Martin Bros Monitor

www.martinbros.com.au

March Quarter 2008 Edition

Paul & Jarrod Martin are Authorised Representatives (259367 & 259249) of ABN AMRO Morgans Ltd.

Our New Look

Welcome to our new look Martin Bros Monitor, care of our team's resident IT expert, Tim.

Hopefully you find our content as interesting and thought provoking as always, only now with a fresh new look.

Of course, please feel free to contact us with any suggestions or improvements you may have for the Monitor.

Thanks Tim!

Stock Review ConnectEast

ConnectEast (CEU) is the new toll road between Mitcham and Frankston currently under construction. This is due to be completed by the middle of this year, five months ahead of schedule.

CEU was floated on 4th November 2005 with a paid up value of $1 per security. CEU is currently trading at $1.28, having reached a high of $1.90 in the last six months. CEU is paying a fully tax deferred distribution of 10.5 cents per security, set until 2010.

Infrastructure stocks such as CEU receive a 'concession period' from the controlling government to build and operate the toll road for a set number of years. Over the life of the project, the expected cash flows are sufficient to repay the cost of building the road (debt) and provide a return to shareholders. This total return to shareholders is expressed as an Internal Rate of Return (IRR) at the commencement of the project.

CEU floated on an IRR of 12.3% per annum over the life of the project. Typically the share price of toll roads increase during the construction phase as the project risk (of construction) reduces and the focus shifts towards future traffic levels.

With CEU only months away from opening and trading on a yield of 8.2% fully tax deferred, with a weighted average debt maturity of 4.4 years and interest rates 100% hedged until 2010 and 80% hedged until 2014, we believe it is undervalued.

Normal Markets ?

The ASX 200 reached an all time high of 6851 points on 1st November last year. As we write, the ASX 200 has just closed at 5380 points. This equates to a fall of 21.47%. If you removed BHP and RIO Tinto from the index (both tied up in a possible merger), the fall would be more like 25%.

Of course this refers to the market at its all time intra day high and does not represent where the market traded for any length of time. None-the-less, it certainly has been quite a substantial fall in a short space of time.

Corrections normally do occur rapidly though as the 'fear' factor sets in and the 'herd' mentality takes over. No one wants to be the last sheep through the gate (to get out), so they stampede the exit for fear of been the only one left in the pen (or stock in this case). This strategy is beneficial when you hold stocks such as ABC Learning (12 month high of $8.45 and recent low of $1.15—currently suspended), Allco Finance Group (12 month high of $12.61 and low today of 39 cents) or MFS (12 month high of $6.85 and recent low of $0.71—currently suspended).

> ***"'The sharemarket is a transfer of wealth from the impatient to the patient"***

In this type of market though, all stocks are tarnished with the same brush and good quality, well run companies, paying consistent dividends are also dramatically sold down. Warren Buffet quotes "the sharemarket is a transfer of wealth from the impatient to the patient". Long term stocks are driven by fundamentals such as earnings per share and return on equity. In the short term however, fear and greed drive the market. We've seen the greed scenario until the end of 2007 with highly geared and aggressively run companies rewarded. In 2008 fear has set in, and some of this past greed is resulting in disaster (refer stocks mentioned above).

In our March and June edition of the Martin Bros Monitor we wrote "With the All Ordinaries currently at 6400 points, we see the possibility of the market correcting to under the 6000 point barrier at some stage in the next six months, but see no catalyst at present for a sustained medium term fall. We would be happy with a period of sideways consolidation because further gains into the high 6000's in the short term, we believe, would risk the market suffering a circa 15-20% fall."

The market did fall to an intra day low of 5491 points in August but closed at 5712 points on the same day. Obviously after this dip it shot back up to the all time high on 1st November.

This time around, the fall has been bigger and lasted longer. Banks and infrastructure companies, once seen as defensive stocks, have been hardest hit, with the resources sector providing strength to the market. We believe this strength could be short lived. With so much concern about slowing global growth and falls in all other market sectors, we are a little perplexed as to how commodities have remained so high. Commodities are not immune from global growth. Global growth drives demand for these. If the global economy does in fact slow significantly, not even China will hold up the entire commodities market. And we know what markets do when they get a sniff of fear!

Many of Australia's most successful companies are now trading on fully franked dividend yields of 6% plus and price to earnings ratios not seen for several years. Markets rarely trade at 'fair value' on any given day and will always overshoot on the upside and the downside. No one will ever pick the top of the market and the same goes for trying to pick where the market will bottom. What we do know is quality companies survive and prosper. Avoiding the disasters along the way is the main challenge. When will the market pick up? Our prediction is last quarter this year.

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US Market Earnings Outlook-ABN AMRO Morgans

ABN AMRO Morgans economist, Michael Knox, has been very successful at reading and interpreting economic indicators with a view to translating these into their effect on equity markets. Below we replicate his most recent work on the US equity market outlook.

The US stockmarket, as everybody knows, has seen a crash in the first quarter. This crash in prices was brought about by a crash in earnings. The fall in earnings in absolute terms in the last 2 quarters of 2007 was greater than the fall in earnings in the entire period of the tech crash of 2001. This earnings collapse is only slightly less dramatic in percentage terms. From a peak level of 24.06c in June 2007, operating earnings first declined to 20.87c in the third quarter of 2007 then collapsing to only 16.81c in the fourth quarter of 2007. Over the 6 months to December 2007, operating earnings per share fell by 30.1%.

This collapse was unanticipated. As late as end of November 2007, the consensus estimate was that operating earnings per share in the fourth quarter would be around 22c. When companies started to report in January, **the much lower level of operating earnings shocked the market**. The market then fell.

So where does the market go from here? From what we have already seen in the past quarter, the future path of the market should be determined by the future path of earnings. So far, the US economy has fallen from a 4.9% growth rate in September 2007 to a 0.6% growth rate in December 2007. This sharp slowdown in growth was the reason for the sharp fall in earnings per share. Right now we think the US economy is about to get worse. **Our view is that the US economy is going into a shallow recession** with a fall in output only as bad as in 2001. This means that we think that output should fall by around 0.4% in March 2008 and 0.5% in June 2008.

By the time we get to the second half of 2008, the combined effect of cuts in the Fed Funds rate and tax cuts should generate a strong kick to the US economy. Growth should accelerate to 3.4% in September 2008 and 2.7% in December 2008. What this means is that we expect that earnings per share for the S&P500 will be very soft until this recovery arrives.

Market consensus of stock analysts (bottom up estimates) are that earnings per share should rise from 16.81c in the December quarter to 22.82c in the March quarter. Market consensus of market strategists (top down estimates) are that earnings per share should rise from 16.81c in the December quarter to 20.23c in the March quarter. To the extent that the market believes either of those estimates, then the market can sustain a strong rally to the end of March.

Personally, I don't believe a word of it. I think that when the March quarter operating earnings start to be reported in April, the market will realise that operating earnings for the March quarter were down, not up. Our own top down estimate is that operating earnings per share should fall to 15.7c in the March quarter, down from 16.8c in the December quarter. This mild decline in earnings is associated with the beginning of absolute declines in US output. This should recover to 17.1c in the second quarter. Only in the final quarter do we see operating earnings per share recovering back to the level of 22.9c per share or around where bottom up estimates currently put earnings for the first quarter.

If we are right, the US stockmarket is in for more shock and disappointment on a quarterly basis **until the good news finally arrives at the end of 2008**.

ASX Trading Hours

The Australian Stock Exchange hours over the upcoming public holidays including the Easter period will be as follows:

- Easter Thursday – closes 2pm
- Good Friday – Closed
- Easter Monday – Closed
- Anzac Day (Friday) - Closed

As always, we will be contactable on our normal numbers throughout the entire holiday period, except on days when the market is closed.

Some Warren Buffet Quotes

"Price is what you pay. Value is what you get."

"Your goal as an investor should simply be to purchase, at a rational price, a part interest in an easily-understandable business whose earnings are virtually certain to be materially higher five, ten and twenty years from now. Over time, you will find only a few companies that meet these standards - so when you see one that qualifies, you should buy a meaningful amount of stock. You must also resist the temptation to stray from your guidelines: If you aren't willing to own a stock for ten years, don't even think about owning it for ten minutes. Put together a portfolio of companies whose aggregate earnings march upward over the years, and so also will the portfolio's market value." -1996

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