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Market Outlook 1st Quarter 2007

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Market Outlook

- 2007 should provide healthy Investment returns, led by equities
- Four key investment themes for the year ahead;
 1. a US slowdown but no recession;
 2. equity market valuations are still undemanding;
 3. excess global savings will support asset values;
 4. demand for Australian equities could exceed new supply by a healthy margin
- Low bond yields, abundant liquidity and favourable valuations support a positive view on equity markets

Equities still the favoured asset class

2007 should provide another year of relatively strong investment returns with equity markets leading the way. Global growth is likely to slow, driven mostly by the weak US housing sector. The healthy state of corporate balance sheets, however, makes a recession unlikely (one of the features of the global expansion this decade is that firms have mostly financed spending through retained earnings rather than debt). Even so, the extent of housing weakness means that US growth indicators are likely to slow sharply early in the year and some commentators will no doubt talk up the chances of a recession. Slower growth and muted inflationary pressures means the Fed could be cutting interest rates later in the year.

“2007 should provide another year of relatively strong investment returns with equities leading the way.”

Australia’s economy will probably perform slightly below trend with the contrast continuing between the booming resource rich states of WA and Qld and the housing bust states of Victoria and NSW. A risk is that slower global growth causes commodity prices to tumble, however, there are few signs that China’s growth boom is ending and tight inventory conditions are likely to persist for most commodities. The RBA has probably finished lifting rates, but ongoing labour market tightness means that rate rise speculation will continue for much of the year.

Review of 2006

2006 saw the Australian equity market produce the fourth consecutive year of double-digit returns: the S&P/ASX 300 has now delivered compound returns of 21% p.a. since 2002. There were double-digit returns from domestic and global listed property, and global equities. The only lacklustre performers were global and domestic fixed income, which both returned less than 5%, reflecting their relatively low yields.

The year had two halves. For the global economy, the first half saw fears that rising inflation would force central banks to lift interest rates to restrictive levels, triggering a sharp slowdown in global growth. These fears culminated in the mid-May correction that saw global equity markets decline by around 10%. The second half saw inflation fears cool as oil prices eased and signs of weaker US economic growth emerged. This allowed the Fed to go on hold after 17 consecutive tightenings.

Australia remained a “two-speed” economy with the booming resource sector offsetting housing weakness. The labour market continued to tighten throughout the year, with the unemployment rate reaching a 30-year low of 4.6%. Capacity constraints kept the RBA concerned about inflation pressures and the cash rate was lifted three times to 6.25%.

The standout features of the year were:

- That US\$70 per barrel oil prices did not cause significant inflation pressures or slow the global economy.
- The ongoing strength in corporate earnings, up around 20% for the year in both Australia and the US. The growth in corporate profitability occurred despite tight labour markets and rising energy costs and interest rates.
- The continuing low inflation economic boom in China – it recorded the fourth consecutive year of double-digit economic growth, yet inflation remained below 2%.
- The glut of global savings, sourced primarily from Asia and OPEC, that more than offset the US current account deficit. This helped keep bond yields low and provided a pool of liquidity that supported equity markets and other risk assets.

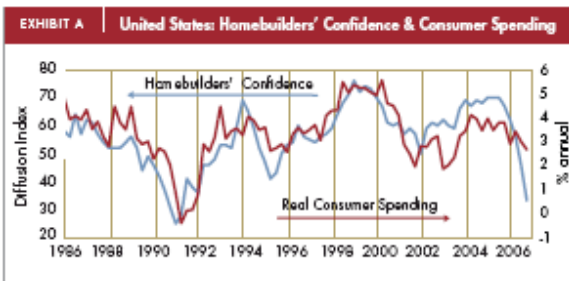
Overall, 2006 was a year in which low inflation, relatively low interest rates, strong profits growth and abundant global liquidity saw growth assets perform strongly. This culminated in the private equity investment boom towards the end of the year. In effect, private equity investors are saying that prospective equity returns are high relative to borrowing costs (equities are cheap relative to bonds) and have enough confidence in the medium term profits outlook to gear heavily into corporate exposure.

Market Outlook (continued)

Investment themes for 2007

Key theme 1 – A US slowdown but no recession

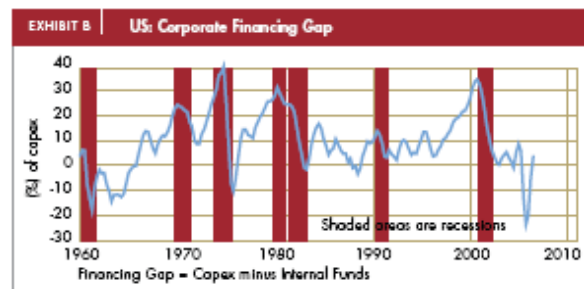
The chart below shows the link between US housing activity and consumer spending. The Homebuilders' confidence survey is a good summary indicator of the overall state of the US housing sector. It's declined to levels not seen since the early 1990s recession. Other housing indicators are seriously weak as well. House prices have declined by around 4% over the past year and housing starts have fallen 25%. Housing has a strong influence over consumer spending through several channels. The direct employment impact is relatively small, with less than 1% of the workforce employed in residential construction. More important is the wealth effect and the spending on consumer durables linked to new houses (curtains, carpets, furniture, whitegoods etc). Taken together, housing construction and consumer spending account for three-quarters of US GDP.



Source: Bloomberg

A downturn in consumer spending will slow the US economy, but a recession requires that the corporate sector start cutting back as well. Fortunately, the US corporate sector is in its best health in nearly four decades.

Earnings growth has averaged nearly 20% per annum over the past four years, and companies have almost more money than they can spend. The following chart shows the financing gap for the US corporate sector. This is the difference between investment spending (capex) and internal funds (profits less dividends and taxes). The gap is positive when capex exceeds internal funds, meaning the corporate sector has to finance expansion plans from external funding (debt or capital raisings). The bars on the chart represent recessions. The US economy has only experienced recessions after the financing gap has turned strongly positive and balance sheets have deteriorated. Right now, the corporate sector is financing nearly all its capex from internal funds. The excellent financial health of the corporate sector means that capital spending and hiring should be relatively resilient to weaker consumer spending.



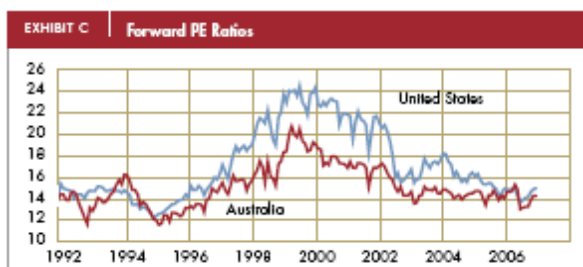
Source: US Federal Reserve, National Bureau of Economic Research

Recessions are always bad news for investors as profits slump and risk premiums soar. Slowdowns, however, can be welcome events as slower growth removes the threat of rising inflation and interest rates, but leaves profitability relatively intact.

Market Outlook (continued)

Key theme 2 - Equity market valuations are still undemanding

Strong earnings growth and low bond yields underpin the favourable valuation case for equities. The price-earnings (PE) ratios for Australia and the United States are below their 10-year averages thanks to earnings growth of around 20% p.a. in both countries over the past four years. The valuation case for equities will, of course, come undone if bond yields rise significantly or profits fall sharply. The prospect for weaker US growth this year and potential Fed easing makes rising bond yields unlikely, while profits are unlikely to tumble should the US economy achieve a soft-landing. Earnings growth has been the main driver of equity market returns over the past few years, but is likely to be weaker this year with global growth slowing and profit margins near record levels. An environment of low interest rates and confidence in the medium term profits outlook could, however, see investors push PE ratios higher. The Australian PE ratio is 14.2X currently. A rise to 15.2X on unchanged earnings would deliver a 7.0% capital gain in equities and still leave the PE ratio below its 10-year average of 15.9X.



Source: I/B/E/S

Key theme 3 – Excess global savings

One of the puzzles of the past few years has been the co-existence of low bond yields with strong global economic growth, inflation pressures and a record US current account deficit. A current account deficit represents the gap between a country's investment spending and savings. Last year, the United States required around US\$870 billion of foreign savings to finance the gap, an increase of US\$480 billion since 2001. This call on global savings should be putting upward pressure on global bond yields. It has, however, been more than offset by rising current account surpluses in China, Japan, and the oil exporting countries. Their combined current account surpluses have increased by US\$630 billion over the past five years. These surpluses have been directed into financial markets through increases in central bank foreign reserves (buying mainly foreign bonds) and the Middle Eastern investment authorities (which could be helping fuel the booms in property, hedge funds and private equity).

“ Excess savings from Asia and the oil exporters have kept real bond yields at historically low levels and supported equity market valuations.”

The net result is that excess savings from Asia and the oil exporters have kept real bond yields at historically low levels and supported equity market valuations. These current account surpluses cannot persist forever. Eventually current account surpluses in Asia will decline as central banks allow currency appreciation in response to domestic inflationary pressures, and as household savings rates drop. OPEC's oil price driven windfall will not last forever either. However, it's likely that these sources of global liquidity will persist for a couple more years and continue to support asset markets.

Market Outlook (continued)

Key theme 4 – Positive supply/demand balance for Australian equities

A specific positive factor for the Australian equity market is that demand for local shares could exceed new supply by a healthy margin. Normal superannuation contributions should direct at least \$20 billion into domestic equities this year and the new superannuation tax concessions mean there could also be a significant increase in voluntary contributions. The new Future Fund (which invests fiscal surpluses and asset sale proceeds) has around \$40 billion to invest. Depending on its (yet to be determined) asset allocation, the Future Fund could have anywhere from \$6 to \$16 billion to place in Australian equities later this year. There is also likely to be strong demand again from private equity firms. According to the RBA, there was \$13 billion of LBO activity in the first 10 months of 2006 (which does not include the \$11 billion Qantas bid) after averaging just \$1.5 billion per annum in the previous five years.

“Demand from superannuation funds, the Future Fund and private equity firms alone could almost match new equity issuance.”

There was around \$55 billion of new issuance on the ASX last year (excluding Telstra). Demand from superannuation funds, the Future Fund and private equity firms alone could almost match new equity issuance. This is without accounting for demand from offshore funds, retail investors and other institutional funds.

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Conclusion: Liquidity will support asset values

As always, the year ahead contains its share of risks and uncertainties and some caution is understandable after four years of strong investment returns. The global downturn could prove deeper and more protracted than anticipated, geopolitics could intervene, or inflation could return and force central banks into more tightening.

There is also uncertainty surrounding the Yen carry trade, where hedge funds have borrowed at low Japanese interest rates to invest in higher yielding assets elsewhere. The threat of a significant rise in Japanese interest rates or a large Yen appreciation could see this trade unwind quickly with consequences for asset markets.

Nevertheless, a positive stance towards growth assets, and equities in particular, seems warranted. Equity market valuations are still reasonable and will continue to be supported by low global real interest rates thanks to excess savings sourced from Asia and the Middle East. The global economy appears headed for a mid-cycle slowdown, rather than a recession which, based on previous cycles, is usually positive for equity investors as the threat of rising central bank rates subsides and the earnings outlook stays broadly intact. Although it's likely that equity markets will remain volatile over 2007 and a significant correction at some stage is probable, equities should nevertheless be the best performing asset class over the year.



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