

Week
45

Stories To Read From FNArena

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FNArena
Passionate About Financial
News

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Too Early To Get Excited About Ten Network

- Ten Network's full year result viewed as disappointing - Earnings estimates down as ad market conditions remain soft - Turnaround will come but may take a year - Stockbroker opinions remain divided

By Chris Shaw

Having previously guided on full year earnings, yesterday's report of full year EBITDA (Earnings Before Interest, Tax, Depreciation and Amortisation) of \$173 million by Ten Network was not a great surprise for the market.

The result was still viewed as disappointing though, Deutsche Bank attributing the weak result to the adverse impact of a change in strategic direction implemented by previous management team and further deterioration in ad market conditions.

The poor decisions of the previous management was reflected in an increase in the previously announced restructuring charge of \$46.1 million to \$85.4 million. The increase is due primarily to further provisions for sports contracts.

On the back of the result, and given ongoing weakness in ad market conditions, stockbrokers have in general lowered earnings estimates for Ten. As examples, Deutsche has lowered its FY12 earnings estimate by 4.3%, while JP Morgan's numbers come down by 11% and BA Merrill Lynch by 19% for the same period.

RBS Australia's estimates have been reduced by a more significant 33% given an expected decline in TV revenue and a small loss of market share, while Citi has gone the other way and lifted forecasts for FY12 by around 5%.

Consensus earnings per share (EPS) estimates for Ten Network according to the FNarena database now stand at 7.2c for FY12 and 8.6c for FY13.

With a number of bad contracts being written down, FY11 was effectively a year of restructuring for Ten Network. This leads Citi to suggest it is now a waiting game with respect to when audiences may improve and the ad market recover.

As Citi points out, there is upside risk to earnings at present from any broad-based recovery in Ten's markets, but such an outcome appears too early to call at present. Citi suggests the earliest any sign of progress is likely to be seen is February of next year, when new programming starts.

BA-ML agrees, taking the view gains in ad market share for Ten are more likely in 12 months time as Ten is currently holding back on some programming for next year, new shows tend to take some time to settle and advertisers may choose to wait for some evidence of ratings recovering before committing.

For both Citi and BA-ML this means a Neutral rating for Ten Network is appropriate, but there are alternative views. JP Morgan and UBS both retain Buy ratings on Ten, the former given good cost control and expectations of an eventual improvement in market conditions and the latter due to longer-term value at current levels.

In contrast, RBS Australia has downgraded to a Sell rating from Hold previously, the move also being something of a valuation call. The cuts to RBS's earnings estimates mean valuation for Ten falls to \$0.90 from \$1.06, while a further discount for ongoing market share risks is factored in when setting a price target. RBS has reduced its target to \$0.81 from \$0.95, which suggests the stock is expensive at current levels.

Overall the FNarena database shows Ten Network is rated as Buy three times, Hold four times and Sell once, with a consensus price target of \$1.03. This is down from \$1.09 prior to the full year profit result. Targets range from RBS at \$0.81 to Credit Suisse at \$1.34.

Shares in Ten Network have moved inside a trading range over the past year of \$0.80 to \$1.66. Friday's price implies upside of around 14% to the consensus target in the FNarena database.

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Can The Markets Be Kind To Macquarie?

- Macquarie's result weak but no shock - Costs, staff and divs cut but is it enough? - Stock well leveraged to market improvement - Inexpensive but is it time to buy?

By Greg Peel

"Following the release of the European financial package," declares Goldman Sachs' equity strategy team, "we believe there is potential for the macro risks, which have been dominating investor sentiment and driving equity risk premiums higher, to diminish as we head into the end of the year".

Goldmans has backed up that belief by increasing the cyclical exposure of the strategists' model portfolio and reducing the defensive stance it has maintained up to now. Out goes the defensive toll collector Transurban ((TCL)) and in comes the cyclically exposed building products manufacturer James Hardie ((JHX)). And along with James Hardie comes Australia's battered and war-torn investment bank, Macquarie Group ((MQG)).

The "upgrade" for Macquarie from the GS top-down analysis team is at odds with the broker's own bottom-up stock analysts. They retain a Hold rating following the release of MQG's first half FY12 earnings result on Friday. While acknowledging that stock analysts limit their views mostly to a 12-month horizon, while strategists are more inclined to change views on an open-ended time scale, the disparity of opinion amongst representatives of the same broking house accurately reflects a more general market view on the company which no longer carries the tag of "The Millionaires Factory".

I last reviewed analyst opinions on MQG following the release of its full-year FY11 result in a report entitled Macquarie A Matter Of Faith. Ever since the GFC destroyed MQG's previously successful infrastructure fund model, the Group has been forced to revert to being basically a common or garden investment bank once more. Such businesses rely on market sentiment and turnover, on demand for advice, broking services and investment opportunities, and on trading profitability potential. In short, it's difficult for an investment bank to make money when markets are weak and volumes are low. Unfortunately such conditions have been the state of play ever since 2008.

It was never going to be easy to predict just when global market sentiment would "normalise" in the wake of the historically rare event that was the GFC. No one was ready for Greece to become an issue in early 2010 and again in early 2011, leading the whole European debacle to dominate the last two years of activity. All Macquarie management has been able to offer at successive six-monthly earnings updates in the interim is guidance based on the caveat of "if market activity improves". It hasn't, so management has been forced to successively downgrade earnings expectations. As Goldman Sachs stock analysts suggest, "[Friday's] result has seen a continuation of the downgrade cycle which has further delayed MQG's recovery to mid-cycle returns".

The longer market sentiment remains subdued, the longer MQG must endure weakening earnings results, and thus the longer the path back to an improved return on equity (ROE). Macquarie could boast ROEs of 20% pre-GFC but at the moment it's lucky to reach 10%. Analysts see 20% as possible again one day but are looking to at least 15% in the shorter term if markets can improve. The longer that improvement takes, the more MQG bleeds and the more it is forced to cut costs and reduce staff. The risk is that such cost-cuts are held up by management on fear the bounce will come immediately after and upside recovery potential will be cramped. It was a matter of faith, analysts then suggested, that MQG was not doing much about cost cutting at end-FY11.

Since then, the European situation has come to a head, and we've suffered two of the most difficult trading months on record in August and September. No one was expecting MQG to post anything other than another weak trading result. It would simply come down to a matter of degree. As it was, the result mostly fell short of analyst expectations which had already been trimmed in the past quarter. As Credit Suisse points out, the "miss" was related to exactly the area one would expect - the Capital Markets division.

On the other hand, analysts note fees from funds management and other "annuity-style" activities (those which provide more predictable earnings flow largely immune to specific market movements) were solid and better than expected. BA-Merrill Lynch values that "annuity" business at \$28.86. The analysts suggest that even if one were to assume zero income from Capital Markets activities, another \$7-14 of value could be released for the Group. Macquarie shares closed on Friday at \$25.15.

Citi is following a similar trajectory in suggesting MQG's current share price implies an ROE of only 7% by FY14. If the Capital Markets businesses can reach at least an ROE of 10% by that time, Citi believes the stock should be trading 20% higher.

Aside from missing expectations and once again watering down guidance, management made two important announcements on Friday. The first was on the subject of cost cuts and the second related to an intended share buyback. MQG may well be struggling but it is not about to go out the back door. A Basel III update at the result release was welcomed by analysts and we can't forget the big dividend due the Group shortly from the MAp Group ((MAP)) restructure.

Analysts welcome an announced dividend cut. Shareholders may not welcome this news but announced cost-cutting initiatives including a reduction of 485 staff should provide a sufficient trade-off going forward. Dividends can only be paid to MQG shareholders after bonuses have been paid to MQG staff. However, on the matter of cost cuts more than one broker questions whether they go far enough.

Citi suggests "there remains scope to go even harder on costs" and UBS believes MQG needs to "right size" the investment bank to deliver more appropriate returns across the cycle. A headcount of 15,000 is down 3% but "still appears too high for MQG's revenue potential," says UBS.

On the matter of a proposed share buyback, analysts were universally supportive as this will go some way to assisting that much needed ROE improvement. However, only an intention to buy back was announced rather than an actual buyback being confirmed. While analysts believe management will be determinedly true to its word, there is a lot to be done before a buyback can proceed. MQG needs to optimise its capital structure, exit legacy businesses, raise hybrid capital, grow retained earnings and receive APRA approval. "This may take a while," says UBS. At least 12 months by JP Morgan's reckoning.

Yet as noted, the true bottom line for MQG is quite simply whether or not market conditions can improve. Brokers were expecting a better result on profit, dividends and outlook on Friday "but these are extraordinary market conditions," notes Citi, "and the stock may continue to rally if investors are relaxing their extreme aversion to risk".

In other words, investors stand to do very well out of MQG if market conditions can just start heading back towards "normal". This would imply positive market direction and a bit more certainty than has been the case in 2011. Or 2010. If markets can't do so then MQG is in for further downgrades and an even longer path back to the ROEs it once boasted. It then comes down to whether the market has now sufficiently priced down MQG. On that, analysts remain divided.

RBS (Buy) is happy to acquire MQG stock at current levels which it calculates to be 0.9x net tangible asset valuation. Merrills (Buy) agrees, and also points out an attractive 0.7x book value. Credit Suisse (Outperform) likes the book value too as well as an implied 7.7x forward PE. Citi (Buy) is forecasting less risk aversion from markets ahead and it, too, makes note of MQG's 10% discount to net tangible assets.

Deutsche Bank (Hold) suggests it's too difficult to know just when markets will return to "normal". JP Morgan (Neutral) believes management has laid out a clear path towards ROE improvement but "it is too early to 'pay ahead' for these prospects". Goldman Sachs (Hold) suggests a ROE greater than cost of equity looks an achievable goal over the next 2-3 years, but "the risk to earnings remains high".

All brokers have trimmed their FY12 earnings forecasts. Of the seven brokers covering MQG in the FNArena database, four have a Buy or equivalent rating and three a Hold or equivalent (Goldmans is not in the database and Macquarie is not allowed to rate itself). There are no Sell ratings. The consensus price target was impacted by moves both up and down post-result, and is today at \$31.00 compared to \$30.61 prior to Friday. The uncertainty of whether or not markets can "normalise" from here is nevertheless reflected in the wide target range, from \$27 (UBS) to \$40 (Credit Suisse).

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Transpacific Restructuring Attracts Stockbroker Upgrades

- Transpacific refinancing removes a headwind - Company should benefit from improved management focus - Goldman Sachs upgrades to a Buy rating

By Chris Shaw

Transpacific Industries ((TPI)) has undergone significant changes since 2009, with a new chairman and senior management team and new governance functions in place. The final step needed was a debt restructuring and capital raising, which is now underway.

A debt refinancing for \$1.5 billion has been achieved on improved terms and a total of \$300 million is to be raised from institutional and general shareholders.

For Goldman Sachs, the news of the recapitalisation has been enough to justify upgrading to a Buy rating from Hold previously. The move to raise funds should see Transpacific's balance sheet return to a more normal gearing level over the next three years, which implies a move to interest cover of more than three times. This should make the stock more attractive to a wider range of investors.

As well, the restructuring means no debt matures between now and November 2014, something Goldman Sachs suggests will allow management to run the business with a view to what is in the longer-term best interests of the group without the distraction of debt issues.

In terms of Transpacific's operations, market growth about equal to that of GDP growth is a reasonable expectation in the view of Goldman Sachs. This should translate into solid growth for Transpacific given strong market positions, the company enjoying about a 20% share of key operating markets in the industrial cleaning, recycling and waste management sectors.

Under such an assumption the stock appears to offer value at current levels, as Goldman Sachs estimates Transpacific is trading on an earnings multiple of around 9.8 times in FY13 and 8.4 times in FY14.

This is based on Goldman Sachs's earnings per share (EPS) forecasts of 5.2c for FY12, 7.6c for FY13 and 8.9c for FY14. These estimates compare to consensus EPS forecasts according to the FN Arena database of 6.4c for FY12 and 8.1c for FY13.

Assuming the Transpacific balance sheet returns to more normal levels, Goldman Sachs sees scope for the current discount to the Small Industrials index of 1% for FY13 and 7% for FY14 to be unwound. This should also see the current 20% earnings multiple discount relative to global peers come in from what are seen as excessive levels at present.

Goldman Sachs has not been the only broker to turn more positive on Transpacific on the back of the debt restructuring. Both Credit Suisse and RBS Australia have similarly upgraded to Buy ratings from previous Hold recommendations.

RBS agrees with the Goldman Sachs view the debt restructuring and capital raising could act as a possible catalyst for the share price of Transpacific, as it removes what had been some headwinds for the company.

Credit Suisse sides more with the other element of the Goldman Sachs argument, in that with debt and balance sheet pressures no longer on the minds of management, Transpacific can focus on growing its operations. This offers some upside medium-term.

The changes to the ratings of RBS and Credit Suisse means Transpacific is now rated as Buy three times and Hold twice, while Macquarie is restricted from offering a rating. Goldman Sachs is not in the FN Arena database.

With the capital raising increasing the number of shares on offer, the consensus price target for Transpacific now stands at \$0.87, down from \$0.90 prior to the refinancing announcement.

Shares in Transpacific have traded inside a range over the past year of \$0.515 to \$1.50. The current share price implies upside of around 23% to the consensus price target in the FN Arena database.

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Get Set For Positive News From Karoon

- Karoon quarterly suggests Browse and Santos projects may be delayed - Delays are timing issues so not a major problem for DJ Carmichael - Ratings on Karoon remain positive given upside potential

By Chris Shaw

For Karoon Gas Australia ((KAR)), the key elements of the group's quarterly production report related to timing expectations for future work on both the Browse Basin appraisal program and permits in the Santos Basin in Brazil.

Perth based stockbroker DJ Carmichael notes work at both prospects may be delayed by a few months, pushing both into the first part of 2012 rather than the final quarter of 2011. Given these appear nothing more than timing issues, the broker sees no reason to shift from a Speculative Buy rating on the stock.

The positive view of DJ Carmichael reflects the upside potential of both projects. The second phase Browse drilling program should delineate the commercial potential of the Poseidon field, with further development work now possible after environmental approval was granted in July.

Currently, the field has a 2C (mid case, contingent) resource estimate of 7 trillion cubic feet of gas and completion of the second phase of work should see the project advance to the development phase. The first well to be drilled will be Boreas-1, a large tilted fault block about 5km from the Poseidon-1 fault block.

Karoon is currently looking to farm-out its five Santos Basin permits and DJ Carmichael expects this process will run into 2012. One positive of the delay is a final contract should be announced early next year rather than just a preliminary agreement.

Drilling on the permits is forecast to begin in the second quarter of next year, DJ Carmichael noting new seismic data should support both the farm-out process and drilling work. Drilling in the Santos Basin is likely to be the major value driver for Karoon next year, as the region has a high success rate and the area offers better fast-track monetisation options than do LNG developments.

The pick up in activity is expected to be accompanied by Karoon releasing an updated resource report in the first half of next year. DJ Carmichael expects a material resource upgrade, as the report will include both the Browse drilling program and the new seismic data for the Santos Basin.

Upcoming activity implies positive news flow for Karoon in coming months, DJ Carmichael suggesting the potential of both projects to add value is giving investors an opportunity in the stock. Credit Suisse agreed in an update last week, noting the South American assets had the possibility to deliver some positive news flow in coming months.

While DJ Carmichael is not in the FNArena database its positive view on Karoon is far from an outlier, as the database shows a perfect five-for-five Buy ratings for Karoon. The consensus price target according to the database is \$8.90, with targets ranging from \$7.65 for Credit Suisse to \$10.00 or more for both Citi and Macquarie. DJ Carmichael's price target for Karoon is \$9.66.

Shares in Karoon have moved within trading range of \$2.60 to \$10.00 over the past year, the current price implying upside of better than 100% relative to the consensus price target of \$8.90.

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Mesoblast: Undervalued Or Overvalued?

- Mesoblast to release further trial results this month - Bell Potter expects good results, see stock as undervalued - In Macquarie's view the risks remain high

By Chris Shaw

In September Bell Potter highlighted two developments for stem cell biotech Mesoblast ((MSB)) that were potential positive drivers of the stock - a new heart attack trial and a manufacturing alliance (see: News Flow For Mesoblast Remains Positive). Results from a 60 patient Phase II trial of Mesenchymal Precursor Cell (MPC) technology for treating heart failure are due to be released at a special session of the American heart Association's annual meeting on November 14.

As Bell Potter notes, if the trial results confirm expectations MPCs can rebuild heart muscle and improve blood flow to the heart, thereby reducing adverse coronary events and hospitalisations, Mesoblast has an entry into multi-billion dollar market opportunities.

On the numbers of Bell Potter, the current Mesoblast share price undervalues the cardiovascular applications of MPCs alone. This is because the MPC technology works in the broker's view, as the stem cells injected appear to release soluble factors that contribute to tissue repair and regeneration.

Tests already conducted also suggest Mesoblast's MPC technology is effective, as a previous 60-patient trial registered no cardiac mortality over an average 18 months of follow up and showed a reduction in the number of patients developing any severe adverse cardiac events.

Data to date for Mesoblast shows its MPC technology is superior to other stem cell approaches, as Bell Potter notes trials by other developers have not delivered results of similar quality. The broker expects the full trial results to be presented this month will allow the company to move straight to a pivotal trial of around 1,000 patients from next year.

The other supportive factor for Mesoblast in the view of Bell Potter is the company is starting to build a valuable spinal franchise, as Phase II trials are being conducted for applications such as posterior interbody lumbar fusion and cervical spine fusion.

For Bell Potter, this opens up Mesoblast to the possibility of being an acquisition target as any buyer would be able to more comprehensively access a large and growing segment of the orthopaedics market.

Given the upside potential it has identified, Bell Potter rates Mesoblast as a Speculative Buy, down from a Buy rating previously. This "downgrade" implies an upgrade to risk. Price target remains at \$16.00 per share.

Not everyone has such a positive view of Mesoblast's value though, as last week Macquarie initiated coverage on the stock with an Underperform rating and \$5.80 price target. This follows a series of meetings with a number of experts in the field, including cardiologists, surgeons and stem cell researchers.

Macquarie suggests while Mesoblast is making good progress with its MPCs, there remain questions as to the effectiveness of stem cells in repairing tissue. This relates in part to there being many types of stem cells with no clear winner in the field, as well as other issues such as the potential for a body's immune system to kill off donated stem cells.

Another problem is potential difficulties associated with ramping up stem cell production without having to re-run clinical trials, as Macquarie notes no commercial production of stem cells has yet been done.

In Macquarie's view the market is currently underestimating the risks and uncertainties associated with stem cell technology in general and with Mesoblast's product. This suggests a far more conservative assessment of Mesoblast is appropriate, Macquarie's valuation range for the stock standing at \$4.30-\$7.29.

Given the uncertainties in the stem cell market Macquarie argues it is difficult to justify a material premium relative to peers for Mesoblast. Yet at present, Mesoblast has a market capitalisation five times greater than its nearest competitor and 10 times that of its second nearest competitor.

Such a premium appears far from justified as data from the heart failure trials being undertaken by Mesoblast, while promising, was not wholly positive in Macquarie's view. The data suggested while the MPC treatment appears safe, it is not possible to prove its efficacy on the information provided.

While Macquarie doesn't expect this will impact on the expected Phase III trial next year, it does suggest gaining significant market share will be challenging unless the trial delivers outstanding results. There is also the risk multiple Phase III trials will be needed before stem cell technology takes a high market share.

When all this is factored in, Macquarie's argument is simply while Mesoblast appears to have some promising technology, it is simply too early to get excited about the stock given the potential for setbacks or the need for significant additional testing. This means investors need not rush to get set in what remains a risky investment.

Shares in Mesoblast today are stronger and as at 11.45am the stock was up 48c at \$8.09. This compares to a trading range over the past year of \$2.59 to \$10.04. Macquarie is the only broker in the FNArena database to provide coverage on the company.

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Iron Ore Weakness Clouds OneSteel Outlook

- Weaker iron ore prices impact on OneSteel's earnings - Brokers cut estimates and price targets - Lower earnings increase debt covenant risks - Ratings downgraded to reflect uncertain outlook

By Chris Shaw

Management at OneSteel ((OST)) yesterday downgraded 1H12 earnings guidance, indicating net profit after tax for the period is now likely to be in a range of \$55-\$75 million. This is well below previous market expectations, as UBS for example had been anticipating an interim net profit of \$112 million.

As RBS Australia points out, the reduction to earnings guidance highlights the negative side of OneSteel's vertically integrated model. Weaker iron ore prices in recent weeks have depressed export sales for the company but there has been no relief to the steel manufacturing operations from lower input costs as steel prices have also dropped.

The fall in iron ore prices has, according to RBS, been exacerbated by Chinese customers requesting contract prices be adjusted to closer to current spot market prices. This could result in some contracts paying 16-32% less in the current month on RBS's numbers.

This flows through to a significant earnings impact, as Deutsche Bank notes the iron ore operations of OneSteel represent around 86% of FY12 earnings. To account for the new guidance from management, brokers in the market have been quick to lower earnings estimates.

Deutsche Bank had already been 15% below consensus for FY12 but the broker has reduced estimates by a further 50% for the full year, while JP Morgan has lowered its base case numbers for the year by 32%. The FN Arena database shows consensus earnings per share (EPS) for OneSteel now stand at 18.6c for FY12 and 32.4c for FY13.

One issue for OneSteel is if present iron ore pricing and steel making and distribution conditions continue for some time. As JP Morgan notes, such conditions would mean debt covenants will be tight by next June.

Deutsche Bank agrees, noting its revised estimates indicate an EBITDA/interest ratio of four times, which is close to the covenant estimate of 3-4 times. If iron ore prices remain under pressure there is further downside risk to earnings in the view of Deutsche, which would add to debt covenant pressures.

While it would likely take a bear case scenario to lead to a covenant breach in the view of RBS Australia, the lack of earnings visibility for OneSteel at present suggests even the possibility of a breach is likely to act as an overhang on the stock until iron ore prices recover.

This makes future iron ore prices important, and here the market has mixed views. UBS has revised its December quarter price forecast to US\$136 per tonne fob, but expects a bounce back in 2012. The broker's March quarter forecast remains US\$170 per tonne.

In contrast JP Morgan suggests there is support for iron ore prices around US\$130 per tonne, though the broker does not fully discount the risk prices dip below US\$120 per tonne over the rest of FY12 and into FY13. Deutsche Bank has taken a conservative route and factored in prices of US\$120 per tonne for the rest of FY12.

On the back of revised guidance from OneSteel there have been downgrades to broker ratings, with RBS Australia cutting its recommendation to Hold from Buy and Deutsche Bank to Sell from Hold. The FN Arena database shows OneSteel is now rated as Buy five times, Hold once and Sell once.

The Buy argument is a valuation one, JP Morgan estimating at current levels OneSteel is trading on an earnings multiple in FY13 of just three times, even allowing for an iron ore price of US\$120 per tonne. UBS and Macquarie offer similar arguments in support of the stock.

For Deutsche Bank there is little scope for OneSteel to outperform in the current environment, especially as there is now a real risk of a capital raising to deal with debt covenant issues. This risk supports the move to a Sell rating.

RBS Australia takes the middle ground, while agreeing with Deutsche the shorter-term outlook for OneSteel is now much more uncertain than had been the case. While the stock should rally if iron ore prices recover, RBS sees better leverage from iron ore plays such as Fortescue Metals ((FMG)) and Atlas Iron ((AGO)).

The database shows a consensus share price target for OneSteel of \$1.91, down from \$2.10 prior to the update. Shares in OneSteel today are slightly higher and as at 11.20am the stock was up 0.7c at \$0.992. This compares to a trading range over the past year of \$0.985 to \$3.06, the current share price implying upside of around 78% to the consensus price target in the FNArena database.

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Grains Ready For A Rally?

By Jonathan Barratt The overall grains complex is starting to look more attractive and the continued volatility of the market is testing the resolve of many of the traders. In essence, we feel that the market is trying to form a low however, traders are reluctant to put on new positions ahead of any statement from the EU. Corn World ending stocks for Corn remain tight and we expect this to remain the same in particular as farmers are reluctant to put their harvest to the market whilst prices remain low. Technically, the range for Corn is US 600 to the downside and US 655 to the top side. Dips back to US 625 should be supported. Our bullish move is frustrated if US 580 is compromised. Any stops on long positions need to go in at US565. Wheat The volatility in the wheat market continues to frustrate traders, this remains the same as last week. We are hearing that the market is nervous about the prospects of supply coming from Australia and Russia. In Australia the recent rain is suggesting that WA will likely double its crop and the countries overall harvest will be close to a record. The main concern we feel is that the BOM is predicting a La Nina event this year so may be a wet harvest. As such protein spreads will be volatile. We are still long the commodity from last week. Technically, support now comes in at US605. We need to see US650 broken on a daily close to see the trend higher resume. Momentum indicators remain bullish. Stops remain at US595. Soybean As mentioned last week the momentum for the move higher was slowing and we could expect the market to enter into a period of consolidation. Taking profit has been the order of the day however, we feel we are getting close to a low. A pull back to US 1215 is on the cards. Technically, momentum indicators are topy and we suggest that we will enter a period of consolidation. This comment remains the same as last week. Rough Rice Rough Rice continues to look supported from the floods in Thailand and traders are getting nervous that production quotas will not be met. We continue to suggest that this will be temporary as we look towards India for a record harvest to fill in the gap as a result of the loss from Thailand. As from last week we continue to expect to see a lift in prices but nothing too dramatic at the moment. Resistance stands at US 17.50 which is the top end of the range. Produced by Jonathan Barratt direct from the trading desks of Commodity Broking Services, Barratt's Bulletin provides expert analysis of commodity markets, global indices and foreign exchange movements. Click here to take a no obligation 21-day trial to Barratt's or to learn more visit www.barrattsbulletin.com. Content included in this article is not by association necessarily the view of FNArena (see our disclaimer).

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Material Matters: Magnetite Winners And Losers, China Balancing Markets

- Magnetite iron ore deposits: winners and losers - Quarterly pricing for iron ore under threat - Met Coal unlikely to fall by as much as iron ore - Chinese production important for balancing metal markets

By Chris Shaw

The development of magnetite deposits is a growing element of the iron ore market, RBS taking the view first mover advantage is critical with respect to beating escalating construction costs and enjoying the current window provided by historically high iron ore prices.

With this in mind, RBS has analysed 33 major magnetite projects in Australia, with a view to highlighting those projects seen as most likely to succeed. In general, the broker's preference is for projects already in or close to commencing production.

The only Australian plays that fit this bill are those of Grange Resources ((GRR) and Gindalbie ((GBG)), with RBS seeing both as well placed to take advantage of current prices and correspondingly strong margins over the next several years.

In contrast, RBS suggests few of the other magnetite projects will actually be developed, this due to high capital intensity, tightening funding availability and a lack of infrastructure access. Other issues include project resource size, as well as the need to secure financing and production offtake agreements with Asian steel mills that can assist in funding development costs.

As well, with estimated development time of more than six years from initial feasibility studies to first production, projects not currently at an advanced stage may miss out on the near-term window of currently strong prices.

Among the 28 projects not yet close to production, RBS sees seven as fulfilling one or more of the criteria seen as necessary to get such a project off the ground. These include Jack Hills for Murchison Metals ((MMX)), Balmoral South for Australasian Resources ((ARH)), Southdown for Grange Resources, Mount Forest for Mindax ((MDX)), Fusion for Centrex Metals ((CXM)), Centrye Erye for Iron Road ((IRD)) and Ridley for Atlas Iron ((AGO)).

In terms of how best to play investment exposure to magnetite developments, RBS rates Grange Resources as a Buy and its top pick in the sector. Gindalbie is also rated as a Buy, while Iron Road is rated as a Hold.

RBS is the only broker to cover Iron Road, while the FNArena database shows Sentiment Indicator readings of 1.0 for both Gindalbie and Grange Resources.

Further on iron ore, Deutsche Bank notes the spot iron ore price's discount to the contract price now exceeds US\$40 per tonne, the largest such discount since the market's move to quarterly pricing. The discount is likely to be enough to break the system, Deutsche expecting a move to even shorter-term contracts.

In the view of Deutsche Bank, the large price discrepancy is not healthy for the industry as it leads to clear and potentially destructive tensions between producers and consumers. One issue is the quarterly pricing system has been of most benefit to the mills, so they are likely going to think hard carefully about moving from the current system.

On a cumulative basis Deutsche notes since the start of 2010, a consumer buying a tonne of iron ore every day would be US\$7,000 better off on the quarterly contract system than on spot. As this bias is likely to remain in a tight market, and Deutsche expects a tight market in coming years, the mills are likely to be worse off from a move to spot pricing.

This decline in iron ore prices of 30% over the past month has been enough for the market to also turn its attention to metallurgical coal given it is the other key ingredient in steelmaking. To date the relationship has been far from equal, as compared to iron ore prices premium hard coking coal spot prices are down just 6% since the start of October.

The magnitude of the fall in the iron ore price is unlikely to leave met coal totally unscathed in Citi's view, but the broker doesn't expect a price fall of the same magnitude for several reasons. The first is met coal is less exposed to the marginal Chinese buyer, as China accounts for only 17% of the seaborne met coal market. This compares to 62% of the seaborne iron ore market.

As well, Citi notes Chinese and Indian buyers have been far more agreeable towards spot or monthly prices in the met coal market, meaning less risk of any reneging on cargoes priced at a massive premium over spot prices.

Finally, Citi suggests the combination of strong Japanese steel production and high prices in the Chinese domestic market should keep import demand high. Given Japan, which accounts for 32% of all met coal imports, prefers premium hard coking coal and most other met coals are priced off this material, prices are unlikely to move violently in Citi's view.

When the risk of another wet Australian summer is also factored in, Citi takes the view buyers are less likely to pull back from the market given concerns over the potential for losing current security of supply.

Citi does accept the current macro environment will likely weigh on spot prices short-term. With spot prices now about US\$40 per tonne below the current quarterly contract price, it appears unlikely prices in 1Q12 will be higher or even unchanged without some sort of disruption on the supply side.

One difference between the met coal and iron ore markets is the cost structure, as in iron ore at present the marginal cost has a number of producers under water and so is likely to generate some supply response.

In contrast, Citi notes the cost structure in the met coal market is relatively flat, so a supply side response is unlikely unless prices were to fall another 20% from current levels.

For Macquarie, one interesting result of the commodity demand boom of China has been the need for solid volumes of high cost Chinese mine and smelter supply to balance a number of metal markets. This has had the effect of changing market dynamics, as the flexibility of this production has meant price moves rather than just changes in stock levels have had an impact on market balances.

As an example, Macquarie notes the lack of seaborne iron ore supply growth in 2010 and 2011 has seen prices trade at a level high enough to attract suitable Chinese material into the market to satiate steel production.

At present Macquarie points out the market is in a disincentivisation phase, as prices are trading at levels where a proportion of Chinese supply is not economic. This suggests any evidence such supply was actually being cut would be a positive, helping clear the decks for the next leg of incentivisation as apparent demand normalises.

Macquarie suggests the October sell-off has seen nickel, zinc, aluminium, steel and iron ore trade into the cost curve. Nickel pig iron produced in small blast furnaces is now extremely marginal, more than 25% of Chinese aluminium smelters will be losing money and around 10% of zinc supply is also losing money at current levels.

Macquarie's view is in most of these markets the price falls have overshoot any drop in real demand, as the Chinese economy is still growing. Macquarie analysts have noted some signs Chinese supply is already adjusting, as zinc smelters are reacting at certain price levels and some smaller ironmaking blast furnaces in China are being kept idle.

Rather than taking the view any lowering of Chinese production would be a negative, Macquarie argues such moves are a positive as it will assist in bringing metals markets back into balance more quickly.

Macquarie's view is as market conditions normalise, it will become apparent too much material has been cut back by the price falls. This means as certainty returns to the Chinese market, prices will need to rise to provide the incentive for a response from currently idle capacity.

Macquarie sees such incentive-disincentive cycles as likely to become more the norm as China's share of global metals demand increases.

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Environment Conducive To Further Gold Price Gains

- Some similarities for gold market between 2008 and now - Barclays sees a number of factors as supportive for the metal
- Positive backdrop suggests further gains are likely

By Chris Shaw

In late September the gold price fell by 10% in just four trading sessions, a price movement Barclays Capital notes was enough to draw some comparisons with the price action and environment experienced in 2008.

In 2008 the gold price broke the US\$1,000 per ounce barrier in March but was back below US\$700 per ounce by October, as gold was liquidated to meet the needs of margin requirements elsewhere in financial markets. Prices then slowly recovered, not breaching the US\$1,000 per ounce level again until the first quarter of 2009.

This year the move was quicker as from an all-time high of more than US\$1,900 per ounce on September 6, it took less than a month for the price to fall below US\$1,550 per ounce as risk aversion and the need for liquidity weighed on the price of the metal.

The common link between both periods according to Barclays is a fragile macro environment, something that remains the case at present given ongoing sovereign debt issues in Europe, US deficit issues and general uncertainty with respect to the global economic growth outlook.

One difference to 2008, notes Barclays, is financial markets and economies today do not look as vulnerable to collapse as was the case three years ago. At present there are high levels of liquid assets and low levels of risk, which Barclays suggests should help the global economy avoid sliding into recession.

As Barclays points out, traditionally gold prices have followed a different trajectory to equity markets, but there are periods when both markets move together. As an example, the one-month correlation between gold and equity prices turned positive in October, matching a similar turn in September of 2008.

The asset allocation experts at Barclays suggest if the global economy can in fact avoid a recession, which is suggested by current robust US economic data, there is potential for gold to return to a "risk on" environment as inflationary concerns would again come to the forefront. This would sustain a supportive macro environment for the gold price.

In the view of Barclays, while credit concerns persist, in Europe in particular, these are not the key driver of the gold price this time around. There remain three steps required to restore confidence in European banks and to spur a sustainable spread rally, something which would be expected to offer some additional support to gold prices.

These are the provision of additional capital to ease solvency concerns, the provision of funding support to offset intermittent capital market access and the stabilisation of asset values to provide clarity with respect to future write-downs.

Historically, a weaker US dollar has supported the gold price but Barclays notes a strong US dollar does not prevent gold prices from moving higher. At present Barclays remains bearish on the EUR/USD over a three month time frame given ongoing uncertainties and risks, but assuming European conditions stabilise the US dollar is then expected to weaken again. Gold should be a beneficiary if this occurs, particularly from safe haven buying.

While gold has never been a perfect hedge against inflation, rising inflationary expectations tend to support the price of the metal. With the difference between yields on 10-year US government bonds and 10-year inflation-indexed bonds again starting to tick higher, inflation is once more becoming an issue of importance. Overall, Barclays expects inflation may not fall significantly, which means ongoing concerns with respect to currency debasement are a further potential driver of the gold price.

Rising real interest rates should mark the turning point for gold in the view of Barclays, as the current low real interest rate environment has been conducive to higher gold prices as the opportunity cost of holding the metal has come down.

From an investor perspective, Barclays notes while a positive view towards gold has largely not changed between 2008 and now, the preferred means of exposure this time around is via bar holdings rather than through futures contracts or ETPs.

One difference between 2008 and now has been investor interest is not the sole driver of prices, as demand for gold in 2011 has come at increasingly higher price levels. Had this not been the case, Barclays suggests price action would have been much more volatile, so creating a significant gap for investment demand to fill.

Barclays also points out the supply side response has been slower this time around, in part because central banks have turned to net buyers having been net sellers of the metal in 2008. This not only takes some supply out of the market but introduces a sizable source of demand at record price levels.

For Barclays, the expectation is gold prices should find good support from the physical market before recovering lost ground and again challenging new highs as investment demand picks up. A backdrop of negative real interest rates, concerns with respect to inflation and currency debasement, rising sovereign debt and financial market and economic stability questions all remain favourable for gold.

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Weather It Be True

By Greg Peel

The flooding rains which began in Australia late last year culminated early this year in tragedy in South East Queensland and astonishing footage of Brisbane being washed away. Today we find it difficult to comprehend television coverage from Thailand which simply evokes thoughts of Coleridge and "water, water everywhere". Immediate impacts of weather events include the loss of lives and livelihoods, but wider global ramifications can be felt through subsequent impacts on commodity prices.

In the first two quarters of 2011 many Australian mining companies suffered extensive loss of production through flooding and the September quarter is only now seeing a return to normalcy for some. Depending on location, different operations suffered by varying degrees. Arguably the hardest hit was the Ranger uranium mine in the Northern Territory, for which water may yet ensure the demise of Energy Resources of Australia ((ERA)).

Across Queensland in particular flooding not only inundated pits but tore up goods rail lines and damaged ports to provide a double-whammy effect in many cases. Some mining companies were sitting on stockpiles which could have been drawn upon to fulfill contracts but for the fact they could not be delivered. Force majeure became popular. Other parts of Australia were also impacted, from NSW to WA and Victoria.

Australia's farmers who had so long suffered from drought in many cases faced the opposite problem. The global importance in Australia's export of commodities such as coal, base metals and grains ensured that restriction in production and supply forced global prices higher but still resulted in opportunity and real losses for Australia's producers.

Right now the Australian gold miner Kingsgate Consolidated ((KCN)) is experiencing the same grief at its highly prospective Chatree project in Thailand. Having spent years dealing with a glacial government approval process (which is ongoing for extensions), Kingsgate is now losing what production it has to the rain.

More importantly for Thailand and the world is the loss of crops to the floods. Rubber plantations can cope with a bit of water and sugar cane actually quite likes a good monsoon to provide an ensuing bumper crop, but Thailand's rice industry is facing devastation. Flood damage to rice production, notes Deutsche Bank, is expected to be extensive.

Thailand is South East Asia's leading exporter of rice. Projections at this stage are of a loss of 24% of average rice exports to 8Mt. In 1995, floods cut Thai rice exports by 11% which pushed the global price of rice up 30%. The Thai Rice Exporters Association is predicting next year's rice exports from Thailand could drop by as much as 30%.

Fortunately weather has a habit of balancing itself out across the globe, often providing the opportunity for net global exports of commodities to do the same. India has recently experienced higher than expected rice inventory levels, notes Deutsche, and hence the government has lifted a ban to allow 2Mt to be sold internationally. Pakistan is also hoping to boost exports next year by 30%. Unfortunately the weather balance can often go too far.

Floods may bring devastation but rice crops still rely on a lot of water. A lack of water has recently reduced production in the US and in key exporting countries in Latin America. Most worryingly, China has recently been suffering from the impact of drought. For the first time in several years, notes Deutsche, China has become a net importer of rice.

Financial markets in 2011 have been thrown into turmoil by the European debt crisis, but a disturbing side-issue has been the forced slowing of economic growth in China. Beijing has the capacity to ease its monetary policy stance to balance out global economic growth, but to date has been unable to do so due to runaway inflation. The most significant inflation has been experienced in the price of food, and for still mostly poor Chinese, food represents a significant proportion of household spending.

Rice forms the staple diet of half the world's population, Deutsche points out, particularly in Asia and Latin America. Food accounts for around 30% of Asia's inflation basket but that figure rises to 33% for China and 46% for India. The greatest food price inflation for the Chinese in 2011 has been experienced in pork which is the country's most popular meat. Pork inflation has eased but remains stubbornly high, while other elements of the inflation basket have now begun to slow in growth. Analysts globally are expecting China's CPI to fall back to around 4.5% by year's end from a current 6% which is where Beijing will feel comfortable.

Now, however, food price inflation is reemerging as a potentially significant threat for the Chinese economy in 2012, suggesting the potential for further tightening from the Chinese government at a time when Europe remains a major problem for the world.

Meanwhile in Australia, meteorologists are warning of increasing chance of another La Nina episode as we approach the end of the year. "Consequently," suggests UBS, "it is increasingly likely that we will see renewed disruption to the seaborne trade of thermal and coking coal, and even nickel laterite trade out of South East Asia".

Australia's meteorologists closely monitor the Southern Oscillation Index in order to make their predictions. Overlaying the shorter term fluctuations of the SOI and El Nino-La Nina events is the Pacific Decadal Oscillator, which is still to be fully ratified and acknowledged by the scientific community. The PDO suggests that as well as the shorter term cycles of typically three to seven years of the Little Boy and Girl, the world experiences longer wet-dry cycles of 20-30 years which overlay the shorter rotations.

Past devastating flooding in Australia (eg Brisbane 1974) has occurred during a combination of a wet PDO cycle and a severe La Nina event. Recent decades in Australia have seen a dry PDO cycle and a rash of El Nino events which have been accredited for the prolonged drought. Last year brought a sudden severe La Nina and subsequent destructive floods. A wet PDO cycle is currently due and that experience suggests to PDO protagonists that it has now begun.

I first wrote about the PDO in an FNArena feature story in February: [Two More Decades Of Wet For Australia? With another La Nina possibly approaching, the theories outlined therein are further supported.](#)

The good news is that the next La Nina is not expected to be as bad as the last one. The bad news is however, as UBS notes, that having suffered through the last one Australia is not in a very good position to cope with another one, even if it is less severe.

From a natural standpoint, the long years of drought meant so little soil moisture in relevant areas that at least the first of last year's rains washed straight in. The persistence of that rain into 2011 nevertheless meant the soil became saturated and flooding ensued. Nine or so months later and that soil moisture level remains generally higher than normal.

From a non-natural standpoint, strict environmental laws in Australia have ensured that many pits have not yet been able to be pumped dry due to the risk of various chemicals contaminating that water. Some older pits still have "substantial" amounts of water in them. Many mines thus have a lesser capacity to take on more water than they did last year, and as such a less severe La Nina can still mean significant loss of production once more.

And that again suggests commodity price inflation for the globe at a time when the global economy is once more threatening to contract, notwithstanding loss of earnings for Australia's miners.

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Material Matters: Nickel, Steel, Gold And Oil

- Cautious outlook for nickel prices - Gold price still likely to move higher - Brent-WTI spread continues to close - Steel market conditions weak at present

By Chris Shaw

LME nickel prices have fallen steadily for much of 2011 but in recent weeks prices have stabilised and, as Macquarie notes, at one point jumped more than 10% above recent lows. This price weakness has been at odds with fundamentals, as prices have come down despite ongoing falls in LME stocks of more than 50,000 tonnes year-to-date.

Macquarie suggests the recent price rally has been largely the result of short-covering, this despite some evidence of a deteriorating demand outlook from the stainless steel industry and a sharp increase in nickel production in the September quarter.

As this increase in production came despite ongoing delays to large greenfield nickel projects and an apparent stalling in Chinese nickel pig iron production growth, Macquarie suggests the near-term outlook for the metal appears bleak.

In China Macquarie notes demand did not pick up as strongly as expected after the summer slowdown, meaning mill inventories started to rise sharply in October. This increase is causing some mills to cut supply by as much as 10-15% in month-on-month terms, with more cuts expected in coming months.

The weakness in nickel ore prices and extra price credits charged for iron content mean costs are falling for nickel pig iron producers. This leads Macquarie to suggest profit margins for marginal producers in this market are not as bad as the press is reporting.

Given higher than normal nickel ore stockpiled at Chinese ports and recent cuts in demand from high-grade nickel pig iron producers, Macquarie expects the production cost of nickel pig iron will fall further.

At the same time apparent supply in the Chinese market is continuing to rise, not only from rising domestic nickel pig iron production but from higher imports of finished nickel products. This combination of deteriorating demand and potential moves down of cost support from marginal nickel pig iron producers in China leaves Macquarie with a conservative view on the outlook for nickel prices

Sharps Pixley is a physical precious metals trader, which gives the group solid insight into the gold market. In the wake of the Greek referendum decision dragging financial markets back into turmoil, the potential implications for the gold price are again in the spotlight.

In the view of Sharps Pixley CEO Ross Norman, the fact gold has done little on the news out of Europe suggests some large forces acting on the price of the metal that are currently offsetting each other. These forces are the positive of strong flows of investment money into gold and the negative impact of a stronger US dollar.

Norman suggests the winning side in this battle over the direction of the gold price is yet to be decided. Most likely in Norman's view is gold moves significantly higher, as the problems in Greece are yet to fully play out. This suggests gold's role as a safe haven will prevail as the key driver of the price.

One point of note according to Norman is the global gold market is relatively small, as if all of the world's annual gold production could be sold at current prices it would give a "market cap" only equal to that of Vodafone.

This means the gold price can easily be driven in one way or another. In Norman's view, it is clear which direction the prevailing wind is coming from at present.

Turning to the oil market, FOREX.com research director Kathleen Brooks suggests the speed at which the spread between Brent Crude and West Texas Intermediate (WTI) has started to narrow post the death last week of the Libyan dictator Gaddafi is a surprise.

Brooks had expected the gap would take some time to narrow, as the extent of damage to Libyan oil supply from its civil strife was not clear. But the narrowing has come sooner, Brooks suggesting a couple of reasons why this has occurred.

One is more Libyan oil is coming back on line as conditions in the country stabilise. The other is early snowfall across the north-east of North America has driven an increase in demand for US oil. This has had the effect of taking some of the shine off Brent crude.

The spread between Brent and WTI has now re-traced 38.2% of its move from the July 2010 low to the high in early October. There remains scope for the spread to narrow further in the view of Brooks, which would mean further downward pressure on Brent crude prices.

There remains potential for the spread to return to more normal levels, which would suggest both Brent and WTI trading at around the same price. This was the case prior to July of 2010.

In steel, industry consultant MEPS notes ferrous scrap prices dripped across the world in October, reflecting a downturn in the global steel market. Buyers have doubts about short-term prospects for the industry given global economic uncertainty, MEPS noting few buyers are prepared to build inventories in the current environment.

With mill order books also weakening, this has translated into lower demand for ferrous scrap. MEPS expects the current environment will extend until close to the end of the year, after which there is potential for a return to inventory rebuilding.

Improved mill order books and tight supply of ferrous scrap should produce a revival in the market, while MEPS also expects increasing input costs for steelmakers. Another potential positive is if the current appreciation of the US dollar proves to be short-lived, which MEPS sees as possible if Europe's debt issues can be addressed.

Steel prices in general also declined in October, MEPS noting this reflects producers needing to offer discounts to stimulate demand given order books are not full at present. At present MEPS notes a number of Canadian mills are operating below capacity, a situation not helped by buyers anticipating year-end specials as was the case in 2010. Such specials may be problematic for producers, as MEPS notes costs are rising given more expensive raw material inputs.

In Europe, buyer caution reflects concerns over the regions financial crisis, which is undermining both business confidence and steel demand. The lack of demand means output cuts have had little impact and MEPS notes more production cuts are planned in the region.

Chinese demand is also a worry, as MEPS notes inflationary pressures have seen the government force banks to cut back on credit supply. This is slowing the pace of growth of steel consumption, as manufacturing output is weakening. While Baosteel has not adjusted its bookings as a result, MEPS notes other large mills have announced decreases.

September saw a sharp drop in Japanese steel export volumes, the fall a reflection of weak demand and growing capacity in the Asian region. Imports are picking up given a strong yen, but MEPS sees scope for inventories to push higher in coming months.

In South Korea the steel manufacturing sector remains depressed, but MEPS notes domestic forecasts are for a small increase in steel demand in 2012 from overseas markets in particular. On the supply side MEPS notes inventory adjustment has been slow.

Barclays Updates Its Commodity Market Views

- Europe's issues, global growth outlook weighing on metal prices - Barclays Capital expects base metal prices should trend slightly higher in 2012 - Precious metal prices also forecast to improve

By Chris Shaw

On the back of sharp declines in prices over the past few weeks, metal markets in recent sessions have been relatively unmoved despite an improvement in underlying fundamentals. According to Barclays Capital, this reflects the market's current focus on Europe and the health of the global economy.

But with the EU Summit reaching an agreement on sovereign debt issues, Barclays suggests one key risk to the market now appears to be receding. This has allowed base metal prices to gain some upward traction, though attention is now likely to focus on China and whether or not that economy can engineer a soft landing.

With this as a backdrop Barclays has updated its views on the base metals suite. For aluminium, prices in recent weeks have remained relatively steady around the US\$2,200 per tonne level, with downside limited by perceived support from the cost curve.

Barclays notes production cuts have yet to materialise, but the apparent positive turn for the European debt crisis and increasing evidence of a soft landing in China should support higher prices. Barclays is forecasting an average price of US\$2,300 per tonne in the final quarter of this year. Average annual price forecasts stand at US\$2,450 per tonne for 2011 and US\$2,544 per tonne for 2012.

The significant volatility in copper prices in recent weeks has seen prices decline and then move back towards the US\$8,000 per tonne level, but uncertainty regarding Europe leads Barclays to suggest there remain hurdles to the price trading more in line with underlying fundamentals.

Assuming the macro environment becomes less hostile Barclays expects the market's fundamentals will push prices higher, as LME stocks have fallen and seasonally stronger demand is coming into play. Mine output also continues to underperform, which supports the forecasts of Barclays of average prices of US\$8,941 per tonne this year and US\$10,075 per tonne in 2012. This compares to a December quarter average forecast of US\$8,000 per tonne.

Lead has also experienced volatile market conditions in October, again Barclays seeing this as a reflection of macroeconomic news flow. A market surplus and a less defined cost curve has meant lead prices have not offered much resistance to fluctuations.

Coming months should be more constructive for the lead market in the view of Barclays, as China is entering a seasonal period of stronger battery replacement demand and this should tighten the market. Given lead demand is more resilient to slowing conditions than any other metal, the group suggests a strong performance could be justified.

Barclays is forecasting an average price for the December quarter of US\$2,250 per ounce, while average annual price forecasts stand at US\$2,466 per tonne this year and US\$2,506 per tonne in 2012.

While nickel prices have moved between US\$18-20,000 per tonne in the past few weeks, Barclays notes fundamental data flow continues to offer clearer and more price supportive signals. LME stocks continue to fall and Chinese import demand has been strong.

Barclays expects this tightening in the market is likely to remain the case until the first half of next year, so prices should be well supported. Forecasts reflect this, with Barclays expecting average prices this quarter of US\$20,500 per tonne, US\$23,402 per tonne for 2011 as a whole and US\$21,125 per tonne for 2012.

The standout performer among base metals over the past month has been tin, Barclays putting this down to Indonesia banning exports and a fall in LME stocks of just over 20% since the end of September. If current market dynamics continue LME stocks may become even more depleted by the start of 2012.

But Barclays is cautious with respect to such an assumption as it sees scope for market tightness to ease in coming weeks. This implies modest price increases, Barclays forecasting annual average prices of US\$26,725 per tonne this year and US\$28,000 per tonne in 2012.

In contrast to tin, zinc has been the worst performed base metal since the start of October, though Barclays does suggest prices appear to have found some relatively solid support at prices around US\$1,900 per tonne.

With zinc having a larger market surplus than the other base metals, more constrained price performance is no surprise and is most likely to continue in the view of Barclays. The group is forecasting an average price of US\$2,050 per tonne for the December quarter and US\$2,229 per tonne for 2011 as a whole, rising to US\$2,300 per tonne in 2012.

The fall in gold prices from more than US\$1,900 per ounce to less than US\$1,550 per ounce was met with higher physical demand and Barclays expects such demand will continue to cushion any downside prior to a pick-up in investment demand.

With speculative long positions also lower there is now a cleaner base from which fresh longs can be established, so Barclays expects the gold price will rise to an average of US\$2,000 per ounce next year. This compares to a forecast of US\$1,619 per ounce for this year.

Silver prices have also drawn some support from higher physical demand, but Barclays suggests more investment demand is required for prices to really gain traction. Downside at present appears to be limited by still solid Chinese demand. Barclays is forecasting annual average silver prices of US\$37.20 per ounce this year and US\$35.00 per ounce in 2012.

After falling sharply in September and early October, platinum prices have slowly started to recover to levels a little above the average cost of production. Chinese imports remain solid, physical demand picking up as prices weakened. Barclays is forecasting annual average prices of US\$1,778 per ounce this year and US\$1,835 per ounce in 2012.

Palladium prices have broadly tracked platinum prices over the past two months, but going forward Barclays notes the metal lacks the same potential cost support as platinum given it is produced as a by-product.

Continued disinvestment in palladium has swung the market balance into a surplus and this is weighing on prices in the view of Barclays. The group's price forecasts for 2011 and 2012 stand at annual averages of US\$758 per ounce and US\$860 per ounce respectively.

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A Potentially Significant Week For Currency Markets

- This week is a critical one for currency markets in ANZ's view - Risk currency rally following European package could continue - G20 meeting could drive further weakness in US dollar - Rate cut expectations will be the key for the Australian dollar

By Chris Shaw

With Europe announcing a new policy package dealing with its sovereign debt crisis last week, ANZ Banking Group suggests this week will be a critical one for currency markets.

For Europe, ANZ's global head of forex strategy Richard Yetsenga notes there have been few if any constructive assessments of the policy package announced last week. Despite this, risk currencies continue to rally.

While there is likely an element of short covering in this price action, positioning isn't enough on its own to explain the price moves in Yetsenga's view. This implies something more fundamental is currently in play.

According to Yetsenga, possible explanations of what this could be are that Europe is not actually in a financial mess, Asia is recovering from its 1H economic slowdown, or the US dollar is structurally weak and this is supporting all risk assets.

As Europe does appear to be a mess, Yetsenga suggests the first option can be ignored. The other two options are probably having some impact as the US dollar has been unable to sustain a rally in the face of bad global news and recent Asian economic data have improved slightly in recent weeks.

Yetsenga suggests if some of the smaller country Purchasing Managers Index (PMI) readings in Asia can stabilise, particularly those of Singapore and South Korea, the current move in Asian currencies could well be extended.

The policy announcement last week in Europe has seen the G20 meeting slip into the background in terms of the market's focus, but Yetsenga suggests the meeting remains important. While only a handful of the players at the meeting matter with respect to Europe, there is potential for some mutual back-scratching at the meeting as various players have some key wishes.

As examples, Yetsenga notes Europe wants foreigners to buy its bonds, China wants to be given market economy status by Europe and Japan needs to garner international support for its currency intervention efforts.

Assuming some mutual agreements were reached, Yetsenga suggests the US dollar may weaken substantially, with USD/JPY the exception. ANZ has been downplaying the potential for successful intervention by the Japanese, but formal European support for the Japanese currency stance would likely see the bank re-visit this view.

Turning to Australia, Yetsenga expects the Reserve Bank of Australia (RBA) will announce a 25-basis point rate cut tomorrow. More important for the currency is not the move but the market's assessment of likely future moves, as Yetsenga notes the short end of the Australian market still has more than 100-basis points of rate cuts priced in over the next 12 months.

If the ANZ view is correct in expecting any RBA easing cycle is likely to be shallow, then any dip in the currency is likely to be immaterial. This is especially the case given Yetsenga's view the fundamentals for the Australian dollar still appear quite robust.

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Top Ten Weekly Recommendation, Target Price, Earnings Forecast Ch

By Chris Shaw

As companies have updated outlook commentary at annual general meetings over the past week, stockbrokers have downgrades to upgrades. Among the eight brokers in the FNArena database eight ratings were upgraded this week recommendations have fallen to 58.2% from 58.7% previously.

One to enjoy an upgrade in rating was Wotif.com ((WTF)), with BA Merrill Lynch lifting its rating to Neutral from Underperform following updated guidance from management and underperformance by the stock over the past 12 months that during the week was biotech Pharmaxis ((PXS)) who finally received product approval from Europe which saw investors jump their ratings and price targets.

SingTel ((SGT)) was also upgraded to Overweight by JP Morgan, this to account for the expectation Singapore's NBN project that market. Regional asset earnings growth should also be solid and this sees the broker ahead of consensus with its ear two notches to Buy by Credit Suisse.

Southern Cross Media ((SXL)) saw an initiation of coverage with an Outperform rating by Credit Suisse and this has lifted the view of the broker, while ratings are under pressure and advertising is weaker this appears priced into the stock at current

On the downgrade side Oz Minerals ((OZL)) saw RBS Australia move to a Hold from Buy previously on the back of change exchange forecasts. Kingsgate Consolidated ((KCN)) was similarly downgraded to a Hold rating by RBS. Earnings estimates OZL by RBS following similar downgrades a week earlier by UBS and Credit Suisse.

Brokers have continued to react to Super Retail's ((SUL)) move to acquire Rebel Sport with Citi the latest to downgrade changes to earnings estimates and price target.

ResMed ((RMD)) was similarly downgraded by Credit Suisse following a Q1 result that showed the group's markets were re and price targets for ResMed across the market have also been revised on the back of the result.

Following an investor day JP Morgan suggests the market may have gotten a little ahead of itself with respect to the downgraded to Underweight from Neutral. The change in rating has been accompanied by adjustments to earnings estimates

Caltex ((CTX)) has also received a few changes to ratings in recent sessions, both BA Merrill Lynch and Citi downgrading to Credit Suisse has upgraded to a Neutral rating on the back of an increase in price target on news of a rationalisation of operations

Valuation has come into play for Computershare ((CPU)) as adjustments to RBS Australia's model and target have been ended Credit Suisse has done the same with Wesfarmers ((WES)). Relative pricing grounds have seen UBS cut its rating on Charter

Some minor changes to its model have caused RBS to lift earnings and price target for Adelaide Brighton ((ABC)), while BA target for Insurance Australia Group ((IAG)) given a tough market for insurance margins and some capital issues.

Leading into next week's result Macquarie has cut its target for CSR ((CSR)) on the back of some adjustments to estimate month.

Earnings forecasts have been lifted for Regis Resources ((RRL)) following a solid quarter of production, while estimates for increased post respective production reports.

Still strong exploration activity levels have prompted RBS to lift forecasts for Imdex ((IMD)), which has also generated an adjustments made by BA-ML and Deutsche Bank.

Further progress at Maules Creek has seen RBS lift earnings estimates for Aston ((AZT)), while a solid quarterly report from UBS to lift earnings estimates and price targets.

Changes to earnings estimates for Panoramic ((PAN)) are more a reflection of changes to expectations for commodity price issues, but weaker production and sales have been behind cuts to expectations for Gloucester Coal ((GCL)).

Forecasts for Macquarie Atlas ((MQA)) have come down post a slightly weaker Q3 traffic result, while weaker nickel price Areas ((WSA)). On the back of a reasonable quarterly production report there have been modest changes to estimates for capital raising has resulted in adjustments to estimates for Transpacific Industries ((TPI)).

Tough operating conditions have seen forecasts lowered for GWA International ((GWA)), while changed commodity price a earnings estimates for BHP Billiton ((BHP)).

Total Recommendations Recommendation Changes

Broker	Recommendation
Suisse,Deutsche Bank,JP Morgan,Macquarie,RBS Australia,UBS	123,122,130,105,88,146,196,160

Broker	Rating	Order	Company	Old Rating	New Rating	Broker	Upgrade																																										
1	ALACER GOLD CORP	Sell	Buy	Credit Suisse	2	Pharm																																											
2	Pharm	Neutral	Buy	BA-Merrill Lynch	4	Pharmaxis Ltd	Neutral																																										
3	Pharm	Buy	Credit Suisse	5	SINGAPORE TELECOMMUNICATIONS LIMITED	Neutr																																											
4	Pharm	Sell	Neutral	BA-Merrill Lynch	Downgrade	7	ADELAIDE BRIGHTON LIMITED	Buy																																									
5	Pharm	Neutral	RBS Australia	8	CALTEX AUSTRALIA LIM	RETAIL REIT	Buy																																										
6	Pharm	Neutral	UBS	10	CSG LIMITED	Buy	Neutral																																										
7	Pharm	Neutral	RBS Australia	11	INSURANCE AUSTRALIA GROUP LIMITED	Buy	Neu																																										
8	Pharm	Buy	Neutral	RBS Australia	13	OZ MINERALS LIMITED	Buy																																										
9	Pharm	Neutral	RBS Australia	14	PRIMARY HEALTH CARE LIMITED	Buy	Neu																																										
10	Pharm	Credit Suisse	16	WESFARMERS LIMITED	Buy	Neutral	Credit Suisse																																										
11	Pharm	17	WESTERN AREAS NL	Buy	Neutral	UBS	18	WESTFIE																																									
12	Pharm	WORLEYPARSONS LIMITED	Neutral	Sell	JP Morgan	Recommendation	Positive	Change	Covered by > 2 Brokers																																								
13	Pharm	Order	Symbol	Previous	Target	New	Target	Change	Recs																																								
14	Pharm	1	ABC	3.343	3.348	0.15%	8	2	CQR	3.317																																							
15	Pharm	Change	Covered by > 2 Brokers	Order	Symbol	Previous	Target	New	Target	Change	Recs																																						
16	Pharm	1	RMD	3.527	3.193	- 9.47%	8	2	OZL	1																																							
17	Pharm	4	KCN	9.658	9.444	- 2.22%	5	5	IAG	3.508	3.435	- 2.08%	8	6	WTF	4.425	4.348	- 1.74%	8	7	RRL	3.287	3.257	- 0.91%	3	8	WES	33.																					
18	Pharm	WOR	28.862	28.769	- 0.32%	7	Earning Forecast	Positive	Change	Covered by > 2 Brokers																																							
19	Pharm	Order	Symbol	Previous	EF	New	E	13.607	15.867	16.61%	3	3	STO	56.425	61.125	8.33%	8	4	WPL	205.928	216.457	5.11%	8	5	OSH	14.479	14.902	2.92%	8	6	MQG	26																	
20	Pharm	8	AZT	24.900	25.275	1.51%	4	9	WEB	16.900	17.125	1.33%	4	10	MMS	72.567	73.333	1.06%	3	Negative	Change	Covered by > 2																											
21	Pharm	Recs	1	PAN	16.450	11.475	- 30.24%	4	2	GCL	50.200	41.220	- 17.89%	5	3	OZL	113.513	94.029	- 17.16%	8	4	MQA	9.683	8.43	34.850	31.638	- 9.22%	8	7	TPI	7.233	6.567	- 9.21%	6	8	GWA	19.583	18.117	- 7.49%	6	9	GRR	10.900	10.250	- 5.96%	4	10	BHP	4

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Weekly Brokers Wrap: RBA Rate Cut A One-Off

- If the RBA cuts this week it will likely be a one-off, not a change in trend - It is unlikely that Europe's problems are over anytime soon - Odds on the rise for a FOMO rally - JP Morgan doesn't see much upside for Australian equities - Global earnings forecasts continue falling

By Rudi Filapek-Vandyck

Economists remain divided on the subject but if the RBA delivers a rate cut on Melbourne Cup Day it will be a one-off rather than the start of a new cycle of monetary loosening, say those economists in favour of the cut, as well as many others. The general view is that the RBA might just decided to slice off 25 basis points from its mildly restrictive 4.75% cash rate, to bring it back to "neutral", simply because the Reserve Bank can.

Inflation has taken friend and foe by surprise by subsiding much faster than anticipated. The unemployment rate has ticked higher. The outlook for the Australian economy as a whole remains strong on the proviso that miners and gas producers stick to their record high capex ambitions. China is slowing but seems to be able to avert worse case scenarios.

A one-off interest rate cut is thus likely to bring some relief to companies and sectors in Australia that have been doing it tough under the RBA's restrictive policy over the year past. For investors in the share market, it remains yet to be seen whether the past can be taken as a guidance were the RBA to deliver a one-off rate cut this week and then nothing more. Banks' share prices have already performed strongly, as they usually do in the lead-up to a rate cut and investors have been positioning themselves into shares of retailers too. However, some market specialists question whether the latter choice will prove beneficial for much longer given the predicted one-off nature of the RBA move.

It is for this reason that market strategists at RBS pointed their clientele into the direction of property developers. RBS reckons retailers will only enjoy mild relief among many challenges for the sector in Australia, but the local property sector should improve more, while share prices for property developers look equally cheaply priced. Traditionally, media companies used to be among the main beneficiaries of rate cuts, but this time around overall sentiment towards the sector remains tepid at best. A dismal financial report issued by Ten Network ((TEN)) which caused a general response from stock analysts to the tune of "too early to get excited" might have further contributed to this as well.

The other Big News from the week past was, of course, the fact that an impotent and divided Europe has finally managed to come up with a plan that should stop the rot in the global financial system, at least for now. As with whether the RBA will act or not this week, there is no universal agreement on what the Ultimate (?) European plan will achieve other than knee-jerk relief rallies for risk assets across the world. According to some, it's all too little too late and European economies will suffer a recession that potentially stretches into 2013. Others are more hopeful, but readily admit the announcement made this week can only be the start of a lot of work that needs to follow through to make Europe less of a basket case that continues to threaten the wellbeing of banks and citizens in other parts of the world.

For most investors in equities the main question on their mind will be whether the October relief rally can last into November-December, and maybe even into the new calendar year? Market strategists at GaveKal are hopeful this may well prove to be the case. All equity markets need right now is further confidence that European leaders are united and working towards a final solution, argues GaveKal. With economic data in the US surprising to the upside and the Chinese economy improving, this may well provide investors with enough ammunition to continue buying equities.

GaveKal is certainly not the only one with such view. One would have to acknowledge that, with funds managers sitting on elevated levels of cash, the risk for equities might well rest with those funds managers panicking if equity markets continue to rise. Such a "Fear Of Losing Out" (FOMO) rally could push equities much higher by year-end. But will it happen?

Market strategists at JP Morgan revealed their skepticism this week by stating they really do not see much "genuine" value in the Australian share market. JP Morgan believes macro-risk such as "Europe", is only one factor weighing on equity valuations in Australia. An erosion of corporate profitability is a much more important story, suggest the strategists, and one that receives much less attention in the media. Anyway, JP Morgan doesn't see the local share market's valuation rising above 4600 and has now set its index target at 4250 for year-end and 4600 for June next year.

On Friday, the ASX200 closed at 4353.

An interesting point highlighted in JP Morgan's analysis is that both banking stocks and miners seem undervalued at present but that the real upside will likely prove smaller than investors would be inclined to think. In the banks' case, this

is because of the risks that could potentially rub off from a serious global meltdown (one that has just been averted by Europe this week past) and investors are likely to continue being cautious because of such risk. In the case of the miners this is because margins will come under pressure, first from capex and rising costs, next from falling prices.

Everyone, states JP Morgan, is convinced prices will come off the boil at some point. It's simply a question whether it will happen gradually, or via a big shock, and exactly when.

The latter theme is one that is currently dominating outlooks for US corporate profits too. Viewed from many angles, corporate profits in the US are as healthy as they've been in a long time, but for how long can this Goldilocks scenario continue? Profit growth is already slowing down. Assuming this trend will continue in the coming quarters, what will the effect be on investors' overall mood?

Globally, and as indicated in the past week's Market Insight (see FNArena website), earnings forecasts are in decline. Not just in Europe, but in Australia, the US and Emerging Countries too. Equity markets do not always take guidance from earnings or forecasts, and they certainly have not done so in October, but if history can be our guide, falling forecasts tend to exert downward pressures that limit potential investment returns.

It'll be interesting to see whether a seemingly better than anticipated US economy can force a break in this downtrend.

I leave the final words with economists at ANZ Bank who were quick in responding to the escalation in crisis between Qantas ((QAN)) and the unions over the weekend: "A short-term grounding of the fleet would have limited economic impact but be of considerable nuisance value for travellers and another blow to Australia's tourism industry already struggling under a high AUD. If the dispute drags on, it would have more serious implications for Australia's tourism industry and associated services and some impact on the various supply chains relying on air freight. This would be a further negative for Australian business confidence at a time when confidence in many industries is already somewhat brittle."

An extra motivation for the RBA to act?

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November Opens The Good Season For Equities

- November usually good for equities, fixed income - Energy sector the commodity standout - Currencies mixed, US dollar in particular

By Chris Shaw

November is historically a positive month for equities, notes Barclays Capital, kicking off a bullish period that typically runs through to March. The group's analysis of seasonal trends shows median returns for equities for the month are positive across the board. It is the best month of the year for the Dow Jones, the S&P, the Swiss and Canadian markets, while the Topix is the bearish standout.

In terms of the likelihood of an advance, Barclays carries the Swiss market at the top of the list with a 75% chance of posting an advance, while most of the major markets such as the Dow Jones, the FTSE and the All Ords are given between 60-70% chances of gaining for the month. The TOPIX and South Africa's JSE All Share index are the laggards, being given chances of just 54% each of closing the month higher.

In foreign exchange markets Barclays notes the safe currencies such as the US dollar and the Swiss franc tend to do well. This is reflected in slightly better than even money chances of the greenback gaining against major currencies such as the yen, the Canadian dollar and the British pound.

Both the Australian and New Zealand dollars are given 57% chances of gaining on the US dollar, while Barclays also has the euro at a 54% chance of posting a gain against the greenback across the month. The euro is also given a 59% chance of finishing the month higher against the yen.

Commodities enjoy a broadly bullish backdrop in November, with natural gas typically the best performer and West Texas Intermediate posting its worst month of the year. Expectations reflect this, as Barclays gives natural gas a 59% chance of a gain this month, the same for copper, followed by a 54% chance of gold gaining.

In contrast, the group gives WTI just a 28% chance of an advance for the month, while silver is expected to lag its precious metal partner by offering just a 39% chance of closing the month with a gain.

With respect to fixed interest, Barclays notes November tends to be a bullish month for most bonds, especially those at the long end of the curve. Bearish exceptions are US 2-year bonds and all 3-month paper.

In terms of the likelihood of any yield advance, Barclays suggests 10-year bonds across the market all offer less than a 50% chance of a yield advance, the range around 30% for Swiss and Japanese securities and 48% for US 10-year securities.

US 2-year bonds are given a 55% chance of delivering a yield increase this month, while the range for three-month securities is 48% for Sterling to 61% for Libor and Euroyen securities.

For yield curves, the steepening tendency is strongest for Japanese 2-year versus 10-year securities, while all other major curves tend to flatten in November, reports Barclays. In relative value terms the yield spread between UK-v-US 2-year bonds has the highest probability of widening at 72% against a 29% chance for Eu-v-UK 2-year bonds.

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Treasure Chest: Playing The New Caltex

By Greg Peel

What?

As management at Caltex ((CTX)) is believed to be considering selling the loss-making oil refineries, execution of such strategy could unlock significant value, which should have a commensurate impact on the share price.

Why?

Caltex management has decided to review the company's Australian oil refining business which is loss-making and detracts from profitability in its refined product distribution business. Were Caltex to close its refinery operations and refurbish those sites into storage terminals, Macquarie sees the potential to unlock value that would imply a net asset value of up to \$21.00. CTX shares closed yesterday at \$13.40.

Macquarie had an Outperform rating on Caltex Australia ((CTX)) but has now added the stock to its Marquee Ideas portfolio which contains stocks for which the analysts have a strong conviction.

Background

Caltex is at present the only remaining company operating refineries in Australia which convert crude oil into petrol, diesel, jet fuel and other petroleum products. Caltex operates one refinery in Sydney and one in Brisbane and otherwise engages in the marketing of products, right down to its retail service station chain. In recent years its refinery operations have become net loss-making in the face of competition from fully imported products from Asia. Macquarie estimates the refining business deducts \$4 per share of value from CTX.

The company is thus now reviewing its refinery business. Last week it announced the pending closure in around a year's time of two facilities at its Kurnell refinery - one producing gasoline and the other bitumen. The closure of one gasoline facility was prompted by two units on site running at only 50% capacity due to a gradual fall in petrol demand and the growing popularity of diesel.

Given CTX is in the process of reviewing its refinery business altogether, analysts are assuming this is the first step towards a complete withdrawal, albeit management has suggested the decision was unrelated. Macquarie's stock recommendation is nevertheless based on Caltex becoming stand-alone fuel marketing business.

Were CTX to cease refining and convert its sites into storage terminals for imported product, considerable remediation costs could be deferred and valuable tax credits would be created via asset write-downs, Macquarie suggests. CTX could also increase its storage capacity to ensure greater security of local supply and to allow for the arrangement of robust supply agreements with Asian refineries.

Such a strategy could also release up to \$800m in working capital and offer the chance to gear up a balance sheet which to date has remained conservatively positioned against the potential volatility of the refinery business. The only problem the analysts foresee here is a lack of actual investment opportunities in Australia's existing wholesale and retail businesses, but then a capital return could be on the cards instead.

As a distributor only and no longer a refiner, CTX's PE multiple should re-rate, Macquarie suggests, given the greater risk inherent in refining. While the analysts don't see CTX re-rating all the way to match typical distribution-led retailers they do note there are retailers listed at present with more challenged growth outlooks that still enjoy a 13% PE premium to CTX.

The risks to Macquarie's excitement begin with the analysts' own acknowledgment that nothing is going to happen quickly, and indeed they only ascribe a 20% chance of a move away from refining in the "near term". Beyond that, UBS analysts have raised the issue of the potential difficulty of securing enough Asian product which both satisfies Australian demand meets tougher Australian specifications.

There is also a suggestion of the risk to Australia's sovereign energy security if there are no longer any refineries in the country. This might imply a dreaded entry into the debate by Australian politicians.

Macquarie nevertheless considers Caltex to be worth an implied "Buy With Conviction" rating and has set a twelve month price target of \$15.50.

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The Importance Of Earnings Certainty

(This story was sent to paying subscribers in the form of an email on Monday).

By Rudi Filapek-Vandyck, Editor FNArena

Here's for an easy prediction to make: unless earnings forecasts start rising at some point, the October month rally for global equities will not prove sustainable.

Analysis by Macquarie has revealed the correlation between the performance of equities and changes in forecasts by stockbroking analysts has become increasingly stronger in recent years, yet sometimes other factors dominate investors' focus. In October all that mattered was that equities looked cheap, European leaders finally put a plan together and economic data in the US and in China surprised to the upside after months of underwhelming. The combination allowed for one of the best October month performances ever for equity markets across the world.

All the talk among stockbrokers and hopeful investors is whether cashed up funds managers are becoming nervous enough about their performance figures at year end? If so, this may well trigger a come-back into equities and thus cause a big rally. It would be a welcome relief after a year that failed to live up to expectations on so many accounts. US equities are now back in positive territory for calendar 2011, but the Australian share market is still down a few percentages. BHP Billiton ((BHP)) shares are down 16% since early January. CommBank ((CBA)) shares are almost flat for the year. Newcrest ((NCM)) shares are down more than 16%. Shares in Woodside Petroleum ((WPL)) still have to catch up close to 12%.

Corporate earnings forecasts started trending south again in July, on a global scale, and they have remained in a negative trend since. Virtually every expert seems to agree more cuts and downgrades remain on the agenda as global economic forecasts have weakened in the weeks past and that puts downward pressure on what individual companies can achieve in terms of margin expansion and sales. The implied margin expansions for industrial companies the world around in particular is receiving quite some attention (and criticism), but there are plenty of question marks for other sectors too, including producers of natural resources.

The fact that global earnings forecasts made a concerted dive into negative territory in July has experts worried. Analysts at UBS and Macquarie, for example, believe a new "downcycle" has started in earnings forecasts. This is not unimportant as the past years have shown that upcycles and downcycles in these forecasts support similar moves in equity prices. Unsurprisingly, the last up-cycle took off in 2009, weakened in 2010 but improved in the second half of last year until May. Making matters worse, both UBS and Macquarie believe the early stages in such a downcycle are the worst for equity performances.

On historical evidence, and assuming all else remains equal, investors should not expect more than single digit returns from the Australian share market in the year ahead, predict both UBS and Macquarie. The good news about this historical forecast is that the ASX200 is today circa 6% below where it was in early July (4600) when this latest downcycle started. This means that on pure statistical form, the index can gain double digits in the next nine months and still remain inside the boundaries as suggested by historical precedents.

The other good news is that the next stage in the cycle will be the best one to enter the share market, generating on average the highest returns, all else being equal. Historical analysis clearly shows that when earnings forecasts are negative and falling (is the case since July), this is usually the worst time to buy into equities. However, when earnings forecasts are still negative but they start turning the corner, which will be the next phase in the cycle, this tends to be the best time to be in equities, generating close to double digits on average in the year ahead.

All this assumes the close correlation between earnings forecasts and the performance of equities as has been in existence throughout the first decade of this century remains intact. (Note: Macquarie research has generated slightly different numbers, but still similar to UBS's thus confirming the underlying thesis).

Of course, nothing is ever set in stone in the world of finance and investing. What could change the course of earnings expectations? Another round of Quantitative Easing in the US could, and some experts believe we may see QE3 back on the agenda as early as Q1 next year. A new stimulus program in China could shake up things as well, though this is at present not anticipated by anyone. A much better performance of economies in the US, Europe and in China could make a big difference too. Last but not least, big movements in FX markets can have a pronounced impact too, but mostly in a negative sense outside the US if these moves are based upon a weakening USD.

Let's for now stick to the script as suggested by Macquarie and UBS (and others), implying we will see continued cuts to forecasts in the months ahead. Conclusion number one is this will erode the potential upside for equities. Certainly, recent updates of investment returns by local stockbrokerages fall in line with this suggestion.

On Monday, market strategists at Goldman Sachs updated their projections for the ASX200 amidst a much better environment for risk appetite, now that European leaders have averted worst case scenarios. Even so, I am certain Goldmans' revised targets will be a disappointment to many a hopeful investor. The new target for the ASX200 by late December this year sits at 4375. The index closed at 4298 on Monday. Targets for June next year (4800) and for December 2012 (4850) suggest double digit returns should be possible, but not in a spectacular fashion.

Note there is no suggestion of a return to 5000 anytime soon.

Last week, market strategists at JP Morgan set their ASX200 target at 4250 for year-end and at 4600 for June next year. Unsurprisingly, JP Morgan finds it hard to locate genuine bargains in the share market, while arguing that margins will increasingly come under pressure for mining and energy companies too and this will translate into less upside potential than may be assumed by investors. Further adding to miners' reduced potential, JPM reports "there is little disagreement that commodity prices will be lower one day and even in optimistic markets the stocks are valued accordingly. The swing factor for the valuation debate is whether the fade assumption is too optimistic because there will be a rout."

It for this reason, and because the RBA is likely to provide some relief, that JP Morgan strategists like "domestic" risk rather than international risks in the Australian share market. A view seemingly backed by strategists at Credit Suisse who stated in their market update on Monday they remain overweight discretionary retail and banks, and underweight resources.

So how is the Australian share market positioned at this stage?

It has to be noted rating downgrades by stockbrokers have been outnumbering upgrades for several weeks now. The week past, for example, saw 25 downgrades against 11 upgrades suggesting more and more equities are becoming less attractive from a fundamental (value) view point, despite the index still being in negative territory for the year.

As far as earnings forecasts are concerned, on FNArena's consensus forecasts for members of the ASX200, corrected for outliers and excluding the six banks, stockbroker analysts are already projecting less than 5% growth only for FY12. While this number is expected to more than double in FY13 (up 13.8%) there are still many question marks about whether this will prove rather wishful thinking or not. Investors should note there's a clearly visible downtrend in earnings estimates for banks as well as for large resources companies, with most companies concerned coming from elevated growth numbers in years past (not expected to be repeated in the years ahead).

Having said so, National Australia Bank's ((NAB)) FY11 results surprised to the upside last week and earnings forecasts as well as price targets went up after the event. Note that NAB is anticipated to grow more firmly than others in the year ahead, with exception of Bank of Queensland ((BOQ)) whose potential growth this year is set at no less than 44%, but questions about asset quality and bad loans are keeping investors away nevertheless.

On an individual basis there are, of course, plenty of companies whose growth will exceed the market's average in the year(s) ahead. Investors will have to pay close attention to two critical points: is that growth potential already reflected in the share price? Plus what are the chances that growth expectations might not be met?

The latter factor in particular is seen as a key danger by analysts at UBS and Macquarie when picking stocks for the year ahead: what are the chances growth expectations will not be achieved? Both brokers suggest investors pay close attention to how much of the anticipated growth is dependent on expanding margins. That's where the major risks lie right now, they suggest.

Most at risk, suggests Macquarie, are companies such as Leighton Holdings ((LEI)), BlueScope Steel ((BSL)), Aristocrat Leisure ((ALL)) and Suncorp ((SUN)), alongside resources plays Energy Resources of Australia ((ERA)), Iluka ((ILU)), Whitehaven Coal ((WHC)), Fortescue Metals ((FMG)), Mount Gibson ((MGX)) and QR National ((QRN)). Investors will have to weigh up the potential rewards against the potential punishment that will follow in case present margin assumptions prove too rosy in the months ahead.

Also, it is not difficult to see why the ten stocks I selected for the FNArena Investment Quiz a few weeks ago have outperformed the share market post 2007. All companies involved achieved consistent growth, at seemingly low risk and with no nasty surprises.

(This story was originally written on Monday, 31 October 2011. It was sent out in the form of an email to paying subscribers on that day.)



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