What's in store for 2008?

After a 17 year dream run of economic growth here in Australia, the cries are getting louder that the good times may be nearing an abrupt halt. Out of nowhere a sub-prime saga has made its presence felt, US home prices have suffered record breaking declines and the ensuing credit squeeze has moved many an investor to the edge of ones seat. To add insult to injury, stock markets the world over have become more volatile, and interest rates in Australia have edged up to the highest levels we've seen in more than a decade.

Yet where some see clouds, others see a silver lining, and the environment unfolding in our markets will bring both winners and losers. In our 2008 outlook we will take you through the here and now of the global economy, and give you the inside word on the sectors poised to outperform in the year ahead.

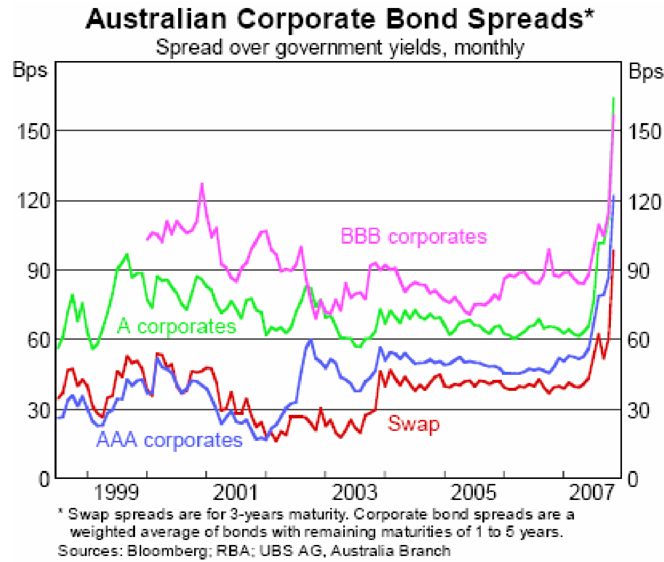
Volatility to continue as sub-prime deteriorates

The volatility we've witnessed of late looks set to continue. Driving this will be problems faced by the world's largest economy, the US. If you thought you'd read enough about sub-prime to last 2 lifetimes, you are in for an unpleasant surprise. Sub-prime is shaping up to be an even bigger story in 2008. The US Federal Reserve has estimated that we could end up seeing some $100-200b in sub-prime write downs.

To date US banks have confessed to $70b in sub-prime write downs, which is actually only a fraction of the estimated size of the problem. Suffice to say the majority of bad news on sub-prime is yet to be confessed to the market by US lenders. As more and more write downs occur, stock markets are likely to stay volatile, and credit markets could become even less liquid.

It is this freezing up of liquidity in credit markets that poses the greatest threat to global growth. Quite simply it means that businesses and people will start finding it harder to borrow money, which should flow into lower levels of spending and economic activity. All that easy money we've enjoyed for some time now is starting to dry up.

Australian credit spreads have spiked and are starting to place upward pressure on interest rates. In our view this will reduce the likelihood of the Reserve Bank of Australia lifting interest rates over the first half of 2008, or at least until the impact of this spike in credit markets becomes clear. Australian banks may also be forced to lift mortgages rates as it becomes more difficult for them to source money to lend.



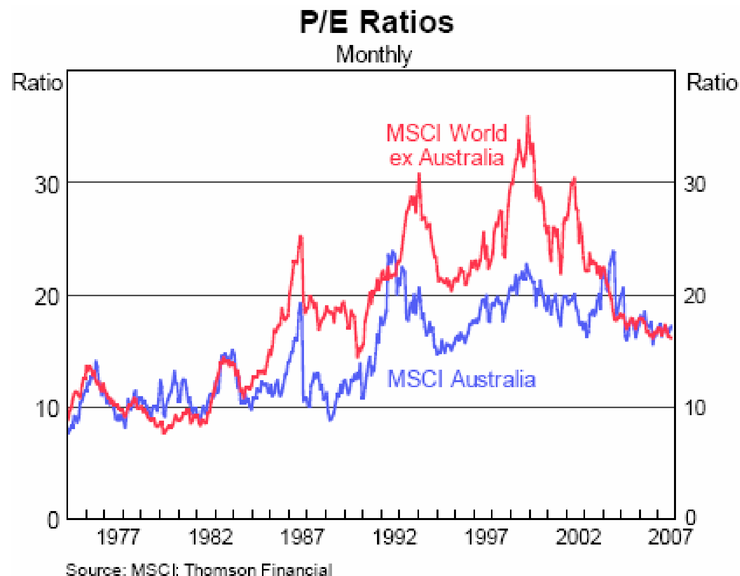
Corporate bond spreads are rising and placing upward pressure on interest rates.

Not all is doom and gloom

There is hope that the booming Asian region will continue to grow at breakneck speed and in doing so offset any slowdown we see in the US. In addition to this, we expect the US Federal Reserve to continue cutting interest rates over 2008 which should boost confidence and help kick-start the US economy.

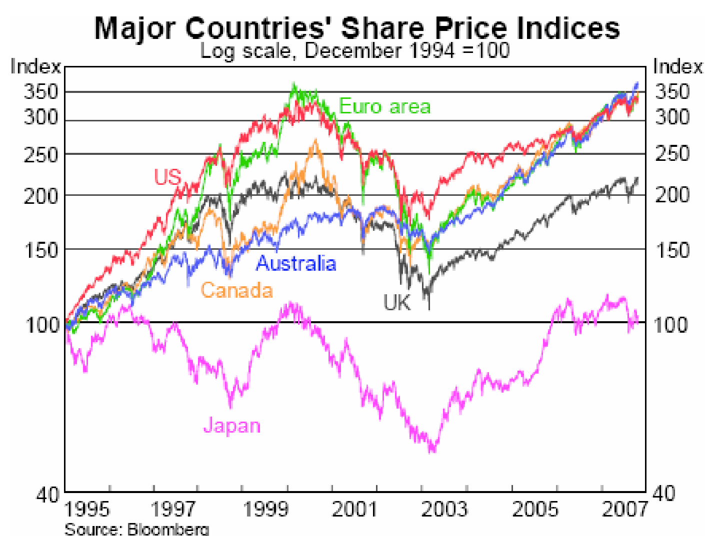
Global economy and valuations are reasonable

PE ratios are a great way to measure the value of a share market. Fortunately PE ratios both here in Australia, and in most overseas markets are at historically very normal levels. This means that both our markets and the majority of global markets are not in bubble territory. The Chinese and Hong Kong share markets are notable exceptions to this, and are looking expensive.



Generally speaking, global markets are valued fairly.

Painting a potentially bullish picture is the fact that many markets throughout the world are yet to break above previous highs that in many cases were set in the late 1990s. While our market has gone from strength to strength over recent years into record high territory, most markets are yet to break above highs set many years ago. Despite growing concerns over the global economy and a notably defensive stance taken by the European investment community, it has been interesting to see major European indices hold onto levels not too far from all time highs. We may yet see these markets break higher and set new records, which would be technically very bullish (from a charting perspective).



Many global share markets are yet to break the record highs set in the late 1990s including many European exchanges. A break above all time highs would be technically bullish.

Can oil de-rail the market?

Oil came within a whisker of the long awaited $100 mark in 2007, trading at an all time high of $99.29. A slowing economy in the US, which is the world's largest oil consumer, could put a temporary cap on gains in the oil price. In the long term however, the fundamentals for oil remain bullish. Consumption of oil is rising quickly in a number of key geographies including China (the world's second largest oil consumer) and the Middle East. We expect this consumption growth will continue to place upward pressure on oil prices.

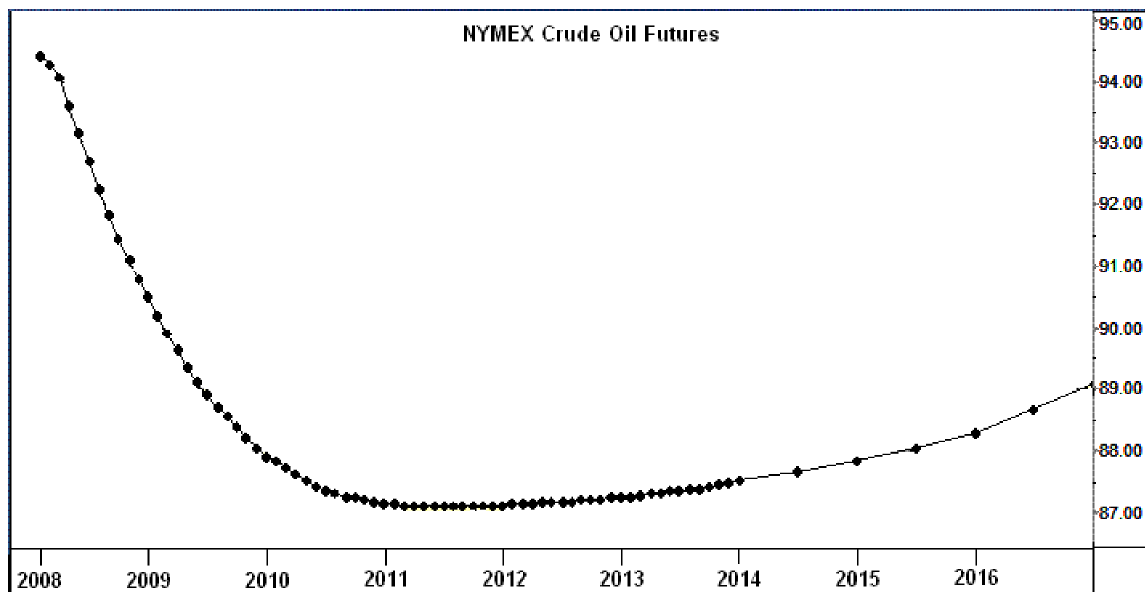
OPEC seems increasingly supportive of high oil prices

2007 ushered in a period where OPEC has started to show a greater reluctance to lift oil production. In November 2006 OPEC announced intentions to cut oil supply by 1.2mbbl/d, followed by an announcement in February 2007 to cut oil supply by an additional 0.5mbbl/d. Needless to say, oil prices have been on the rise ever since.

OPEC has deflected criticism on its reluctance to lift oil production by increasingly pointing the finger at hedge funds, suggesting that their trading systems are pushing oil prices beyond what supply and demand would suggest is appropriate. The perceived complexity of the trading methods hedge funds use has meant that few have questioned this. Whether or not this is true, OPEC has still made a deliberate decision to stop lifting oil production.

If the world's largest oil producers are reluctant to increase production even as oil approaches $100 a barrel, it appears the days of cheap oil are behind us. Will this derail the stock market? We suspect not. Oil prices are currently high on the back of booming levels of demand. In the past, high oil prices have caused economic problems when supply shocks have triggered the high prices. A classic example is the oil shock of the 1970's when OPEC made substantial cuts to oil supply.

Futures markets are less bullish on oil and currently suggest a modest fall in oil prices to a long term price of $89.00.



NYMEX crude oil futures suggest that oil prices may fall towards a long term price of US$89.00 per barrel.

Sectors poised for out-performance

While credit markets are likely to generate volatile trading conditions and uncertainty over 2008, and high oil prices are a risk factor for some businesses, we still see plenty of opportunities in the Australian market. Overall the global economy remains strong, and global growth is above historical averages.

As an investor it does of course help to be backing the right stocks that can continue to perform in this challenging environment. The hottest sectors are shaping up to be IT, mining services and infrastructure. Sectors most likely to underperform are manufacturing and US housing.

Mid-Tier IT

The trend for businesses to build an online presence and boost their IT capability remains as strong as ever. While in the past, businesses focussed on using IT systems to cut costs, today businesses are increasingly looking to IT as a way to grow sales, especially online.

Another important shift in the IT sector has been the tendency for large IT contracts to be broken down into smaller component parts. This has meant that the very large contracts that were once the domain of multinational IT groups are now open to medium size players. Most importantly, the medium sized or mid-tier IT players have been

increasingly winning these contracts and growing their businesses on the back of them. We expect this trend to continue into 2008.

Wise-owl.com picks in the Mid-Tier IT Sector:

- **Melbourne IT Ltd (MLB)** is a leading global provider of online services that is well positioned to grow on the back of more businesses establishing an online presence to drive sales and branding.

- **Oakton Ltd (OKN)** is a mid-tier IT consultancy group that is growing quickly from smart acquisitions. The company has recently established an Indian office which is helping it keep a lid on costs.

- **DWS Advanced Business Solutions Ltd (DWS)** is a mid-tier IT consultancy group with a competitive advantage that includes a loyal client base leaving the company less susceptible to fluctuations in the IT sector. A further competitive advantage is the company's ability to grow and harness the talent of Generation Y recruits.

Mining and engineering services

We all know that the commodities boom has delivered some impressive share price gains to our mining companies. The good news is the spoils from booming commodity prices are spilling over to the industries that offer services or support to them.

What makes these support companies particularly exciting is that they are not directly exposed to minor falls in commodity prices, yet can share in the upside of rising commodity prices. If commodity prices were to fall from here it would immediately impact most miners through lower profits and lower share prices. However, as long as these mines keep operational, the companies who service mining operations will enjoy business as usual.

Wise-owl.com picks in the Mining and Engineering Services Sector:

- **Austin Engineering (ANG)** fabricates many of the components used in mining machinery and also offers maintenance services for heavy machines. Austin is in a stronger position than many of its competitors as it uses robotic welding methods that reduce its exposure to blue collar labour shortages.

- **Neptune Marine Services (NMS)** has a unique technology for underwater welding which achieves bonds that are much stronger than competing methods. This welding technology is becoming increasingly adopted in the offshore oil and gas sector.

Miners

We expect the miners to continue their run of out-performance as production rates drive higher earnings and merger and acquisition activity encourages prices to heat up. BHP has positioned itself as a purchaser of RIO, and several

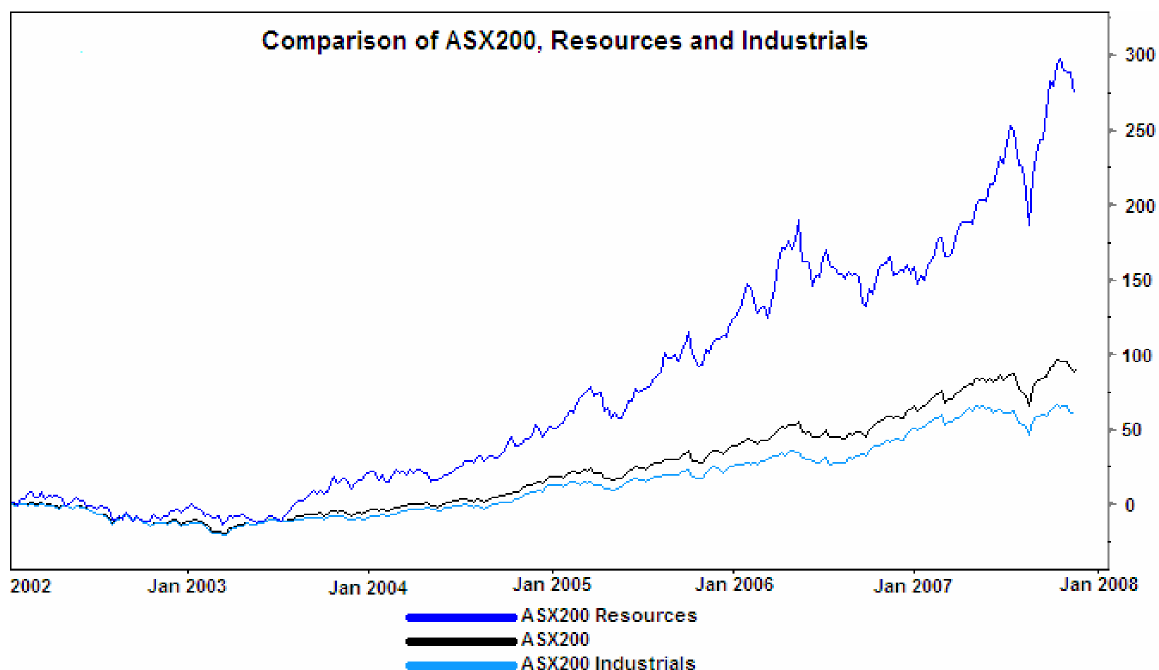
industry majors have large cash balances and undergeared balance sheets that could support mergers. On the global front, mining giants Xtrata and CVRD have expressed intentions to expand via acquisitions and locally there are very few miners who are not putting the ruler over their peers.

Needless to say the environment is ripe for a merger and acquisition frenzy, especially as junior explorers make the transition to producer status.

Wise-owl.com picks in the Mining Sector:

- **Equinox Minerals (EQN**) is busy constructing Africa's largest copper mine, and is scheduled to begin production in the second quarter of 2008. The project's long mine life makes the company a ripe takeover target.

- Two local miners that we expect to outperform are **Kagara Zinc (KZL)** in the ASX200 and **CBH Resources (CBH)**. Both companies have scheduled strong production ramp ups over the next few years and have exciting exploration upside. Although both companies are exposed to the zinc price, which has been weak recently, their high quality asset portfolio's give us overriding confidence in their outlook.



The ASX200 resources index has staged an impressive record of out-performance.

Soft Commodities

More mouths to feed, a booming biofuel industry and rising levels of prosperity in developing nations such as China and India are placing upward pressure on soft commodity prices. Understandably, as people become wealthier, one of the first things they do is buy more and better food. To compound this further, a well known drought here at home has contributed to lower supplies of many soft commodities such as wheat.

Opportunities to gain exposure to growth in soft commodities are few and far between on the Australian market, and many of them are trading at levels that even the most imaginative soul would struggle to justify. Fortunately there are always exceptions to the rule as some stocks in this sector still represent good buying.

Wise-owl.com picks in the Soft Commodities Sector:

- **TFS Corporation (TFC)** is looking to take advantage of the mouth watering fundamentals driving the Sandalwood industry. The inaugural harvest of the company's sandalwood plantations is still a few years away, but is eagerly anticipated given the fact that sandalwood prices have been rising at an annual compound rate of 22% for the last 15 years.

- Fertiliser manufacturer **Incitec Pivot (IPL)** is one of the few stocks in the ASX200 offering exposure to the agricultural sector that has actually been increasing earnings despite the drought. It will be interesting to see how the stock performs should operating conditions improve.

Infrastructure

Following years of underinvestment, public infrastructure is gaining more public attention and bigger government budgets. The Minneapolis bridge collapse in August could also form a trigger for substantially higher levels of spending on public infrastructure in the US. Once again the developing economies of China, India and the Middle East are also playing a key role.

Mining ventures also require infrastructure expansion to support higher rates of commodity production locally, while offshore booming economies and oil wealth is resulting in high levels of infrastructure spend.

Wise-owl.com picks in the Infrastructure Sector:

- **Macmahon Holdings (MAH)** is set to benefit from its recent alliance with market darling Leighton Holdings (LEI), through which it has become Leighton's partner of choice. A strong order book and a blue chip client base only add to the stock's appeal.

Sectors to avoid:

Manufacturing

Many manufacturing companies find themselves on the 'other side' of the commodities boom. In other words, it is the manufacturers that are paying record commodity prices and in turn delivering record profits to the mining sector. These record commodity prices are raising manufacturer's costs and lowering profits. Many of our local manufacturers are also exposed to a strong Australian dollar which is hurting profits further.

- **Amcor (AMC) Ltd** is a global packaging manufacturer that is being hurt by high oil prices and a strong Australian dollar. Both of these factors are unlikely to change in 2008, so we see this company as one to avoid for now.

US housing

At the heart of the US sub-prime crises is an American property market in free fall. Companies exposed to this are facing an uphill battle that is likely to continue in 2008, so we are inclined to avoid these.

- **Boral Ltd (BLD)** is a supplier of building and construction materials and derives a large portion of sales from the US which are at risk of softening.

- **James Hardie Industries (JHX)** is a supplier of building materials, the vast majority of which are exported to the US. With housing prices in the US falling as fast as they are, building activity is set to be slow, and in turn make it unlikely that James Hardie will emerge as an out performer.

The Banks

At current levels we see a number of our local banks as representing good value, with ANZ and BNB as standout examples. However with more news still in the pipeline from subprime mortgages and tightening credit markets, one can't help but think that even more attractive buying may emerge over the course of 2008. While a long term investor may be happy to buy at favourable levels now, we are on the watch for an even better buying opportunity that may emerge.

- **ANZ Bank (ANZ)** is trading on a PE of 12.4, boasts a franked dividend yield of 4.8%, and is growing its presence in Asia, one of the few bright spots in the global economy. ANZ is our preferred pick of the big 4 banks.

- **Babcock & Brown Ltd (BNB)** remains a long term growth story which we expect to outperform the market over time. Sentiment towards the investment banks is at risk of being poor over the short to medium term so long as uncertainty surrounds credit markets.

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