit financial markets in August. Since then, and in particular since the Fed's monetary easing, the US has resumed its downward slide.

The Australian dollar is now trading at just under 90 US cents, having breached the 90 cent barrier briefly after quarter-end. The main factor driving the Australian dollar higher has been the weakening of the US dollar in trade weighted terms, which has been largely driven by the USD current account deficit reaching 6% of GDP. Sustained strong commodity prices have continued to support currencies like the Australian, NZ and Canadian dollars against the US dollar, while a combination of RBA tightening and Fed easing has delivered additional momentum to the Australian dollar.

The weak US dollar was again troublesome for unhedged investors in international equities. Over the past year for example, the difference in returns between hedged and unhedged international equity exposures was a staggering 15.3% (17.4% vs. 2.1%).



Source: FactSet

10. Equities recover from the abyss – Australia and Asia shine

One of the most striking events of the quarter was the stellar recovery in equity markets following the August collapse. Although the global market managed (just) to claw back its losses, both the Asian (ex Japan) and Australian markets shot through previous levels to reach all time highs.

The Asian market was driven primarily by strength in the Chinese equity market, which has risen by more than 70% year-to-date. The Australian equity market also benefited from the China theme, in particular through the outstanding performance of resource stocks like BHP (+28.3%) and Fortescue Metals (+41.1%).

Perhaps the biggest factor supporting the Australian market of over the quarter was the enormous inflows into the market from superannuation and the government's \$50bn Future Fund (although the asset allocation is not yet known, it's fair to assume a large proportion is allocated to the local market). Adding to this was the negative net equity issuance over the period as takeovers of Rinker, Investa and Alinta were finalised. The market was therefore buoyed by strong inflows, combined with a substantial decline in the number of securities available for purchase. It is therefore not surprising to have seen such strong returns from Australian equities over the period.



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



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