



# Go for growth stocks in year ahead

*Next year looks rocky, but there are profits to be made*

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THERE are some ominous signs in the Rudd Government's first days, including a record \$2.9 billion trade deficit (despite a China-led commodities boom), an economy operating at full capacity and rising inflation.

On the job is the Reserve Bank, which lifted interest rates during the federal election campaign, held off this month but may raise them again in February, to contain inflation below its targeted upper limit of 3 per cent.

There is \$31.5 billion in tax cuts due to start hitting our pockets next year, which may neuter the rate rises. Whether the cuts survive or not is a question no analyst wants to answer at this early stage.

The question for investors is, with a few storm clouds forming, what's in store for investors in 2008?

First, Australian economic growth is forecast to fall from 4.3 to 3.5 per cent next year.

"Perhaps the most significant economic challenge facing the new Labor Government is that the economic cycle is maturing, monetary conditions are being tightened to deal with inflation pressures, the global economy is slowing and the real exchange rate is high," Merrill Lynch chief economist Peter Osborne says.

"The rapid deterioration in the trade position here is being caused by the drought impact on

rural exports, capacity constraints on the mining sector, the \$A effect on export receipts and the impact of very strong domestic demand and the high \$A on imports."

To add to our woes, the Australian share market — which has outperformed the world share market (MSCI World Index) for the past seven years — is now looking expensive in price earnings (PE) terms, bordering on being over-valued. This includes resources and industrials.

Thus, stockbroking firm Bell Potter is predicting a respectable (but not spectacular) 12.6 per cent return for Australian shares in 2008 (8 per cent capital gains and 4.6 per cent dividend yields).

This compares to the 20 per cent-plus returns common over the past few years.

Deutsche Bank equity strategist Tony Brennan believes that with resources stocks at record highs, there's not much more upside for investors in mining.

Deutsche has changed its portfolio recommendation to underweight Australian resources (mining and energy), is staying underweight in banks and raising cash.

And because of a recession risk in the US, due to the sub-prime loan crisis, it is re-assessing stocks exposed to the US.

It will replace Aristocrat and

Computershare in its recommended portfolio with Lion Nathan and CFS Retail Trust.

Bell Potter reckons US S&P 500 company profit growth will halve from 15.7 per cent to 6 to 8 per cent — no thanks to sub-prime woes and a tempering of the global resources boom.

Global economic growth (GDP) is set to be stable but slower in 2008 (see table), which will subdue investment returns.

Commsec senior equities economist Martin Arnold notes that the resources sector will remain the driver of Australia's export performance next year, contributing almost 80 per cent of the value of commodity exports, but this depends on global demand.

"Production levels should remain buoyant over the coming year but the expected slowing in the global economy could weigh on the industry," he says.

"Lower global demand for resources will put downward pressure on prices and detract from export growth."

With unknown billions of dollars in sub-prime losses yet to be revealed by global banks, Nelson Wicas, principal of Pennsylvania-based Vanguard Quantitative

Equity Group, says US Federal Reserve chairman Ben Bernanke will continue cutting interest rates "in a measured way for the benefit of the whole US economy, not solely for the benefit of financial markets".

The Fed is expected to cut rates by 0.75 percentage points over the next few months to restore financial market confidence.

This will be a positive for the US share market.

Bell Potter research shows that in eight similar rate-cutting episodes since 1984 — in response to recession or crisis — the S&P 500 rose 12.8 per cent on average in the year after the cuts.

AMP Capital senior Australian economist Robert Cuneen says that in deciding to keep interest rates on hold this month, the RBA is concerned about the impact of the sub-prime problem on global growth next year and will monitor it closely.

Respected economist Don Stammer says the trick for any forecaster is to work out turning points in business conditions or financial markets. But it may be crystal-ball stuff.

His main advice for investors is to buy on any market dips



(corrections) and be prepared for "X-factors", or unforeseen events.

Investors should also understand that investing in the share market is fraught with uncertainty and risk, but it rewards patient investors.

It's also important to make measured judgments.

For instance, Bell Potter's Peter Quinton is unmoved by the prospect of the US going into recession: "So what if it does?"

He says it is "an urban myth" that China is an export-led economy, when in fact only 10 per cent of its output is exported. The rest satisfies Chinese domestic demand, which he says will continue regardless of what happens in the US.

Even then, only 20 per cent of Chinese exports go to the US.

Quinton's advice for internationally focused investors is to concentrate on high-growth, emerging-markets funds for now and delay new US investments until it is clear what exposures banks have to the sub-prime crisis.

In terms of where to invest in

Australia, Quinton is definite.

"Go for big growth stocks — which should be resilient even if economic growth slows — because of their ability to grow faster than the market."

The firm's four investment themes for the next six months include:

Large stocks will outperform small stocks, as a more volatile environment should favour financially strong companies.

Growth stocks should outperform value stocks, because longer-term sustainable profit growth and resilience should become more important as overall profit growth decelerates.

Stocks with relatively high and secure dividend/distribution yields should benefit as investors become more risk-averse.

The resources sector will continue to advance.

Bell Potter's favoured stocks in the large-growth category include Cochlear, CSL, Woolworths, Billabong, Harvey Norman, Qantas, Boart Longyear, Orica, United Group, Onesteel, Babcock & Brown, Macquarie,

ABC Learning, BHP, Rio Tinto and Woodside.

Favoured mid-cap growth stocks include Australian Wealth Management and Transfield, while favoured high-dividend-yield stocks include ANZ, Commonwealth Bank and Westpac.

"However, investors should note the dividend yield for banks, including franking, is now only about 4.5 per cent — and the days of double, triplicate and more capital growth for bank stocks is probably gone," Quinton says.

For higher (and riskier) yields, investors must opt for infrastructure stocks. Here Bell Potter favours Babcock & Brown Infrastructure, Transurban, Macquarie Airports and Babcock & Brown Wind Partners.

Wise-owl.com equity strategist Simon Guzowski says Australian economic growth and its share-market outlook is still "bullish".

Guzowski says the main issue in the US is "a confidence problem", which should be fixed by interest rate cuts.

"US banks have reported some \$36 billion in writedowns so far. However, the US Federal Reserve has estimated that the problem is likely to be in the \$200 billion category," he says.

And until the market knows the extent of the problem, things are likely to remain volatile.

"For picks in 2008, I can't look past mining services and engineering stocks," he says.

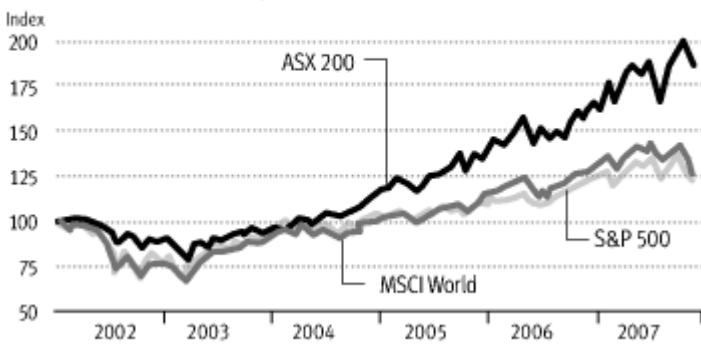
"They are exposed to the upside of the mining boom, but are not as exposed to commodity price volatility or rises in the cost of production."

In that sector, he likes Neptune Marine and Austin Engineering. He also likes midcap information technology stocks, which, despite a tight labour market, can thrive due to use of automation. Here he likes Oakden and DWS.

He is avoiding manufacturers such as Paperlinx and Amcor, which have difficulties protecting themselves from price rises for their packaging.

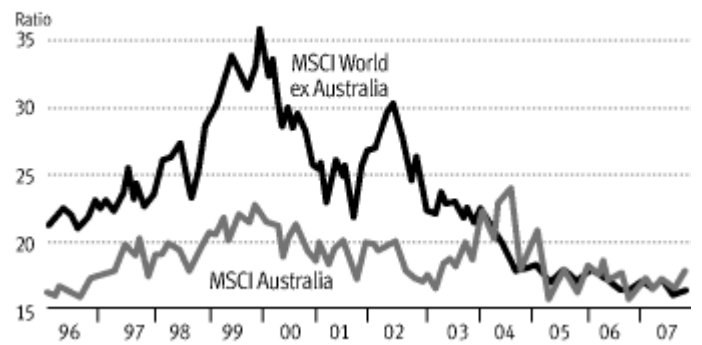
## Outperforming Aussies

Australian and world share price indices



## Ticking up

P/E ratios



## Slow and steady

Global economic growth (%)

	Weight	2005(a)	2006(a)	2007(e)	2008(e)
Australia	—	2.8	2.7	4.3	3.5
US	0.22	3.1	2.9	2.0	2.4
Canada	0.02	3.1	2.8	2.6	2.9
Japan	0.07	1.9	2.2	1.9	1.8
Western Europe	0.21	1.7	2.9	2.6	2.2
Asia	0.30	8.3	8.7	8.8	8.5
Latin America	0.07	4.4	5.2	4.7	4.2
Eastern Europe	0.07	5.1	6.4	6.2	5.7
Rest of world	0.04	5.9	7.4	5.0	4.0
World	1.00	4.6	5.1	4.7	4.4

Source: Bell Potter



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**Bullish outlook:** Wise Owl analyst Simon Guzowski, in Sydney this week, says US confidence should soon recover