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## The Angle

Issue 4 - Jan 21 2008

### Happy New Year

Welcome to Issue 4 of The Angle, the Financial & Investment newsletter from Ark Finance. A very happy new year to all of our clients, associates and Angle readers. In this issue; I will recap on the remarkable year that was 2007, I will mark my own 2007 scorecard and will look ahead at global prospects for 2008. Thanks to those who have provided feedback on the last issue and I will endeavor to get four editions issued in 2008.

### 2007 - Return Of "The GUBU"

After the main suspect in a murder hunt was found in an apartment owned by the then attorney general (top government law officer) in 1982, the then Irish premier Charles Haughey described the situation as being .. "grotesque, unbelievable, bizarre and unprecedented". The acronym "GUBU" was coined by an Irish journalist who went on to use it to describe a number of controversies in Haughey's own administration.



I feel it is appropriate to use the term GUBU for describing the financial woes of 2007. Let's have a look at some of GUBU events that occurred during 2007.

- **Grotesque** – Sub Prime Loans given by US Banks without diligent underwriting, to risky customers who can't get a normal (prime) mortgage – customers begin to default in early 2007 and bring down the US housing market, which impacts western equity markets in early 2007.
- **Unbelievable** – The same risky loans were sold on as low return (assumes low risk) investments, to global private & corporate investors through a number of global Banks. Now these investments are worth little - many of the big banks holding sub prime assets write down billions off their investments (\$100bn and rising) - some of the leading US banks replace their CEO's.
- **Bizarre** – Banks not lending to each other, due to lack of trust (not knowing who may be further exposed to sub prime write downs) – low liquidity sees bank inter lending rates shoot upwards - a total of \$25bn is invested in the hurting Financial sector (Morgan Stanley, UBS, Citigroup) by Asian & Middle Eastern government investment vehicles (China, Singapore and Abu Dhabi)
- **Unprecedented** – Global Central Banks join together to pump in money to help liquidise the global credit markets - Irish House Prices Fall by approx 7% - \$100 barrel oil reached – People Queuing to withdraw their deposits from a UK Bank – The ISEQ index down 26% in one year – bank mortgage rates rising without the ECB rate increasing – Gold prices reach historical highs.

Witnessing all of those events, it's no wonder that a recent survey of European investors marked that their confidence is at the lowest since 2001 after the dot com bubble burst. However, when you look at many of the World markets and especially Asian markets, economic & asset value growth was robust, regardless of global GUBU occurrences.



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## Equities –

Despite the various issues facing equity markets during 2007, there were many winners as well as some big losers. It illustrates what the cornerstone of every investment strategy should be; spread your investment risk by diversifying geographically and across asset classes.

Market	Index	LC return %	Euro return %
China	Shanghai Composite	105.1%	101.8%
India	Sensex	47.4%	49.0%
Latin America	S&P Lac 40	46.9%	37.2%
Hong Kong	Hang Seng	38.4%	28.3%
Asia	MSCI Asia Ex Japan	30.5%	20.9%
Germany	DAX	20.4%	20.4%
Australia	S&P/ ASX 200	11.8%	12.4%
Europe	FTSE Euro Plus	2.0%	2.0%
UK	FTSE 100	3.8%	-4.6%
US	S&P 500	3.5%	-6.1%
Japan	Nikkei	-11.1%	-14.7%
Ireland	ISEQ	-26.3%	-26.3%
Global	S&P 1200	7.0%	-2.6%

## Asia –

The China equity market was top again with over a 100% return during 2007. Although I expect that the index will increase again in price in 2008, I would advise caution, as stock valuations are reaching very high levels. There is likely to be a correction during 2008, probably in the second half after the Beijing Olympic games. There are a large number of private retail investors in the Chinese market, most of whom have little experience of stock investment. The main driver of Chinese economic expansion (estimated 11.6% increase in GDP in 2007) has been manufacturing, the vast majority of which is exported. Many global brands use China as an outsourced manufacturing location, due to the low cost base.

However as western economies slow during 2008, the global demand for consumer goods will also slow. Look at Marks & Spencer's poor December results, I believe this trend will continue during 2008. So, unless the Chinese economy becomes more internally consumer driven (making & selling goods for its own market) the rate of economic growth will decline, in line with a slowing of western economies.

One result of slowing Western economies, will be large corporations looking to reduce indirect costs in order to maintain profit growth. This could see the increased outsourcing of indirect labour activities to lower cost locations. I feel India & Eastern Europe may reap more of the benefits of this, as these locations would be seen to be the proven location for the outsourcing of service activities.



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India had its 2<sup>nd</sup> highest annual GDP growth since independence in 1947, at 9.4%. This was reflected in a stock market price increase of over 47% in local currency. As I stated in the September Angle issue 3, the valuations on the Indian stock exchange looked attractive. The index grew 25% over the remainder of the year.

India's GDP growth should continue at current levels into 2008. But again, it remains to be seen how the slow down in western economies impacts the Indian market. I expect the GDP impact of western economy slowdown will be slight and I would expect that the Indian equity market could have another double digit growth year in 2008. Stock valuations in general appear more attractive than Chinese markets, but be aware of potential market corrections, especially after the impressive price run in Q4 of 2007.

## USA –

Recession is an odds on favourite for the US economy, with some analysts saying it is already started. Even if the economic growth stays positive, it's not looking like a good year for the US economy. In addition the dollar looks set to stay weak and perhaps even weaken further. There is expectation of 0.5% cut in Fed rates in first quarter, but this attempt to stimulate the economy will take at least 12 months to be seen. I would not favour investment in US equities or property in 2008.

## Europe –

**Germany**, which will be overtaken in 2008 by China as the 3<sup>rd</sup> largest economy, appears to be finally coming out of its slumber following reunification. The Dax was up over 20% during 2007. There were over 650,000 more people employed in Germany during 2007, with 2007 GDP growth of approx 2.7%. However wage demands may cause some headaches for continued economic growth in 2008, but still the outlook is reasonable and I expect there to be continued high single digit price growth in German stocks.

**The UK**, with its close ties to the US equity markets, was impacted by all of the sub prime woes. Many of the financial houses impacted, have subsidiaries in London city, which in turn pour money into the London & UK economy. I don't see a great degree of change in 2008 for the UK stock market, there may be a small rebound in the second half if it is established that the credit crunch is over. A downward movement in interest rates will also help economic activity but this may not be visible until 2009. Notwithstanding all of the above, GDP growth should come in at approx 3% for 2008.

Last but not least, **Ireland**. We all know that the ISEQ index is made up of a small number of heavyweights tied to the Irish property market, the financials and construction companies. So, with the global woes of 2007 tied to a slowing residential property market, these stocks that make up most of the ISEQ index took a hammering.

One of the factors in such a downward movement, was that; when a small market has bad news and starts to lose some confidence, global fund managers reduce their holdings quickly, cutting their losses. The stocks which are cut are the ones which make up the index, as many funds target higher cap shares when investing in markets. When prices drop further, confidence is further eroded and this knock on impact can bring a small market down fairly rapidly.



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But the ISEQ has a robust track record and will bounce back, but not until 2<sup>nd</sup> half 2008 at the earliest and it will probably be 2009 when the real reversal will take place. It will take foreign investors / fund managers to come back in, to buy and get the prices moving upwards.

I now think generally Irish stock valuations are attractive. I like IAWS, Anglo and CRH at present, but again you may need to wait to 2009 to see real gains.

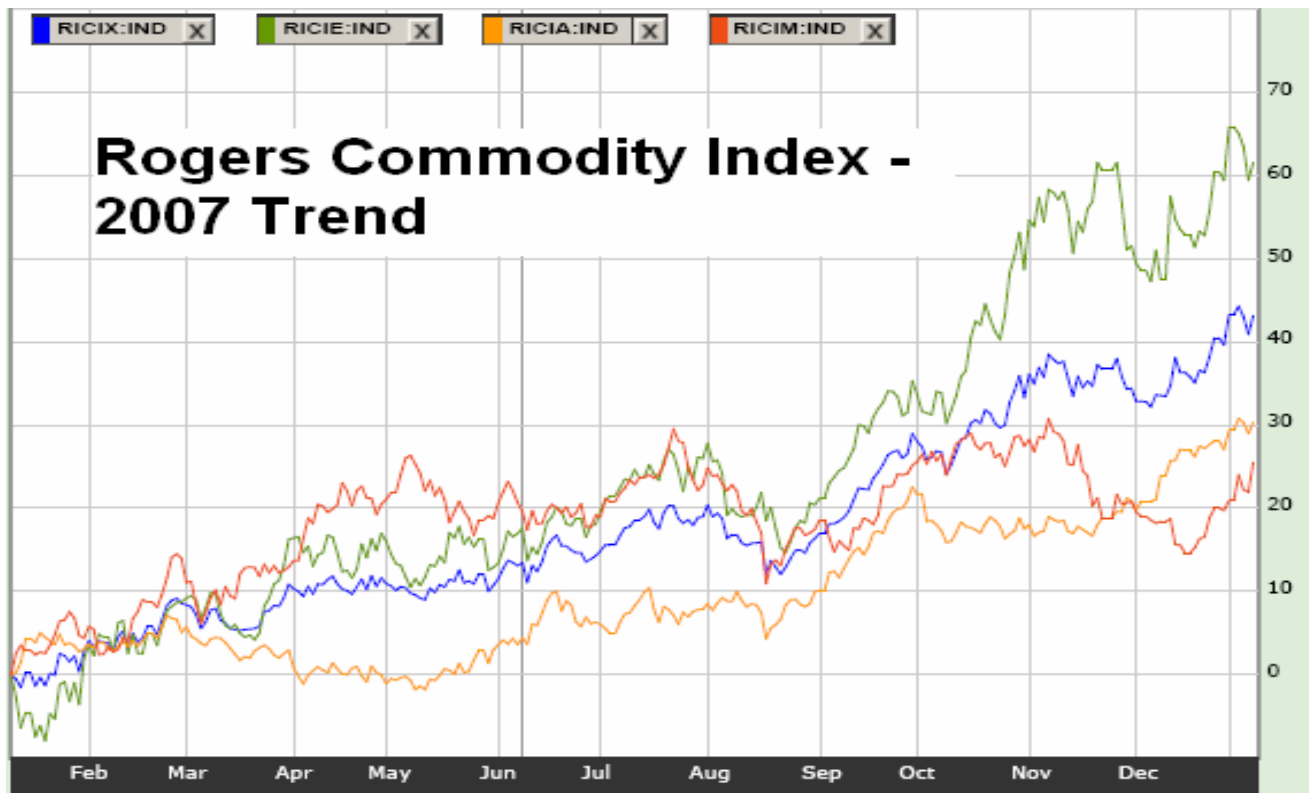
## Commodities –

The overall Rogers Commodities Index (blue line in graph below) is up 34% during 2007. The main driver is the increase in energy prices up 47% during 2007 (green line); main component of this was the increase in oil prices.

Metal prices were up 10% and agricultural commodities up 21% during 2007.

I would expect commodities to grow moderately in 2008, high single digit growth. The US recession may slow demand for metals and energy, however if Asian markets continue to grow the demand from this quarter will help sustain commodity price levels. I can't see the growth in Oil prices that was witnessed in 2007 being repeated, prices may hover in and around the \$100 a barrel level, long term trend is upwards.

It is possible to get exposure to commodities, through funds tracking commodities indices and many of the life offices are now introducing exposure to commodities in their specialist funds.





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## Metals –

The metals sub-index (RICIM – red line) has continued to grow. As can be seen from the table below, Tin and Copper were the base metals with greatest price increase. Base metals vary in price based on demand and supply.

Although the rise in precious metal prices is also based on demand and supply, demand for some metals can be enhanced when equity markets face periods of turmoil. Gold especially is seen as a safe haven for investment funds during periods of economic uncertainty. Governments who hold foreign reserves in a devaluing currency may wish to switch to Gold reserves in order to maintain their reserve value.

<b>Metal Price Trends 2007</b>				
11/01/2008				
		<b>Closing 2007</b>	<b>Opening 2007</b>	<b>Movement YTD</b>
<b><u>Base</u></b>				
<b>Nickel</b>	\$ / t	25,800	33,550	-23%
<b>Zinc</b>	\$ / t	2,285	4,259	-46%
<b>Tin</b>	\$ / t	16,370	11,620	41%
<b>Lead</b>	\$ / t	2,531	1,725	47%
<b>Copper</b>	\$ / t	6,676	6,201	8%
<b>Aluminium</b>	\$ / t	2,350	2,830	-17%
<b><u>Precious</u></b>				
<b>Silver</b>	\$ / oz	15	13	13%
<b>Palladium</b>	\$ / oz	370	332	11%
<b>Gold</b>	\$ / oz	837	640	31%
<b>Platinum</b>	\$ / oz	1,529	1,136	35%
<b>Uranium</b>	\$ / lb	90	72	25%

Uranium ended the year up 25% in price. The UK government, amongst others, announced recently it was investing heavily in Nuclear energy, so I would expect to see the price rise over time, although the price can be volatile. One of the main Uranium mining stocks, Cameco opened the year at \$41.45 and closed at \$40 but did hit \$56 in June. I'm holding mine until it hits the \$100 mark, perhaps in 2009!



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## Property –

**Ireland – Residential** – Now a deep breath, here comes my socioeconomic political speech.

For corporation Ireland, “potentially” the best thing that happened in 2007 was the fall off in house prices. Firstly let me acknowledge that I know many businesses connected to the housing market were impacted, including our own mortgage services. We also have clients in the building sector which have had to let staff go. It’s not pleasant for those in the sector, I know that. However, if the Irish economy is going to continue to thrive it’s going to have to be on the backbone of something stronger than just building houses.

Ultimately, when you look at recent economic growth in this country, it was fuelled by the housing market expansion and consumer spending on the back of cheap credit. Some people borrowed cheap money through their mortgage as their home value increased and some just spent more cash because they felt richer, due to the increasing level of equity in their homes. If you don’t think that house building fuelled our economy here are some hair raising facts;

### **20/12/2007 – The ESRI economic forecast**

- House completions of 55,000 in 2008 compared to 77,000 in 2007 and 88,000 in 2006
- 2008 GNP forecast growth at 2.3%, the lowest for 16 years
- Unemployment to rise to 5.8% in 2008



### **03/01/2008 – 2007 Government Exchequer Returns**

- Government surplus in 2006 +€2.6bn
- Government deficit in 2007 -€1.6bn, this is three times larger than forecast
- Stamp duty take in 2007 down €700M on forecast
- VAT receipts in 2007 down €400M on forecast

It’s naïve to expect the Celtic tiger to survive on the housing sector alone. The catalyst for the Celtic tiger was the arrival of the multinationals in the 1990’s, increasing employment and increasing salaries. This gave Irish workers spending power for houses and consumer items. [Note: that when Harvey Norman came over from Australia – first stopping point off in Europe was the Irish market!].

Then cheap money post euro, allowed the building boom to take off, which required immigrant workers to help build more houses, which saw the economy heat even further.

There haven’t been too many incremental multinationals choosing Ireland as a location over the last few years. We are too expensive for manufacturing and the low corporate tax trick has been copied by other emerging European countries.

So what is going to drive the Irish economy forward? Where are the thousands of Irish entrepreneurs growing the indigenous business base, going head to head with the multinationals they previously worked for? I struggle to think of many growing post Celtic Tiger Irish owned & run companies competing internationally, there are some but not enough.

Successive Irish governments have had no strategic view of how to sustain economic growth and it’s a little sad to see the reduction in stamp duty getting the headlines in December as an economic stimulant.



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Hopefully the government will develop a long term economic strategy that will see economic growth based on indigenous companies, with the potential to compete in international markets.

The latest PTSB/ESRI index from November shows residential house price decline of -6%. I expect that when the full year report is released in a couple of week's time, that the full year decline will be over -7%.

The PTSB/ESRI index is based on purchase completions mortgaged through PTSB (about 20% of the mortgage market). There is a time lag of at least three months between price agreement and closing the sale. So I would expect further declines to be seen in the index for the first quarter 2008 and that the index will not bottom out until mid year at the earliest. However I feel we have seen the bottoming out of prices on the ground, which are down approximately -10% in the last year.

Developers have put the brakes on new builds and I would expect 40,000 home completions in 2008. However there is a large stock of unsold houses on the market and it will take some time for these to sell through, probably the full year.

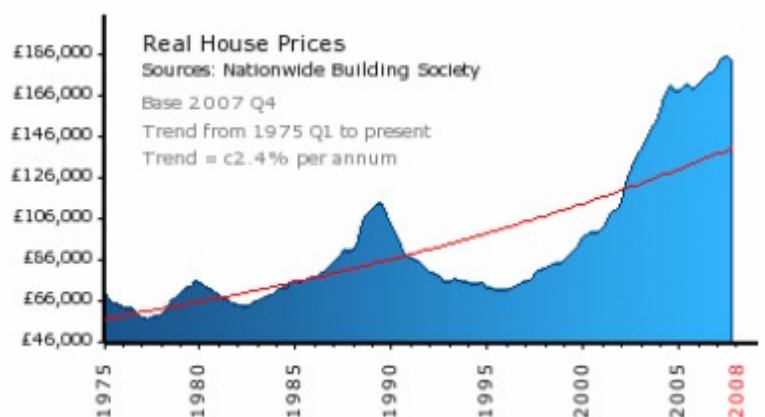
I expect the residential price index to show no growth for the full year 2008 and probably low single digit price decline. Prices on the ground could start to show increases in the second half especially if ECB rates decline to attract first time buyers back into the market.



**Ireland – Commercial** – Although the final figures have yet to be published, the Jones Lang LaSelle Irish Property Index showed a 2007 nine month total return to end of Sept 2007 of 8.7%. I would expect that the final full year 2007 ungeared returns to be 11%, with prices increasing approximately 7% during the year. Investment & development land completions fell from €3.6bn in 2006 to €1.5bn in 2007 and I feel this does not bode well for 2008 commercial property activity. I am expecting the index returns in 2008 to be low single digit for the year ahead.

**UK – Residential** – The December Halifax UK House price index shows annual UK residential price inflation at 5.2%, below the long term average of 8%. The monthly increase was 1.3% which follows three consecutive months of price falls. Halifax are forecasting UK house prices to be flat in 2008, some other market analysts are forecasting a far worse picture, with significant negative price returns. I would be somewhat more optimistic of price rises in the second half of the year following Bank of England rate cuts in the first half of the year. The outlook for the UK economy is slower economic growth, in tandem with reduced consumer spending.

The graph across shows the trend for UK house prices since 1975. Certainly based on historical trends it would appear that the significant price growth from 2000 onwards, has come to an end, for now. However the UK government will not want a repeat of previous UK price crashes and will exert influence on the Bank of England to do the right thing.





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**UK – Commercial** – After a sustained period of strong capital appreciation, the UK commercial property market has slowed dramatically. With borrowing becoming more difficult during the “Credit Crunch” and also debt becoming more expensive, it became more difficult for investors to complete deals. It could be argued that the strong buying activity up to first half 2007 had pushed prices to a natural peak. Although the market is showing little activity at present, there have been a couple of reported deals completed, where buyers would appear to be getting value in their acquisitions, with attractive yields. Buyers are focusing on the London Office sector as providing the best potential return. Secondary locations are not attracting much buyer interest at present.

The most recently published IPD UK commercial property index shows the monthly December return for all commercial property was down -3.7%. This is the worst monthly return since the index began back in 1986. Total returns for 2007 were down -5.5%, but a sharp drop of -9.5% in the second half of the year.

Property & other assets – monthly total returns %							
	Total return	Income return	Capital growth	Longer period total returns			Total return index
				3 mth	6 mth	12 mth	Dec 1986=100
<b>Direct property</b>							
All property	-3.7	0.4	-4.2	-8.5	-9.5	-5.5	852.6
Retail	-3.4	0.4	-3.9	-8.7	-10.2	-7.6	818.5
Office	-4.7	0.4	-5.1	-9.4	-9.3	-3.0	728.1
Industrial	-3.0	0.5	-3.5	-6.9	-8.2	-4.4	1276.3
<b>Other asset classes</b>							
Equities <sup>(1)</sup>	0.3	-	0.2	-0.3	-2.1	5.3	847.6
Property equities <sup>(2)</sup>	-2.5	-	-2.8	-15.1	-23.8	-36.7	595.6
Bonds <sup>(1)</sup>	1.4	-	1.4	4.7	9.6	6.4	607.4
Inflation <sup>(3)</sup>	0.6	-	-	-	-	4.0	211.6

The fall in value of UK commercial property will most likely continue into the first quarter of 2008. Credit markets have started to return to normal, but it will take a little more time for this to impact the commercial property market. Inter bank lending rates (1M LIBOR) have come down from September highs of 6.7% to 5.67% last week. So it would appear that the credit squeeze is coming to an end, despite more sub prime write down announcements from US banks last week.

Despite the continued level of uncertainty in the UK commercial property market, individual deals can provide potential for high returns. Remember an index is an average of a large number of properties, within that index there are individual properties that will demonstrate various levels of gain and loss. 2008 will most likely see total returns reduce further until second half and then return to positive territory. It may be the best year yet to buy and wait for returns to strengthen through 2009 and 2010. A lot of the life office property funds are being forced to sell properties to maintain liquidity within their funds. This opens up buying opportunities for buyers not reliant on high levels of borrowing. London is the UK location which would offer the greatest long term potential.



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## Morton's Scorecard 2007 –

Here are the main things I forecast at the start and during the year. Let's see what I got right, got wrong and got somewhere in between.

Topic		
<b>Oil</b>		I said prices would go upwards and upwards they went!
<b>ISEQ</b>		I knew it could not repeat a 26% gain – but never could see a full reversal of this in 2007. It surprised many. However in May when the index was up 1.9% I did say... <i>"I would reduce exposure to the Irish stock market, due to the slowdown in construction activity and the reliance the Irish economy has on the growth of this sector"</i> .
<b>US</b>		I said the FX movement would ruin any gains and this is exactly what occurred.
<b>UK V Europe</b>		I expected the UK to shine over Europe, it returned similar low digit growth to European composite index, but blown away by the Dax.
<b>India</b>		I'm happy I called this right, as we placed a number of investors into Indian equities during 2007. Last issue it looked like there was a lot of growth potential, as the sensx was only showing 11% growth to Sept. It had a run of over 30% from Sept to end of the year.
<b>China</b>		I'm going to call this marginal, as initially I said my preference was China, I was less sure mid year based on valuations and preferred India. The economy is growing strong, but not as quickly as the markets.
<b>Asia</b>		I said that I did not fancy the Japanese market and excluded it from the Asian recommendation. I will still exclude it in 2008.
<b>Irish Residential Property</b>		I said mid single digits at best for residential in 2007, it was single digit price drop!
<b>UK Residential Property</b>		I said 7-9% for residential. While UK residential prices have moderated, there was still a full year 5.2% increase in prices.
<b>UK Commercial Property</b>		I said mid teens for UK commercial property. Commercial property has been hit by the credit crunch with a negative full year return of -5.5%.



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My “**Angle**” portfolio had a tough year like most investment portfolios, it returned +**0.3%**. In a normal year that would be poor, but when you consider the poor performance of property markets and the overall global S&P equity negative return of -2.6%, to come out of the year unscathed is not too bad. As the portfolio is diversified it can withstand losses in a number of markets. In hindsight, I should have diversified the property exposure more across a number of geographical markets. I should also been a lot braver with Asian markets, given my obvious enthusiasm for them during the year.

### Here is how each asset class returned within the portfolio

Equities	+6.5%
Property	-9.1%
Commodities	7.1%

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Here we go again; I’m assuming a 2007 base portfolio value of €50,000, so the 2008 starting base is €50,150 all bought in Jan 1. It may prove to be another tough year and January returns across most markets have been negative, but value opportunities are appearing for investors.

### **My 2008 investment portfolio** (*not necessarily yours*)

<b>Equities –</b>	<b>55%</b>	<b>5% Ire</b> (Stocks IAWS, Anglo, CRH)   <b>10% Germany</b> (Dax) <b>10% Europe ex UK</b> (FTSE Euro+)   <b>20% Asia Pacific</b> (MSCI Asia ex Japan) <b>5% India</b> (Sensex) <b>5% Latin America</b> (S&P LAC40)
<b>Property –</b>	<b>30%</b>	<b>10% UK Commercial</b> (IPD)   <b>10% Euro Property</b> (EPRA Index) <b>10% Asian property</b> (TSE REIT Index)
<b>Commodities –</b>	<b>15%</b>	<b>5% Uranium</b> (Cameco)   <b>10% Commodity Index</b> (RICIX)

*Note: I have added specific indices in each sub segments. Both the EPRA and TSE REIT indices are based on companies exposed to property assets. Direct property investment should be viewed as long term and will differ from the indices used in this portfolio.*

**By Morton Rennick – ACMA QFA**

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