

SIRA Group Pty Ltd

Market Update: 27th July 2007

The Big One?

After last night's fall on Wall Street, we have to ask ourselves whether this is the beginning of a major bear market. We think not!

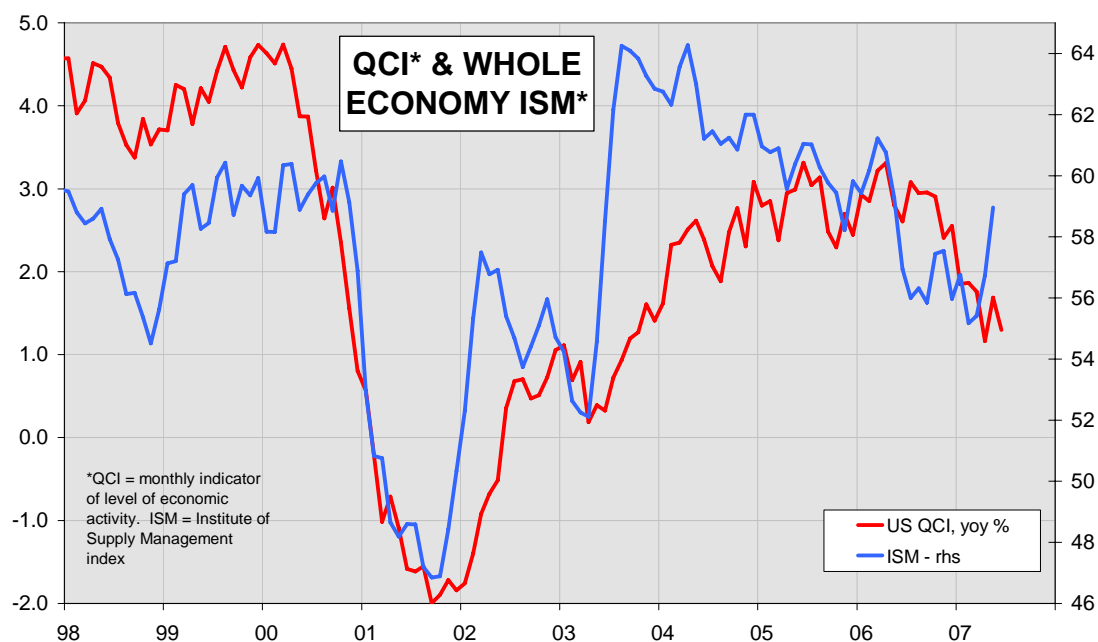
One of the paradoxes of the market is that when everybody is extremely optimistic it tends to coincide with a top, and when everybody is very pessimistic it often shows a market bottom. (Actually, there is sound logic behind why this is so, so it is only an apparent paradox, but we won't go into the reasoning here.) It reassures us though, that the market has so many concerns – about 'sub-prime' lending in the US; about interest rates and inflation; about the sustainability of the long bull run (rise in share prices).

All the same, the sub-prime lending fiasco in the US is a valid concern. Some lenders provided mortgages to people who wouldn't normally qualify – "low doc" loans which require no documentary proof of income or creditworthiness; mortgage payments fixed at low levels initially, with sharp rises in later years; and loans which represented a larger percentage of the property value than is prudent. As mortgage rates rose with the rise in the official US discount rate and long-term interest rates (such as long-dated government bond yields), house prices grew more slowly and then started to fall. Nationwide, they are now down 5% over the year, and are still falling. The lenders are now writing off the bad loans on their books. Many sub-prime lenders have closed their doors. And the fallout hasn't stopped there. These loans were packaged up and 'securitized' and the resulting products on sold to hedge funds and other investors. A number of hedge funds here and in the US have been forced to suspend redemptions or even to close.

Many commentators fear that the tightening of credit standards that has been the inevitable result of this entirely predictable mess will lead to a slowdown in consumer spending and a recession.

While that clearly is a possibility, we disagree. The economy has slowed, but by much less than has occurred in previous housing slumps. That's because the US dollar has fallen; to record lows against the Euro and on a trade-weighted basis; to 20 year lows against the pound; 10% against the Chinese yuan since it was 'floated'; and 18% against the Japanese yen over the last two and a half years. A fall (devaluation) in a currency makes that country's exports cheaper in the rest of the world and, within that country, it makes imports from other countries more expensive. This has helped sustain employment and incomes in the US, despite the housing meltdown.

In fact, a very reliable indicator of economic health – the ISM index – has started rising sharply (see the chart below), suggesting that the US economy has turned the corner. This index has turned up before every major economic cycle over the last 70 years.



At the same time, Chinese growth has rebounded, the BRIC economies (Brazil, Russia, India, China) continue to surge ahead, and Europe and Japan continue to grow.

So although the sub-prime problem is causing concerns, we remain confident that the overall economies, in the US and the world as a whole, will hold up.

Since the current bull market began in March 2003, there have been 5 corrections:

Timing	Begin	End	% fall
Oct/Nov 03	3305.3	3175.7	3.9
March/May 05	4255.8	3940.5	7.4
Oct 05	4591.5	4340.5	5.6
May/June 06	5285.5	4830.8	8.6
Feb/March 07	6021.9	5642.4	6.3
July 07 - ??	6456.7	6138.0	5.1 (so far)

The average (excluding the last few days) is 6.4%. So if this is just a correction in the bull market, then we have perhaps another 2% or so to go. There is 'technical' support at 6140 on the All Ords index (i.e., where the market is now, as I write) and again at 5946 (another 3.1% lower, or 8% total from the peak).

The ratio of prices to the last year's earnings per share (the P/E ratio) at 14.5 times, is not high. At the beginning of the last major bear market, in 2002, the P/E ratio was 20.5, as shown in the chart below. By recent standards – a time of low inflation and interest rates compared with the 1970s and 1980s – the market is not overvalued.



And the US equivalent of the All Ords, The Standard and Poors 500, has support at 2.5% and 6% below current levels.

On balance, we believe that this a correction, not the beginning of a new bear market. The correction is however probably not over, and the market could be 'soggy' for a few weeks.

As always, we are watching the markets carefully, and will be ready to act if it proves necessary.

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