



Owen Hodge Financial Planning



Market Review 1st Quarter 2007

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Riding the bumps to greener fairways

I enjoy a game of golf. Unfortunately, I tend to make a mistake that is common not only to golfers, but investors too. No, I'm not suggesting investors should see a coach about that uncontrollable slice. I'm referring to the bad habit of dropping my bundle after just one bad hole, and letting it negatively affect the way I play the rest. Similarly, too often investors let one bad experience change their behaviour, often capitulating and selling out at the bottom of the market.

During the March quarter the world's equity markets had a 'bad hole' when a sell-off in the Chinese market sparked a one day fall of approximately 3% across the globe. As is often the case, however, the markets responded strongly following this fall, with the global equity market returning 2.1% (in local currency) and the Australian equity market powering on to gain 7.0% over the quarter.

The main lesson to come out of this blip in the market is that volatility is a fact of life, just like bad golf shots. The key is to ensure we don't let the volatility change the way we play the game. History tells us that riding out the bumps and maintaining a disciplined approach yields better long-term results than knee jerk reactions to short term events.

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

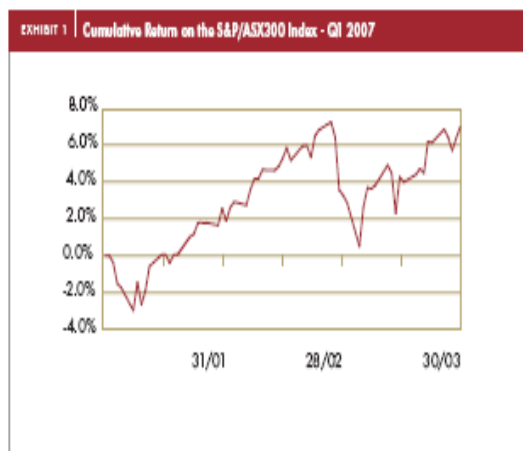
Snapshot

- Almost all the losses from the February 28 market decline were recouped by the end of the quarter
- The performance of bonds and cash on this day provides a timely reminder of the role defensive assets can play in a diversified portfolio

1. Investors gain from staying the course

February 28 2007 saw the largest one day fall (2.7%) in the S&P/ASX 300 index since September 2001, mirroring similar falls across the globe. These declines were triggered by a 9.0% drop in the Shanghai stock market, which fell on fears of government intervention in the financial markets. This news was compounded by the release of weak US economic data and concerns of a collapse in the US sub-prime lending sector.

History tells us that such declines are often followed by market rallies, and this one was no different. As the chart below shows, almost all of the losses from the February decline were recouped by the end of the quarter. Avoiding the temptation to panic and sell out therefore proved a good strategy over the quarter, as it has tended to do in the past. Indeed, of the 50 largest one day declines since 1980, the average return over the subsequent 6 months was 14.7%. Although the nature of equity market volatility means such a positive result is by no means guaranteed, it should provide some comfort the next time the market takes a backward step.



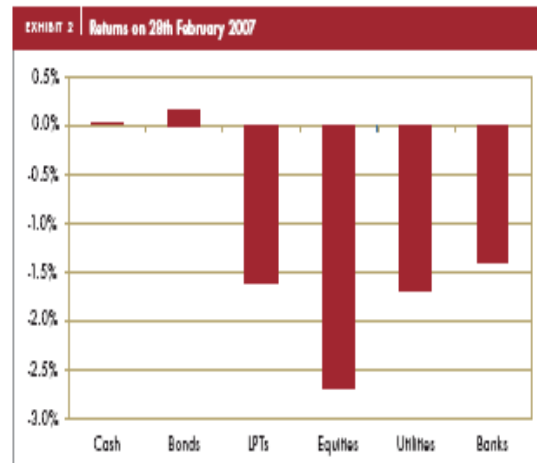
Source: Bloomberg

2. Difficult lie for defensives

The February market decline highlighted that volatility in equity returns is not going away. This volatility is the reason equities tend to outperform more defensive asset classes over the long term. For investors willing to ride out the bumps, such volatility should therefore be welcomed. For those less willing or able to bear such volatility, however, the role of defensive assets becomes more important.

The chart below shows the returns on a range of sectors on the day the equity market plummeted. On the day the Australian equity market fell 2.7%, the LPT market also fell but not as far, dropping 1.6%. Unfortunately for LPTs, they didn't continue this defensive orientation through the entire quarter and actually posted a negative return. Other traditionally defensive sectors, including the Banks and Utilities, fared similarly to LPTs on this day, falling 1.4% and 1.7% respectively. One of the best defensive plays on this day was Woolworths, which bucked the trend to rise 1.2%.

As expected, when the equity market plummeted cash was unaffected, while the domestic bond market rallied 0.2%. The performance of bonds and cash this day provides a timely reminder of the important role defensive assets can play in a diversified portfolio.



Source: Bloomberg

Snapshot

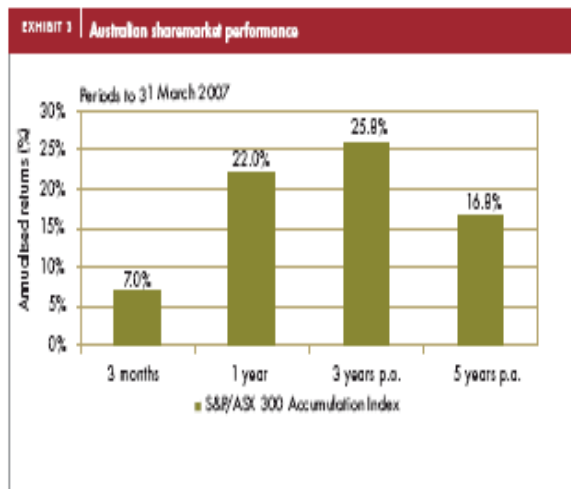
- The Australian equity market continued its strong run gaining 7.0% despite a substantial correction in late February to mid-March
- Global equity markets rose 2.1% in local currency terms, driven by strength in the materials sector

3. Australian shares recover from the bunker

Despite a correction across global equity markets at the end of February through to mid-March, the Australian equity market continued its strong run, returning 7.0% for the March quarter.

Over the quarter the Australian equity market was buoyed by a strong flow of economic data that suggested both domestic consumer and business sentiment remains strong. Also, the recent M&A activity continued unabated, with Bank of Queensland instigating a bid for Bendigo Bank along with a private equity bid for Veda Advantage.

The Resources sector performed well for the quarter, with the larger firms such as BHP and Rio Tinto benefiting from renewed strength in the copper price and a more confident outlook for the price of iron ore. Over the quarter, the Materials sector underperformed as the outlook for the US housing and construction market continued to deteriorate. James Hardie was the worst affected, falling 13%. The LPT sector fell by 2.3% for the March quarter, ending the record run of seven consecutive positive quarters as the sector felt the impact of a strengthening Australian dollar.



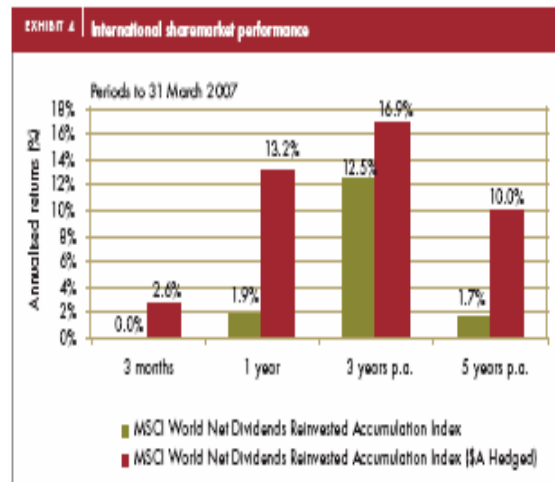
Source: Bloomberg

4. International shares score a solid par

Global markets rose 2.1% in local currency terms during the March quarter. For Australian investors, the strong domestic currency depressed these local currency gains as the international equity market returned 0.0% in Australian dollar terms. Materials stocks ended the quarter up 8.7% (in local currency) with particularly strong gains from the metals and mining sector despite concerns over declining profit margins and high valuations.

Technology was the biggest laggard during the period, falling 0.6%, with many of the communications equipment companies retreating with increased competition in the industry. The financials sector also lagged due to underperformance by large US banks such as Lehman Brothers and Merrill Lynch, both down over 10% for the quarter.

Regional performance trends favoured the Pacific ex-Japan region (+5.6%) with gains tied primarily to some of the region's large resource stocks, including BHP Billiton, which posted a gain of more than 19%. After gaining more than 8% through February 27, Japan lost ground in March and finished the quarter up only 2.6%. In contrast, after falling during the markets' February sell off, the emerging markets regained some momentum in March resulting in a gain of 2.2%.



Source: MSCI

Snapshot

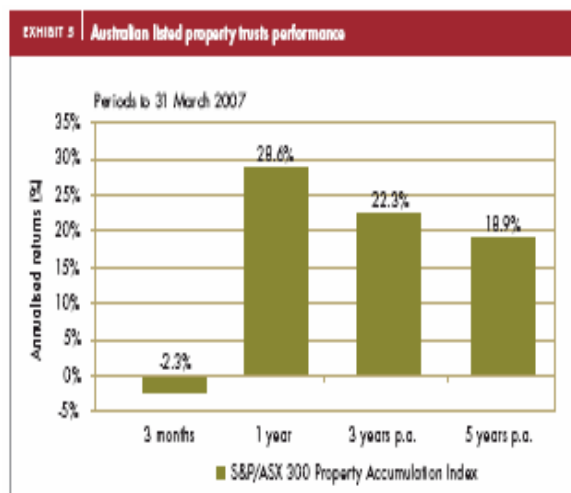
- The LPT sector delivered its first negative return of 2.3% after seven consecutive positive quarters
- Asian property stocks lead the way as the international property sector posted a stellar 5.2% first quarter return

5. Double bogey for listed property trusts

The LPT sector delivered its first negative return of 2.3% after seven consecutive positive quarters, significantly underperforming the broader equity market. After a stellar December quarter fuelled by offshore capital, LPTs started to retrace with the bulk of the underperformance coming in March as the sector fell 4.0%.

Domestic LPTs were adversely impacted by volatility in the global REIT market. The strength in Australian dollar against the US dollar also raised concerns given the US dollar earnings streams of a number of trusts. Approximately \$2.3 billion was raised over the quarter, with \$1 billion of this being used to fund Centro's takeover of New Plan Excel. Such high levels of supply acted as a further drag on sector.

All sub-sectors posted negative returns. Retail trusts (-1.3%) performed best, lifted by Westfield's improving performance (+0.3%). Diversified (-3.1%) was the worst performer, led by the poor performance of GPT.



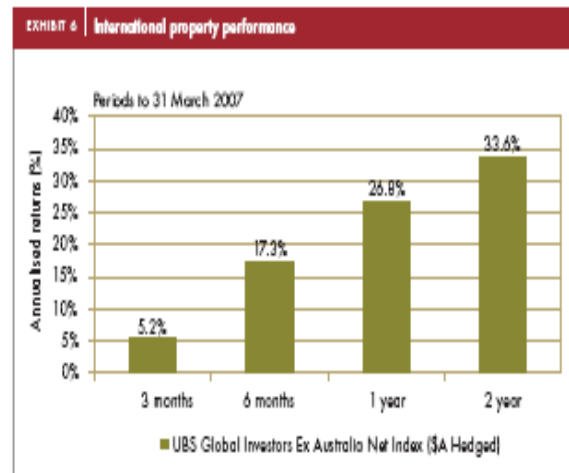
Source: Bloomberg

6. Int'l property benefits from Asian hitout

The international property securities market returned 5.2% in the first quarter. Asia (+19.6% in local currency terms) delivered the strongest returns followed by Continental Europe (+8.9%), North America (+4.0%) and the UK (-3.8%).

Performance was generally positive in Europe, with France (+12.5%) and Sweden (+11.1%) leading the way by a wide margin. The UK lagged following a strong run-up in the fourth quarter of 2006 and an unexpected interest rate rise at the beginning of the quarter. Japan (+24.9%) topped the Asian region, followed by Hong Kong (+15.6%) and Singapore (+10.3%). Japan continues to experience strengthening property market fundamentals, while strong residential prices in Singapore continue to drive this market.

In North America, Canadian (+5.5%) real estate stocks pushed forward while the return in the US (+3.8%) masked a relatively high level of volatility. In the first half of the quarter, REIT prices soared 13%, due mainly to the heated bidding war for Equity Office Properties (EO P). The downdraft of about 10% during the second half of the quarter was driven by broad equity market weakness, weaker than expected fourth quarter earnings, disappointing 2007 earnings guidance and high valuation levels.



Source: UBS

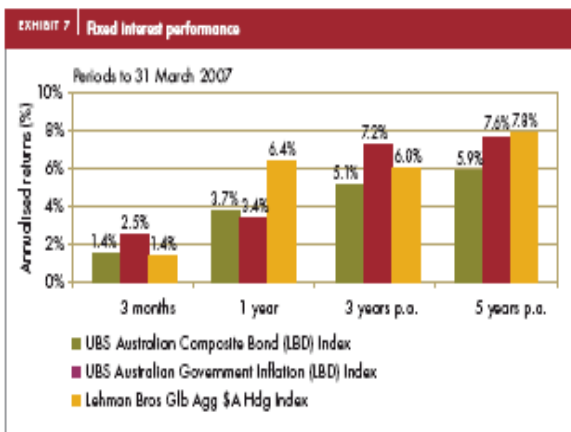
Snapshot

- Australian and international bonds survived a volatile quarter to each rise 1.4%
- After a 2006 that growth stocks would rather forget, there was somewhat of a comeback in early 2007

7. Fixed income avoids the hazards

The Australian bond market advanced 1.4%, lower than the return on bank bills at 1.6% but in line with international bond markets. The Australian bond market was strong in the first half of the quarter before weakening towards quarter-end. Lower than expected Q4 CPI data dampened fears for an RBA rate hike early in the quarter, although this was somewhat tempered by strong domestic demand and near full employment, which has seen the market reprice a full rate hike into the market by June.

Global bonds had a volatile first quarter, but still managed to return 1.4%. The spike in volatility at the end of February was sparked mainly by credit concerns in the US sub-prime mortgage sector, a global equity sell-off and former Federal Reserve (Fed) Chairman Alan Greenspan's remarks over a possible economic recession in the US. Investors re-assessed risk premia and moved into safer assets. Despite safe-haven buying at the end of February, high yield and corporates outperformed governments. The mortgage backed security (MBS) sector underperformed, driven by the slowdown in the US housing market and concerns about whether the sub-prime mortgage crisis would affect the entire mortgage sector.



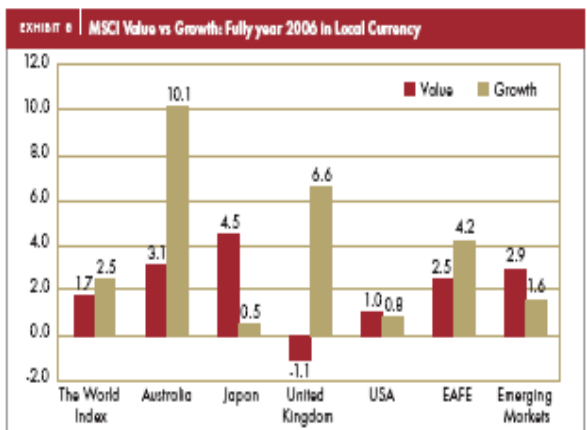
Source: UB S, Lehman Brothers

8. Growth takes match play honors over value

After a 2006 that growth stocks would rather forget, there was somewhat of a comeback in early 2007. The MSCI Australia Growth Index outpaced the Value Index by a staggering 7%, while a similar pattern was witnessed in the UK, with growth stocks outperforming value by 7.7%.

Although value outperformed growth in the US and Japan, the net result for the World Index was value rising 1.7%, trailing the growth return of 2.5%. In the US, growth stocks continue to struggle to meet their value peers, with stocks like Microsoft and Cisco Systems weighing down the sector in the March quarter. The sustained underperformance of US growth stocks has only increased the chorus of market analysts who claim that the sector is substantially undervalued and likely to outperform going forward.

Small cap stocks continued to outperform large cap in the Australian market, although by a narrower margin than in the December quarter. In Australia the Small Ordinaries Index returned 7.3%, outpacing the S&P/ASX 50 Index return of 6.8%. In the US small caps also outperformed, with the small cap Russell 2000® Index gaining 2.0%, ahead of the large cap Russell 1000®, which rose 1.2%.



Source: MSCI

Snapshot

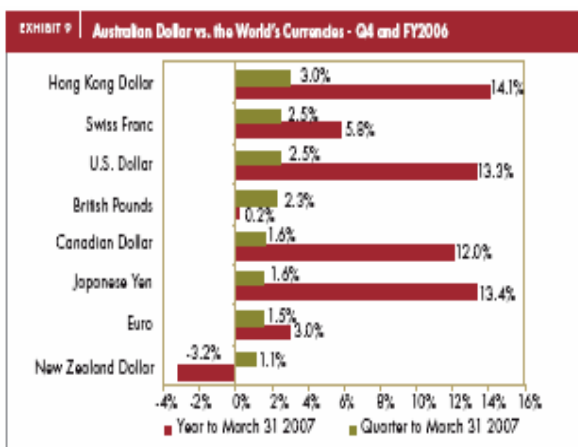
- The Australian dollar shot through USD\$0.80 for the first time in nearly 20 years
- The shake-out in the US sub-prime mortgage lending sector emerged as a major theme in the March quarter

9. Currency: Australian dollar opts for the driver

The Australian dollar resumed its strength from 2006 through the first quarter of 2007, shooting through US\$0.80 for the first time in nearly 20 years. A weak US dollar has continued to be the key driver of the domestic currency. In addition, market views on Australian and US monetary policies have diverged significantly, adding further strength to the Australian dollar. Hawkish comments from a senior RBA official have seen the market price in an additional quarter-point tightening, while in the US the housing downturn and weak business investment reports have markets pricing in at least 50bp of Fed easing by the end of the year.

Other currencies that have benefited from US dollar weakness include the New Zealand dollar, euro and the Pound, gaining 1.4%, 0.9% and 0.2% respectively over the quarter. Asian currencies have also risen relative to the US dollar, with the yen gaining 0.9% and the Singapore dollar rising 1.0%.

For unhedged investors in International shares the strong Australian dollar again reduced returns, with the MSCI World Hedged Index outperforming the unhedged index by 2.6%.



Source: FactSet, Reserve Bank of Australia

10. US sub-prime mortgage market takes a drop

In late February the United States witnessed the beginning of a shake-out in the sub-prime mortgage lending sector, with the dramatic rise in defaults emerging as a major theme for the quarter. While the initial period of market volatility had multiple precipitating causes, the current broad weakness in risky assets seems more directly linked to worries that the ongoing and unfolding sub-prime lending problems could spread more widely.

While cracks in this sector began to visibly appear in late February, the roots of the problem have been building for some time. The key causes have been a slowing US housing sector combined with a rapid increase in the number of mortgages classified as 'sub-prime'. The chart below shows Corporate bond spreads in the United States widened during the quarter amid the turmoil in the sub-prime mortgage market. Even so, spreads remain low by historic standards and have only returned to levels that prevailed in mid-2006. The danger is that further fall-out from the sub-prime mortgage market could trigger a more general aversion to risk, sending credit spreads wider.



Source: Moody's BAA less 10-year Treasury, Datastream



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