

Reflections on a Bear Market!

As we move into the second half of 2008 the bear market remains in place notwithstanding the flirtation of the occasional bear market rally. Investors continue to seek a bottom but significant challenges remain to be worked through before we can exit this downturn.

Oversold?

A broad range of indicators continue to suggest that investors have continued concerns as to the state of the US and global economy, and the impact of these stresses on market outcomes.

When there is such strong conviction, news is received from a very particular stance. Any positive news can have a powerful effect precipitating a short squeeze. The sharp jump in prices can lead to a re-interpretation of the news in a new light. Marginally positive news can be read as having greater significance than might seem reasonable. Alternatively the market can convince itself that it has already armed itself for the worst, and is now capable of looking to the other side.

This is one potential broad interpretation of events in April and May this year. A sharp bear market rally had seemed inevitable, yet of course the outstanding question remained? Was the worst yet to come for the economy? Had we yet reached a stage where we could fully dimension the extent of the strains under which the global economy is operating, to the extent that the market could have already discounted them? Or are such concerns exaggerated in the midst of a liquidity squeeze of historic proportions in credit markets, and that with the wide range of interventions instigated by global authorities have we exited the apparent 'valley of death'. Maybe the valley was just a projection of doomsayers, gold bugs, and Calvinist Millenarianism.

Bulls and Bears

Sustaining confidence may allow the economy and the market to navigate a treacherous transition safely. The bulls may argue that valuation is now sufficiently supportive and that liquidity will power upward momentum. Additionally, corporate M&A activity is now accelerating. Events have now transpired to show that a

bear trap has been set with an oversold market bouncing on short covering and hope that the worst may be over. Positive moves in the face of negative news-flow allow the market to build faith that it has discounted the worst, and possibly even reinterpret the data, that the worst isn't that bad after all? But real negative variables are still in play, that have always in the past led to significant downturns. High oil prices, inflation, a credit crunch show no sign of abating.

From our perspective, the question is how to position in a market knowing that there is a reasonable likelihood of further bear traps. Bear traps are formed not by illogic, but by logic. People fall into them not because they are stupid, but rather that they are rational, yet impelled by the logic of the system. And things 'might' be different this time? One needs to look to stocks to find some cross checking process. The insights from the stock specific level offer certain counter points, but again one must not kid oneself. Even the best companies cannot be wholly above the winds operating through these cycles.

Earnings Outlook

Given the high level of bearishness in the market it is likely that expectations, whether they be reasonable or not, are set below the level suggested by analyst forecasts. Analysts' downward revisions have barely commenced. Such a process is made exceedingly difficult by the highly ambiguous nature of the current economic climate. Equally in many instances companies are yet to see what may or may not be implications of these economic headwinds.

Profits from energy or raw materials producers are understandably likely to be well above analysts' forecasts.

The simple question that has haunted the market has been 'surely' sustaining such high commodity prices can not be ultimately 'good' for equity markets as they risk sparking

inflation, putting an additional negative strain on consumer's disposable income. And given the global is slowing how can such high commodity prices be maintained?

Profits from U.S. domiciled exporters would be supported by a global economy that had either decoupled from the U.S., or was yet to see a material deceleration. Those profits would be further significantly supported by the devaluation of the US dollar.

Financials

Most interestingly and possibly surprisingly however are the results from the financial sector. This is the one sector that has exceeded the market's already negative expectations; to the extent we can understand them. Yet this is where one of the most significant technical phenomena has manifested. This sector is of course inextricably bound to the dynamics of credit markets. The Fed's underwriting of liquidity meant that the price on a number of credit instruments improved markedly. That improvement was from extraordinarily oversold levels, prices representing a panic, a buyer's strike, rather than the likely default rate even under the most extreme assumptions. The improvement still has the price of credit trading at extreme levels. It happened even whilst underlying asset quality continues to deteriorate, housing prices continue to plummet, and corporate bankruptcies accelerate. Against this backdrop, the question becomes solvency, not liquidity.

Yet most importantly for short term market sentiment the thing that surprised the market has not been the size of the losses, but rather the significant amounts of money prepared to finance a string of rights issues and placements made by the banks. The terms of these capital raisings are highly ambiguous, given the diversity and complexity of the varied instruments that are being used. One is hard pressed to derive from them an inferred value on banks equity.

On the positive side yield curves have steepened widening net interest margins. Classically banks underlying profitability starts to expand at this stage of a credit cycle. Furthermore the strong banks will take significant share from not only weaker institutions, but also prospectively from investment banks as a greater portion of credit is sourced from bank balance sheets, and institutions that are highly dependent on wholesale funding are further disadvantaged.

In July, the banks have rallied significantly from their lows against a continued backdrop of write-downs and poor earnings results. Time will tell whether the financials have bottomed or whether this is another short covering bear market rally. We favour the latter view!

Caution on Commodity Price Strength!

One of the most telling characteristics of current markets is that mining stocks in many ways have become the defensive stocks of the current cycle, whilst financials have become the most exposed. Traditionally defensive sectors are now seen as vulnerable to significant structural headwinds. The two which spring to mind are Telecoms and Pharmaceutical Companies. They continue to perform erratically despite the high levels of economic uncertainty.

The level of commodity prices of course has reflected a fundamental shift in the source of growth in the global economy to the industrialisation of Asia, driven initially by exports to the developed world, but now increasingly by internal dynamics. Some of the reasons suggesting caution on the commodity trade included:

1. The increasing likelihood of a material global slowdown.
2. The sense that commodity trades are overpopulated and commodity prices are in a bubble, driven by some form of unreasonable speculative interest?
3. Commodities can be seen as 'hedging' two inter-related events, a weak US\$, and inflation. Given this dimension a stabilisation of the US\$ was seen as likely to lead to a rotation of funds out of commodities back into monetary assets generally, the US\$ most specifically.

China, Oil, Inflation and World Growth

The impacts of a high oil price and the prospect of rationing of oil are beginning to ripple through the global economy with the subtlety of a sledge hammer. The idea of US energy independence is one obvious response. It has been an important element of US foreign policy for an extended period. Now with mandated ethanol levels

designed in part ostensibly to reduce America's dependence on foreign energy a significant portion of crop production is being transferred to sources of ethanol. For example 30% of US corn crops are likely to be dedicated to ethanol production in 2008. Oil related products are a crucial input into the production of fertiliser, obviously a fundamental cost in global food production. Global food price inflation hence can be seen as significantly echoing the stresses in the oil market.

Food production in China, and globally, has proved far more precariously placed than had been anticipated. We are seeing the classic application of a capital cycle playing out with systemic underinvestment in agriculture. In the case of China growing incomes in the cities inspired internal migration from the land. High oil prices have driven up globally the price of fertiliser. Ethanol production has reduced grain production available for human consumption.

This is putting downward pressure on real Chinese incomes. The kind of pressure that is placed on incomes by food inflation in the developing world cannot be compared to experience of the consumers of developed markets. This kind of pressure causes distress. It causes not just labour strikes, but rioting. As a result it is unsurprising that the government is inspired to adopt a range of policy responses if it is not to risk a major disruption. Higher food prices mean higher labour costs.

Europe and Japan...

The news is not much better out of Europe. Property prices are sagging in many parts of Europe, not just the UK. Business confidence is falling and inflation is accelerating despite a strong Euro. In May the head of the Bank of England had 'not ruled out recession'. The position of the ECB represents an intriguing and polarizing force. Trichet and Bundesbank head Axel Weber lead the

charge that tight monetary policies must remain to stamp out inflation, and corrosive asset bubbles. Yet it is unclear whether some of the inflation drivers stem from excessive demand out of Europe, rather than the more likely driver of global cost push. Unlike the Fed the ECB does not focus on Core versus Non-Core inflation.

Whereas Europe might be challenged by 'excessive strength', Japan is in the exact opposite position. It is now faced with one of the weakest government's in living memory. The opposition controls the upper house. The government has difficulty passing certain legislation. Most symbolically it could not get up its choice as Governor of the Bank of Japan, in part because it could not accustom itself to not controlling the upper house and negotiating with the opposition. But on the positive side, unlike many other markets Japan found itself singularly lacking any basis for optimism, a classic buy signal. In Japan stocks were well and truly priced for a worst case scenario, though Toyota's recent poor results clearly suggest that global economic headwinds can even affect the best companies.

Summary

We remain concerned about the outlook and are not convinced that we have bottomed at this point. Downward pressure on economic activity in many countries has escalated, yet to meet the challenges, unlike traditional cycles, the issue is not a surplus of investment, but rather a shortage of it. That is what bid up the prices of assets and caused inflation. The question is how can investment be stimulated in a world seeking to hold down inflation?

We acknowledge that the 'worst' might be behind us, the worst being a meltdown of the banking system, but remain highly cautious and respectful in our approach to the markets. The 'bear' will remain unpredictable at best!

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