



Owen Hodge Financial Planning



Market Outlook 2nd Quarter 2007

Level 2, 12 - 14 Ormonde Parade
Hurstville NSW 2220
ph. 9570 7844
office@ohfp.com.au
www.ohfp.com.au

Market Outlook

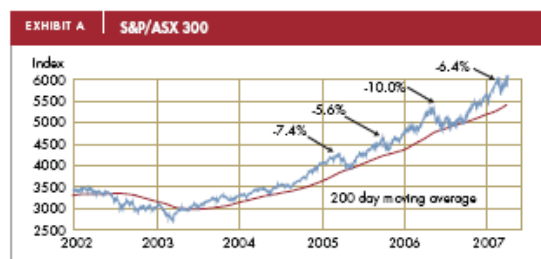
- Volatility is normal in equity bull markets and more may be on the way given the strong recent rally.
- Positive medium term market outlook is underpinned by the low market PE ratio, high dividend yield and outlook for continuing low bond yields.
- Equity market is transitioning from earnings driven to being driven by valuation re-rating.

Shaken but not stirred

Investors' nerves have been tested over the past couple of months with global equity markets suffering two sharp jolts. The first, on February 27 was in response to a 10% one-day decline on the Chinese stock market that saw the US market suffer its biggest daily loss (-3.5%) since September 2001. The second in mid-March was triggered by concerns about rising default rates in the subprime US mortgage market and resulted in 2% declines in both the US and Australian share indices.

"Share markets do not appear over-valued in PE ratio terms and offer good value relative to government bonds."

By mid-April, however, these setbacks had become a distant memory with the S&P/ASX 300 setting record highs. More volatility is likely over the next few months. The S&P/ASX 300 is trading well above its 200-day moving average – a warning signal that the market may react sharply to any adverse news. Furthermore, markets still have to digest the extent of the US housing led economic slowdown (some commentators are predicting a recession). In Australia, there is the possibility of more Reserve Bank interest rate increases.



Source: Datastream

Even so, the medium term outlook is still positive and the risk of a bear market appears small. Share markets do not appear overvalued in price-earnings (PE) ratio terms and offer good value relative to government bonds. We expect the US economy will avoid recession this year – housing weakness will dampen consumer spending, but the corporate sector

is in the best shape in decades. The two factors that could trigger a major equity market downturn – a substantial rise in bond yields or a large decline in corporate earnings – seem unlikely in an environment of low inflation, moderate economic growth and plentiful global liquidity. Market volatility could persist for several more months and there is the risk of a 10-15% correction, but the medium term trajectory for equity markets should be upward as investors become convinced the US can avoid recession and that the medium term outlook for corporate profitability is intact.

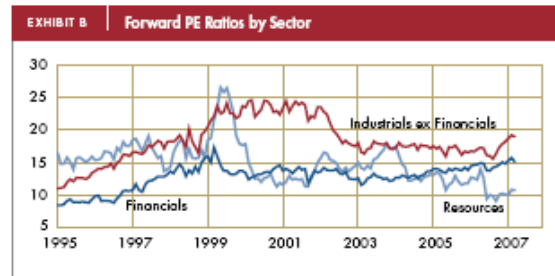
Equity market valuations still reasonable

The main rationale for remaining positive on the outlook for equity markets is that valuations are still broadly favourable. PE ratios, based on one year ahead consensus analyst earnings forecasts, are below their 10-year average in Australia and most other major markets. The case for equity markets is even stronger when the earnings yield on equities (the inverse of the PE ratio) is compared with the yield on government bonds.

A particularly supportive factor for the local equity market is the high dividend yield. This currently stands at 3.7% for the S&P/ASX 300. It rises to 5.0% when grossed up for franking credits, only 80 basis points below the 10-year bond yield.

There is an argument that the overall forward PE ratio for the Australian market of 14.8 times provides a misleading impression of reasonable value as it is underpinned by cheap resource valuations. Resources are trading well below their long-term average on a forward PE ratio of 10.7 times in contrast to Industrials on 18.9 times and Financials on 15.0 times – both well above their long-term averages. Certainly, Industrials and Financials look fully valued from an historical perspective and Resources appear cheap, but all this suggests is that the next leg up for the Australian market will most probably be driven by a rotation by investors back towards Resources.

Market Outlook (continued)

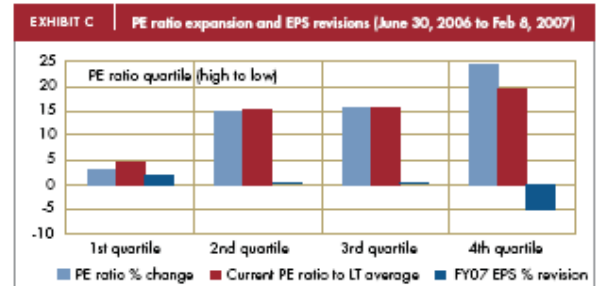


Source: I/B/E/S

Private equity drives up low PE stocks

One factor behind the big rise in industrial PE ratios is the large increase in leveraged buy-out (LBO) activity by private equity groups. According to the Reserve Bank, \$27 billion worth of LBO deals were either completed or recommended by company boards during 2006, with the majority occurring during the December quarter. This compares with an average of \$1½ billion per annum in the previous five years.

Exhibit C breaks the S&P/ASX 100 excluding resources into PE ratio quartiles, with the first quartile the highest PE ratio stocks and the fourth quartile the lowest. It shows the percentage increase in the PE ratio, the current PE ratio relative to its 10-year average, and the percentage change to analysts' consensus earnings-per-share (EPS) forecasts for the current financial year.



Source: UBS

The chart shows that the biggest PE ratio rises since the middle of last year have occurred at the lower end of the PE ratio spectrum. This quartile is trading at the highest premium to its 10-year PE ratio average and has also seen EPS forecasts downgraded.

The logic of private equity favours low PE ratio stocks (high earnings yield) with reasonably certain cash flows. This is because private equity involves borrowing heavily to purchase a company, which makes sense if the yield on the investment exceeds the borrowing costs. In this regard, private equity can be seen as the third leg of the yield compression story underway since 2003. The first leg involved the narrowing of credit spreads, the second saw yields on listed property trusts bid down and third is focusing on the high yielding, low PE ratio end of the equity market. Private equity interest is likely to continue until either borrowing costs rise or valuations lift to an extent that makes LBOs uneconomic.

Market Outlook (continued)

Equity markets in transition

2007 is shaping as a year of transition for equity markets from an environment where market gains have been driven by rising corporate profitability to one where market revaluation drives a larger share of returns as profits growth slows. The importance of earnings growth to market performance is shown by the fact that PE ratios have been flat or falling in most markets since the equity market upswing began in 2003. Australia's forward PE ratio stood at 15.0 times in mid 2003 compared with 14.8 times currently. This is despite the share price index (the "P") almost doubling over the same period. The forward PE for the S&P500 has fallen from 17.7 times to 14.5 times since mid-2003.

There are good reasons for believing that the peak period of earnings growth has passed. Profit margins are at record levels in Australia and are cyclically high in the United States. Rising labour costs and slowing productivity growth are eating into margins in both countries. The profits slowdown appears more pronounced in the United States than in Australia, however. The annual growth in one-year-ahead consensus forecasts for S&P 500 EPS growth has slowed to 9.7% from 15.6% in the middle of last year. Forward EPS growth for the S&P/ASX 300 has slowed to 16.0% from 25.0% mid last year.



Source: Standard & Poor's, The Conference Board

The Conference Board's survey of CEO confidence in the United States tends to lead annual EPS growth by around two-quarters. It's suggesting that profits growth will be fairly moderate over the next couple of reporting seasons.

US mid-cycle slowdown still on track

A key element of our relatively positive view on equity markets is that the US economy slows this year but avoids recession. The two most bearish scenarios for equity markets would be:

- Higher than expected US economic growth that generates inflationary pressures, causing bond yields to rise and forcing the Fed to resume monetary tightening.
- A US recession that causes profit margins to contract sharply and sends risk premiums higher across asset classes.

The downturn in the US housing sector means that US economic growth is unlikely to surprise on the upside. The debate is over how deep and protracted the US downturn is likely to be. Already, former Fed Chairman Alan Greenspan has predicted a 30% probability of a recession this year and several high-profile market economists have started talking up the chances of a deeper than expected economic downturn. The economic data on the housing sector is undeniably weak; housing starts have fallen 29% over the past year and house prices are down 9% from last July's peak.

As we have argued previously, the housing downturn will almost certainly cause an economic slowdown through its impact on consumer spending. A recession, however, requires that the corporate sector start cutting back on employment and investment spending. This seems unlikely with the corporate sector in its best financial health in decades; profits growth has averaged 20% per annum over the past five years and debt levels are the lowest since 1993 as a proportion of corporate net worth.

**Market
 Outlook**
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Article
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Interest rate differentials add to A\$ upside

The Australian dollar reached a 17-year high of 83¢ in mid-April as views on Australian and US monetary policy diverged sharply. Local markets had breathed a sigh of relief when the December quarter CPI report showed core inflation easing to just under 3% and the RBA's subsequent monetary policy statement seemed to imply that policy would be on hold for the foreseeable future. However, some hawkish comments from a senior RBA official saw markets price in a further quarter-point tightening. In the US by contrast, the housing downturn and weak business investment reports have markets pricing at least 50bp of Fed easing by the end of the year.

The March quarter inflation figures on April 24 will decide whether the RBA tightens. A further moderation in core inflation will see local interest rates remain unchanged until after the Federal election (likely to be held in October/November). A post-election tightening will be linked to the emerging evidence that labour market tightness is starting to flow through to labour costs. However, the RBA may find it difficult to raise rates later in the year if the US and global economies are slowing and the Fed has commenced easing.

The A\$ could retrace some of its recent gains if the RBA leaves interest rates on hold. Longer-term, however, we continue to see an upward bias to the currency. This is primarily because the large current account deficit means the US\$ is likely to remain under downward pressure. With Japan, China and the other Asian currencies operating quasi-pegs against the US\$, the burden of US\$ depreciation will continue to fall on the freely floating currencies. Under this scenario, the A\$ is more likely to head above 85¢ than towards 75¢.

Conclusion: more volatility near term, but equity bull run not over

Global equity markets are likely to remain volatile for several more months as the extent of the slowdown in the US economy and corporate earnings becomes clear. The Australian market could be especially prone to volatility given that local shares have run well ahead of the US market over the last six months and as RBA tightening fears linger in the background.

"Equity market returns are likely to be lower than in recent years, but still respectable."

Reasonable valuations and continuing strong liquidity conditions mean that equities should still be the best performing asset class over the year.

However, the market is transitioning from earnings driven to revaluation driven. As a result, equity market returns are likely to be lower than in recent years, but still respectable. For the Australian market, the next leg up will likely require outperformance by the resources sector.



**Located at Owen
Hodge Lawyers
Hurstville Office**

Level 2
12-14 Ormonde Parade
Hurstville NSW 2220

Appointments available at the Hurstville and CBD offices
Telephone 9570 7844
office@ohfp.com.au ■ www.ohfp.com.au

