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Fear dominates the market

Large US merchant banks are now going cap-in-hand to sovereign equity funds for financial support.

PETER STRACHAN

STOCK markets worldwide are driven by varying amounts of fear and greed.

In the good times, when share prices appear to move ever higher with monotonous regularity, everyone can be a winner. At these times, greed is the main factor driving the market. Punters throw caution to the wind and scramble to get set in the next winning speculative story, and easy money is made.

When conditions turn tougher, fear becomes the predominant emotion driving markets, and risk gains a higher price.

US investment guru, Warren Buffett, says stock markets are places where money is transferred from impatient to patient hands, while in a bear market phase, money is seen to return to its traditional home or rightful owner, depending on your point of view.

Briefcase has not been alone in warning of tougher times to come for the stock market, suggesting investors consider selling stocks that had not yet established a sustaining cash flow from operations and thus relied on being able to raise new funds on the market.

Growth-orientated companies which have an operating cash flow, or which have funding in place for new projects, are the preferred investment choice for the patient-but-aggressive investor in a bear phase.

A rise in the cost of debt globally, resulting from the US's sub-prime lending debacle, combined with weaker share prices, has raised funding costs for many small companies by well over 30 per cent, assuming that they can find funding. Just to reiterate, *Briefcase* believes we have entered a bear phase with an initial target of 5,300 on the All Ords Index being equal to a 38.2 per cent pullback on a five-year bull run from early 2003 to the November 2007 peak. A 61.8 per cent pullback would correspond to an All Ords Index level of 4,600, which *Briefcase* believes remains a remote possibility in 2008, should economic conditions deteriorate further.

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The current US reporting season is producing some massive write-offs by leading financial institutions, which have flown-on to negatively affect the sentiment towards global markets. By some measures, the smart guys on Wall Street have blown $600 billion on dud loans, which has the potential to reduce lending by $6 trillion over the coming year.

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In the US and the UK, slow spending patterns have put retailers under some heat. Recent short-term rallies in the US market were paradoxically triggered, not by news of better corporate profitability, but by hopes for falling official interest rates in response to the weaker economic activity. These rallies have not been sustained, since in the long term, it is higher corporate earnings that drive markets, not falling interest rates.

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In Australia, BHP's desire for Rio Tinto may be put on the back burner, but could emerge again mid-year when share prices will most likely be lower. Inevitably, the stronger resource companies will now be able to use their bulging cash positions to acquire companies which have failed to ensure they were adequately funded for a bear phase.

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Oh how the mighty have fallen. Large US merchant banks are now going cap-in-hand to sovereign equity funds for financial support. Pools of superannuation and government funds from Singapore and Beijing to Dubai are circling financially crippled Wall Street banking franchises and injecting new cash at historically favourable rates.

While price for shares in the likes of Goldman Sachs and Citgroup will most likely fall further, early movers among the sovereign equity providers will ensure that they gain a long-term advantage for ongoing funding and additional control.

It is interesting to see government and superannuation funds arriving from such undemocratic and often authoritarian states in order to prop up the pillars of US capitalism. Who knows where this will lead?

Briefcase believes these actions provide further evidence for a decline of the American empire. In the longer term, the US financial system must be severely weakened by its recent lack of discipline and self-regulation. *Briefcase* suspects that some level of control will pass to new shareholders, representing petro-dollars and Asian wealth, which will change the landscape of global finance in as-yet-unknown ways.

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Arc Energy has recently found it very hard to kick a goal. Drilling

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problems at its third Canning Basin well left the 100 per cent owned Valhalla well untested and in need of a side track, while highly permeable rocks at the deeper Nullara Limestone Formation, intersected at its Stokes Bay well, could not be tested. Gear problems and the encroaching wet season weather have compounded problems.

Meanwhile, fire at its 33 per cent owned Beharra Springs gas project in the Perth Basin, dropped out about 23 terajoules per day of gas production, just as hot weather lifted gas prices to peak levels, where the Origin Energy operated Beharra Springs had just doubled output as a result of bringing on-stream a new well. Luckily for Arc, gas sales contracts were not so tight that it could not declare unexpected circumstances and the company hopes to recommence gas sales by early February, once Origin gets its act together.

Briefcase estimates that Arc Energy is now trading with a market capitalisation of just 2.4 times its pre-tax, operating cash flow, making it one of the cheapest oil and gas companies on the market. I have long felt that the company has a risk adjusted target value of about $2.20 per share, but merger negotiations between Arc and Anzon Australia have clouded the picture, potentially offering an opportunity.

By comparison, Woodside trades with a market capitalisation of about 8.2 times its current, estimated pre-tax operating cash flow.

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Local speculative exploration company, Venture Minerals, has transformed itself into a focused iron ore exploration and development company, working in a highly prospective region of NW Tasmania.

The company is fast tracking a program of drilling and metallurgical studies, aimed at outlining between 15 million tonnes and 20mt of magnetite mineralisation, suitable for open-pit mining.

Briefcase believes Venture Minerals can become a serious contender in the iron ore game, leveraging off available local infrastructure. Definition of an ore position by mid 2008 would lift Venture Minerals' profile and could attract attention from a neighbouring magnetite ore mining operation at Savage River.

Metallurgical tests on the Mt Lindsay mineralisation indicate an excellent response to conventional processing, with high recoveries of iron to concentrate.

Results from drilling activity at Mt Lindsay, involving up to four drilling rigs, will enable Venture Minerals to fast track feasibility work during H1 2008, adding value for shareholders.

While Mt Lindsay is at a very early stage of appraisal, *Briefcase* estimates that outlining just 25mt of magnetite ore could be worth more than $150 million on net present value basis, comparing favourably with Venture's current market capitalisation of $20 million.

Meanwhile, China is not going to go away and global markets for iron ore remain extremely strong, prompting customers to seek out new sources of supply in relatively stable political environments.

• Peter Strachan is the author of subscription-based analyst brief StockAnalysis, further information can be found at Stockanalysis.com.au

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