Week

33

Stories To Read From FN Arena

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FN Arena
Passionate About Financial News

PO Box 49
145 Sydney Road
Fairlight NSW 2094

info@fnarena.com

Your editor
Rudi Filapek-Vandyck

Your dedicated team of journo's
Greg Peel
Chris Shaw
Terry Hughes

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Chinese Inflation Runs Rampant

By Greg Peel

If there was one thing Chinese authorities were afraid of, it was that surging 11.9% economic growth would bring with it a consequent surge in inflation. As food prices have jumped across the globe, nowhere else have they been more felt than in China. This is particularly politically sensitive, as it affects China's vast low income population most specifically.

China has been at pains to fight against the economic bubble, without actually forcing a hard landing. Interest rates have risen three times in the past six months, and one to two more increases are expected by year end. But when the currency is artificially pegged at an undervalued level, and real interest rates are negative, inflation is always going to be a problem.

From June to July China's inflation rate jumped from 4.4% to 5.6% - the highest monthly rate since February 1997. Within that jump were a surge in pork prices of 45.2% and eggs of 30.6%. Pork is a staple of the Chinese diet.

The country has been suffering from its own version of foot & mouth. Pigs have suffered from an outbreak of blue-ear disease and thousands of animals have been destroyed by authorities. However, pork (and egg) prices have also been affected by higher feed prices, which in turn have been driven by surging global grain prices. Chinese pork is a victim of the US subsidy of ethanol.

A Chinese statistics bureau spokesman tried to put a brave face on the inflation increase, noting that the problem was only really in food. Prices in clothing and other non-food goods have risen only 0.9% from July last year. Industrial product prices and services prices remain relatively stable, and the bureau is not expecting overall prices to rise sharply. Consumer prices year to date rose 3.5%.

Chinese authorities are providing free vaccination against blue-ear, but are also making investigations as to whether the food price surges may involve any price collusion amongst farmers and food companies.

The government cannot afford to allow the Chinese economic machine to roll on and create a western-style, ever-widening gap between the new haves and the disadvantaged have-nots. China is not a stranger to the odd revolution.

FNArena has reported in the past that even the most bullish of equity market analysts suggest that if one thing could derail the bull run (even including a credit crunch) it could be high food prices in Asia.

Will China Now Export Inflation?

By Greg Peel

For the last few years the emerging markets boom has driven up commodity prices, particularly base metals and oil, to levels which have surprised even the most astute of analysts. The China story in particular has led to the commodity super-cycle - a secular shift in world commodity valuation that stepped-jumped expected average prices to much higher levels and blew away slow-moving analysts still clinging to anachronistic concepts of mean reversion.

As the world was coming off a period of extremely easy (some would now say too easy) monetary policy following the effects of the dotcom bust and 9/11, it was a given that strong global economic growth would force tightening phases and higher interest rates. However, in the earlier stages economists remained baffled as to why global inflation had not skyrocketed as a result of skyrocketing Chinese demand.

It soon became clear, however, that China was absorbing the imported inflation of higher commodity prices and recycling it back to the world as exported deflation. This is because the mass-production machine was able to sell particular everyday goods - from computers to mobile phones to fridges - at ever lower prices. While a pegged renminbi has made this possible, the bottom line is that the world has outsourced its manufacturing industry to emerging markets in which the average wage was significantly below that of so-called Western countries. Given the sheer enormity of the populations of the likes of Brazil, Russia, India and China (BRIC), those wages remain well below Western levels today.

And deflation has not just occurred in goods. India has given the world the notorious Mumbai call centre, allowing everything from insurance to phone plans to be sold at a lower cost to the provider.

Inflation has, nevertheless, been experienced across the globe, but not at levels that were initially assumed. That which the BRICs cannot provide, such as child care, financial market services and medical care for example, has dramatically increased in price. The world is paying a lot more for energy now, and food prices have become the latest to soar given a conspiracy of weather conditions and developments in biofuels.

Which brings us to China's latest problem.

As noted in "Chinese Inflation Runs Rampant" (Asia; 14/08/07), China has just recorded a 5.5% inflation figure for the month of July, precipitated by extraordinary food price hikes including China's staple, pork, which rose 45% in the month.

The Australian and New Zealand central banks, among most others, have been forced over the past two years to constantly raise interest rates against the threat of inflation in strong economies. These moves have been necessary (according to central bank thinking) despite the dampening effect of exported emerging market deflation. Now that China's domestic inflation measure appears to be out of control, how long will it be before Chinese deflation turns to Chinese inflation? Are we suddenly staring double-digit interest rates in the face once more?

No, say Macquarie Bank economists, but that doesn't mean the world should not keep a wary eye on Chinese developments.

For one thing, a lot of the rise in the pork price has had to do with an outbreak of a dangerous disease that has forced the destruction of many pigs. This has curtailed supply, and pushed prices higher. Once supply stocks can return to normal, and Chinese pig farmers rush to cash in on high prices, the situation should ease. Hence inflation should ease. Importantly, Macquarie notes non-food Chinese inflation in July was a far more modest 1.0%.

That is not to dismiss the fact that Chinese export prices have actually begun to rise considerably in recent

months, matched by data suggesting US import prices from China have risen. Imports from China account for about 14% of all imports to both Australia and New Zealand. China is no longer having the same deflationary effect it once had.

But even these numbers are divergent from the trend, say the Macquarie economists. There should be some reversion and hence there is not an immediate concern for our local economies. But nor should we remain unwatchful as "tradeables", such as that which China readily exports, account for some 45% of our CPIs.

There is no doubt that the Chinese figures are more than just an aberration. The price of eggs in China also rose 30%, just quietly. There is no chicken disease outbreak at present, as far as we know, and although Chinese authorities are suspicious of price collusion there is a simple reality that surging global ethanol production has forced up the global price of grains at a time when drought and flood has hampered the supply side. Chickens are fed grain - hence higher egg prices. The same is true for pigs, as well as other meat sources. Nor are Australia and New Zealand immune to similar effects on the supermarket shelf.

Food aside, slow but constant moves by Chinese authorities to revalue the renminbi will only make all Chinese export prices higher. Indeed, it is anticipated that incremental currency moves will systematically wipe out a lot of Chinese manufacturers who are already trading on paper thin margins. A reduction in the supply of goods must also force up prices. Macquarie notes that if the price of goods from China starts rising in any "meaningful" way, inflation expectations would start rising at "a more rapid clip".

Next step, much more aggressive monetary tightening.

What On Earth Is Bendigo Thinking?

By Greg Peel

"This does not look like a great deal for either shareholder group - BEN because it is overpaying and ADB because it is being paid in overvalued BEN scrip." - JP Morgan

JP Morgan's Brian Johnson and team are somewhat taken aback by yesterday's merger announcement, or more correctly, Bendigo Bank's (BEN) scrip offer for Adelaide Bank (ADB). He suggests that given Bendigo rejected a thirty something percent premium offer from Bank of Queensland (BOQ), it appears that "size and ego are over-riding valuation". The UBS team questions whether this is simply an attempt by Bendigo to protect its independence, having been spooked by the BOQ swing.

Prior to yesterday's announcement, Bendigo boasted a sad 0/4/5 B/H/S ratio in the FNArena database, with ABN Amro abstaining on advisor grounds. Adelaide was not much better at 0/7/2. This looks like a battle for The World's Biggest Loser. If anything can be drawn it's that following a poor result Adelaide has been offered about a 23% premium, which is pretty good, but then as most analysts had already declared that Bendigo's shares were overvalued one might consider it a hospital pass. Bendigo has levered off its PE to seal a deal that appears about 18% EPS accretive. Nice move, but what's the point?

While acknowledging this financial benefit UBS is struggling to find any strategic rationale. As Bendigo is largely a retailer and Adelaide a wholesaler, UBS can't see why Bendigo wouldn't just outsource to Adelaide and save all the cost. And avoid all the integration risk, which Credit Suisse describes as "not insignificant".

The vocal JP Morgan team considers Adelaide Bank to be "challenged", given its over-reliance on mortgage brokers for distribution and securitisation markets for funding. What does this add up to? A collapse in lending profitability ahead should bring along further potentially substantial weakness given the subprime crisis will limit further funding and the interest rate rise will curb demand. While Bendigo might be small-fry it is a retail deposit funded business. Exactly what a bank wants to be when credit is drying up. So why throw that all away?

Merrill Lynch sees that there are some potential cost savings, but assumes the merger must be all about financial strength and the creation of cross-selling opportunities. Such opportunities, says Merrills, are "a promise worthy of some caution".

Given the level of accretion in the deal, Deutsche Bank sees the potential for substantial earnings upgrades. This is the basis behind the analysts lifting their rating from Sell to Hold. But the analysts also note that the accretion comes at a material cost to Bendigo's return on equity. With ROE dilution to under 12% until at least 2010, Deutsche suggests this is "hardly a pleasing outcome".

With ABN out of the picture, and GSJB Were also moving to restricted on account of its participation, we are left with Bendigo on a 0/4/4 ratio with a slightly higher average target of $16.42 against yesterday's close of $16.40. The shares are off 3.7% at lunch time but this is hardly a day to judge. Adelaide holds its ratio at 0/6/2 but the target has jumped from $14.56 to $16.71 on the basis of the bid. Its shares are off 3% after its big surge yesterday.

Bizarre.

Value In BMG Project Confirmed By Sale

By Chris Shaw

As the latest machinations in global credit markets make raising funds more expensive Beach Petroleum (BPT) has adopted an alternative approach, selling a 10% stake in the Basker-Manta-Gummy project to Itochu for $123 million.

According to Merrill Lynch the sale is a positive as it both allows the company to generate a profit on its stake while also confirming the value of the project as a whole. On its numbers the company should make a profit on the sale of around $70m, while retaining a 40% interest.

Anzon Australia (AZA) also holds 40% of the project and Itochu now has a 20% stake after also buying 10% from Anzon.

The lower stake means Beach Petroleum's share of production will be around 4% lower, so the broker has adjusted its earnings estimates accordingly. This means its estimates in FY08 have been cut by 15% and in FY09 by 10%, resulting in earnings per share estimates of 9.9c next year and 8.9c in FY09 after an expected 8.6c this year.

Macquarie has made similar adjustments with only the magnitude differing slightly, its forecasts for the next two years being cut by 7.8% and 9.9% respectively. It also points out performance in terms of production for the company has of late been impacted by some one-off factors so is not an entirely accurate portrayal of the outlook for the company.

Apart from the earnings impact Merrills points out the deal provides Beach with additional proceeds with which to advance future development plans, while at the same time reducing its share of the required capex at the Basker-Manta-Gummy project. This is estimated at a gross cost of $200-$300m for the Phase 2 oil development, so the company’s reduced requirements are significant.

At the same time it leaves the company with a large enough stake in the project to benefit from any future upside, which Citi notes is possible if exploration planned for 2008 is successful in increasing oil reserves substantially.

Both Macquarie and Merrill Lynch have retained their Buy ratings on the stock as a result of the deal, with almost identical target prices of $1.60 and $1.62. The FNArena database shows ABN Amro also rates the stock as a Buy with a $1.55 price target but the last update on record from the broker dates back to February.

According to Thomson One Analytics the median price target for Beach is $1.78, indicative of the upside potential from exploration success Citi alluded to in its update.

Shares in Beach this morning are slightly weaker despite a stronger overall market and as at 11.20am were down 2c at $1.21. Over the past 12 months the stock has ranged between $1.04 and $1.68.

Partner Anzon is only covered by Citi (out of the ten experts we monitor daily) and the announced deal has led to Citi analysts pushing up their price target by 20c to $1.30. Their recommendation for the stock remains Hold, High Risk.

Risk Appetite Was Already Waning

By Greg Peel

JP Morgan analysts like to use a measure of price/earnings dispersion in the ASX 100 Industrials as an indicator of risk appetite. PE dispersion is the distribution of PE ratios from the lowest to the highest. When JPM last crunched the numbers back in January, PE dispersion had blown out to its highest spread since late 2005.

This indicates, say the analysts, that earnings expectations were rising up to that point. This means P's got ahead of actual E's and pushed out PEs at the top end. But the latest numbers for the last five months to July show that PE dispersion has collapsed. What this suggests is that the market was already starting to query sustained earnings against high prices well before the carnage of the last couple of weeks, as FY07 earnings expectations had remained largely unchanged. Risk appetite, it seems, was already on the wane.

It is unlikely that it would have done anything other than wane further in August.

The collapse in dispersion was to the centre, meaning high PEs pulled back and low PEs pushed ahead. The dispersion measure fell 10% from 13.7 to 12.3 in July, but the 20% fall from 15.4 to 12.3 since January represents the largest continuous move over a period for the last three years. Earnings expectations actually fell in July given 12-month roll-forward estimates have fallen.

Does any of this matter now? Surely PEs have been shot to pieces on recent market moves. It may all be academic, says JPM, but the analysts suggest that any move by central banks to cut rates in response to the credit crisis would suggest the best value buys would be those stocks that have de-rated from high PEs.

Some examples of those are News Corp (NWS), Macquarie Communications (MCG), Wesfarmers (WES), Computershare (CPU), Goodman Group (GMG), Brambles (BXB), Aristocrat (ALL), West Australian News (WAN), Woolworths (WOW), Toll (TOL), AMP (AMP) and AXA Asia-Pacific (AXA).

Expect More Acquisitions From Sonic

By Chris Shaw

When Sonic Healthcare (SHL) first expanded into the German market it was seen as a beachhead acquisition, something to establish the company in that market but offering little tie-in with its existing operations.

This has now changed as the company has announced the acquisition of Bioscientia for 190 million euros in a deal that will see it bring the new company into the fold of its existing Shottdorf assets, which as Merrill Lynch notes will create the largest corporate pathology player in the German market.

While not getting a steal in paying 9.7x EBITDA for Bioscientia the brokers covering the stock are generally positive on the company's move as it provides scope for significant synergies to be generated, Macquarie noting the company's increased scale in Europe in general and Germany in particular should serve to enhance the synergies achievable from any future expansionary moves in the region.

Estimates on just how earnings accretive the acquisition will be vary from broker to broker, Macquarie estimating it adds only 1.2% to FY08 earnings but 6.2% in FY09 and 10.1% in FY10 as the synergies really kick in. The broker is forecasting earnings per share (EPS) of 67.1c this year, 72.5c in FY08 and 84.7c in FY09, while UBS sees the deal as adding 2.8% to its FY08 forecast and 4.8% in FY09 so it estimates EPS of 69c, 84c and 96c respectively.

These forecasts compare to median market estimates for the stock according to Thomson One Analytics of 67c, 77c and 86c, while ABN Amro is at 64.6c, 81.1c and 92.6c after minor increases to its forecasts.

Most of the experts who cover the stock don't see this as the company's last deal either in Germany or Europe generally, UBS pointing out the German market in particular appears ripe for further consolidation.

For the company to partake of this an equity raising is expected as the current deal brings gearing to a relatively full level, but according to GSJB Were any impact on the share price as a result of any issue would represent a potential opportunity to get set in the stock for the longer-term.

Again estimates of the size of any capital raising vary, Merrill Lynch suggesting $200-$250m should be enough and GSJB Were seeing scope for as much as $300-$500m to be raised. Either way, the impact on earnings per share is not expected to be great, Weres estimating a 1% impact for each $100m raised.

Following the announcement of the acquisition Merrill Lynch has upgraded its rating to Buy from Neutral as on its numbers the upside valuation case from the German move results in a valuation of $17.70.

ABN Amro has similarly upgraded to Buy from Hold on the likelihood of further earnings accretive expansion in Germany, the broker echoing the sentiments of UBS with respect to that market offering a number of opportunities.

These changes mean the stock is now rates as Buy seven times and Hold twice in the FNArena database, with an average price target of $17.00, up from $16.88 prior to the acquisition and in line with the median price target according to Thomson One.

Shares in Sonic this morning are stronger despite a weaker overall market and at 10.40am were up 41c or 2.8% at $15.00.

Cochlear Simply Delivers Again

By Chris Shaw

Until a few weeks ago the market showed little interest in companies generating reliable and solid earnings growth, favouring instead a riskier approach in buying companies in hot sectors and those with some share price momentum.

The liquidity crisis has changed this and currently everything is being sold off, but at some point the market is likely to settle and with investors assuming a lower risk approach quality stocks with quality earnings should again come to the fore.

According to Macquarie Equities this will bring investor attention back to stocks such as hearing implant manufacturer Cochlear (COH), which it expects will continue to deliver strong solid growth in coming years.

The company has reported core earnings for FY07 of $107.6m, an increase of 24% on the previous corresponding period and slightly ahead of Macquarie's and the market's estimates.

The strong result comes on the bank of continued growth in emerging markets, an increase in upgrades in implants and growth in the take-up of bilateral implants, all trends the broker expects will continue.

Impressively the earnings result was achieved in the face of adverse currency movements, UBS pointing out if the currency can settle this year the company should enjoy stronger margins.

On the back of the result management has guided to 15-20% earnings growth in FY08, the broker noting such guidance is historically conservative and this should again prove to be the case in the coming year. One area of upside in its view is China, where momentum is likely to pick up after a relatively slow FY07 performance. The potential of stronger growth in China also sees Merrill Lynch view that market as a source of upside risk to earnings.

Following the result the broker has lifted its earnings estimates slightly, its FY08 earnings per share (EPS) forecast increasing by 3.5% to 235c and in FY09 by 3.6% to 284c, which compares to the 196.5c recorded for FY07.

Others in the market have reacted similarly in adjusting estimates, though as Macquarie notes the changes are not material as consensus forecasts had already factored in a result of $128m next year, which is at the upper end of post result guidance. The major exception is UBS, which is forecasting EPS of 235c in FY08 and 300c in FY09, which compared to pre-result consensus estimates of 227c and 266c.

With earnings expectations being scaled up broker target prices have followed suit, the FNArena database showing an average target now of $67.50 against $65.55 prior to the result. By way of comparison, the pre-result median price target according to Thomson One Analytics was $64.82.

Following the result only Aspect Huntley has changed its rating, upgrading the stock to Buy from Hold. This leaves the stock as rated Buy five times, Hold three times and Sell once, this courtesy of Credit Suisse.

Shares in Cochlear have done well today in a weak overall market as at 12.30pm the stock was down just 2c at $63.23 despite the market falling around 2%.

Banking Sector Wrap - Week Ending August 15

By Greg Peel and Rudi Filapek-Vandyck

The biggest news in banking this week does not include the major banks, unless one includes the Commonwealth Bank's (CBA) final result out yesterday that came in with a slightly higher than consensus profit. But we'll get the pillar-news out of the way first before turning to other disasters.

While CBA posted a record half-year profit, bringing the full-year result to $4.604 billion ahead of a consensus forecast of $4.549 billion, management did flag an expected slowdown in consumer and business credit ahead. It did, however, expect FY08 performance to either match or exceed the bank's peers. While the result would have gone some way to supporting the stock price in yesterday's most recent carnage, CBA has outperformed the other pillars in recent months. Analyst reports will be published this morning.

Westpac (WBC) made the only other announcement of interest this week, regarding its intention to spin off part of its BT funds management arm. While analysts thought this wasn't a bad idea, and may be replicated, the valuation effect was deemed immaterial.

As the five majors again fell less than the broad market in another week of global panic selling, some analysts reiterated their calls that the big boys are always safe havens in such times, or as ABN Amro put it - shelter from the storm. UBS agreed and both brokerages are pointing to valuations that were only three weeks ago looking stretched and are now looking fair. Of course, "Buy" ratings on the sector reflect a relative recommendation and not an absolute one. In other words, don't necessarily expect banks to rise, just expect them to fall less.

The ASX 200 fell 5.1% this week while the big five fell 2.7%. Top pick Westpac was this week hardest hit with a 3.9% fall, and Macquarie analysts downgraded from Outperform to Neutral.

-- Relative movements for the week ending 15 August 2007: National -1.64% CommBank -1.83% St George -2.50% ANZ -3.50% Westpac -3.94% ASX 200 -5.11% --

There was some consideration given to the impact of the interest rate rise, as there always is at such times. Suffice to say rate changes are a bit swings and roundabouts for banks. A rise is generally seen as negative, however lost credit demand and increased loan losses are to some extent offset by not raising the deposit rate as much as the lending rate.

But black sheep amongst the bank analysts - JP Morgan - reiterated its warning last week that the global credit crunch is going to have a more marked negative impact than many might believe. JPM advised that while buying the dips might prove profitable, selling the rallies would also be prudent.

There was big news amongst the regionals this week as Bendigo Bank (BEN) rather shocked analysts and announced an intended merger with (takeover of) Adelaide Bank (ADB). Not one analyst could see any particularly sensible reason why Bendigo should make such a move, given Bendigo has a significant deposit base compared to Adelaide's reliance on now expensive outside funding, and that Adelaide has a large lower-quality mortgage book. A strange strategy in these troubled times. Not even Adelaide shareholders' big win was enough to enthuse, given they will receive Bendigo scrip.

The suggestion was made that Bendigo was simply reacting to attempt to shore up its independence in light of the failed Bank of Queensland (BOQ) bid. While BOQ appears to have shrugged and moved on, snapping up Mackay Permanent in an ongoing Queensland consolidation move, at least one analyst suggested a counter bid for Adelaide by BOQ is not out of the question.

-- Current FNArena

ranking, Buy/Hold/Sell ratios and average target price (between second brackets suggested share price upside): #1 Westpac 6/4/0 ($28.58) (+13.68%) #2 ANZ 5/5/0 ($31.76) (+15.07%) #3 CommBank 4/4/2 ($56.11) (+5.87%) #4 National 4/5/1($42.83) (+11.65%) #5 St George 0/9/1 ($35.76) (+9.02%) ---

And now on to the real stories of the week - the diversifieds.

No Macquarie Bankers (MBL) - it wasn't just a bad nightmare. Last week the diversified investment bank had recovered 12% of its 28% fall from its high but this week it gave that back with interest to be down 15% at yesterday's close. For the hundreds-of-thousandaires factory workers, the global credit crunch and panic reaction could not have come at a worse time. Staff have only two escrow windows per year in which to sell their vested stock bonuses, and now is one of them. JP Morgan notes the bank's shares have been hit by a wave of short-selling from near and far and whether or not it is justified, it is certainly effective.

JP Morgan insists, along with other brokers, that Macquarie Bank is now ridiculously cheap, but when to buy? Perhaps September 14 when management is due to provide an update. Short covering could be just as volatile.

Macquarie's Mini-Me - Babcock & Brown (BNB) – was even more harshly punished by the avalanche of selling orders during the week. The stock lost close to 20% in value.

But the biggest news in the sector was the announcement by ASX-newcomer RAMS Home Loans (RHG) that difficulty in acquiring credit, despite having negligible "subprime" loans on the books, could force a 15% profit reduction. Shares in RAMS have now fallen 51% from their July 23 $2.75 listing. Timing is everything. The news resounded through the entire financial sector, knocking down share values of similar institutions through to the Mac Banks and even pillars of the market, proving that this global credit crunch is more than simply a problem with a few US subprime mortgages.

The big question is: have we seen the worst yet? To this extent Tuesday's insights by highly regarded US based market commentator Dennis Gartman offers no room for relief:

"We are hearing reports, with some very real credibility, that Wall Street has sold CDOs, CLOs and the like to any number of public pension funds, who are now moving to reject those positions and are demanding of The Street that they be taken back and that "par" be paid for them. The Cockroach Theory is alive and very much well, and we are disturbed and growing very much more concerned."

(Note: the Cockroach theory as mentioned by Gartman simply works off the thesis that if you see one in your kitchen there are probably many more hiding elsewhere. The same theory is applied by Gartman on the current crisis in the global financial sector.)

CommSec chief equities economist Craig James put it in a more friendly manner: "The main problem for Australian financial stocks is that while fundamentals are rock solid, the "guilt by association" problem may result in a loss of investor support."

Don't expect any major changes soon with James predicting the current global shakeout in financial stocks is likely to last weeks, rather than days.

Produced by FNArena for banking sector e-zine The Sheet.

--- FNArena closely monitors views and recommendations by ABN Amro, Aspect Huntley, Citi, Credit Suisse, Deutsche Bank, GSJB Were, JP Morgan, Macquarie, Merrill Lynch, and UBS. The above mentioned Buy/Hold/Sell ratio is based upon the recommendations by these ten local experts. The ranking is as a result of the ratios. The average target price is an average of each of the broker's target price where published. ---

Agriculture Turf Wars To Support Prices

By Chris Shaw

The concept of turf wars comes from gang culture and refers to rival gangs fighting over an area to obtain the right to control the distribution of whatever activity in which they are involved.

According to the Commonwealth Bank the term can equally be applied to the current situation in the agricultural commodities sector, as there is a similar conflict underway as markets attempt to influence the crop choices of farmers.

This battle has resulted in prices for both grains and oilseeds rallying over the past year as the world adjusts to being short of both commodities, but as the bank's commodity strategist Tobin Gorey notes it is not a simple catch up from shortfalls in crops resulting from factors such as poor weather but stems from growing global demand for both food and energy, the former as populations continue to increase and the latter as fears of oil shortages encourage the development of alternative fuel sources such as ethanol.

This increase in demand has pushed the agricultural sector to the limits of its production capabilities, which is in turn pushing up price forecasts in both sectors. As evidence, Gorey points out both the OECD and the USDA (US Department of Agriculture) have forecast average prices for 2007 that are well above the levels of 2006.

Now, Gorey accepts stronger prices won't last forever as there will at some point be a supply response, but the interesting feature in his view is the future year estimates from both groups don't show prices returning to pre-2007 levels.

In other words, prices will ease at some point but they aren't going back to their old levels as these prices were too low for farmers to make any money.

This meant there were not enough farmers involved in producing the various commodities, which has contributed to the shortage of supply the world is now experiencing.

Gorey suggests then a large part of the increase in prices experienced over the past year or so is a catch-up to more sustainable pricing levels for the industry rather than representing significant absolute price gains.

This leads him to suggest the trend towards higher prices will continue for the longer-term, as agriculture looks set for a lengthy period of expansion to meet the world's increased demand.

Spot Uranium: Lower, Lower, Lowest

By Rudi Filapek-Vandyck

Industry consultant TradeTech has followed up on last week's severe weekly spot price indicator drop by Ux Consulting with another significant price reduction.

Following last week's U3O8 spot price fall to US$120/lb by Ux Consulting, TradeTech has now reduced its own weekly spot price indicator by US$15 to US$105/lb.

It was only weeks ago that both weekly spot prices peaked at US$136/lb (UxC) and US$138/lb (TradeTech) respectively.

TradeTech said it had recorded one transaction over the past week. Tullett Prebon Plc, the world's second-largest inter-dealer broker and a dealer in uranium futures contracts, sold 50,000 pounds of the metal at US$105/lb.

Some experts quoted by other news services are predicting spot uranium prices are likely to fall as low as US$80/lb in the short term.

Spot Uranium: Lower, Lower, Lowest (2)

By Rudi Filapek-Vandyck

One transaction by Tullett Prebon Plc, the world's second-largest inter-dealer broker and a dealer in uranium futures contracts, in the past week proved sufficient to bring two uranium industry consultants back in line with their respective weekly U3O8 price indicators.

After TradeTech clocked off on US$105/lb (minus US$15 from the previous week) earlier this week, colleague/competitor Ux Consulting has followed suit with a similar US$105/lb for the week, down from the US$110/lb price set last week.

Apparently, Tullett Prebon sold 50,000 pounds of the metal at US$105/lb during the week.

Interestingly, Ux Consulting notes it has reduced its forecast global production volume for this year by 5 million pounds to 112 million pounds. The consultancy finds it “disconcerting that production plans continue to disappoint at current price levels”.

The long time price indicator has remained unchanged at US$95/lb.

Ux Consulting further comments the market for uranium appears to have become even more illiquid than in the first half of 2007 when prices continued to move up strongly. Those were the days buyers found it very difficult to get what they were after. These days, however, the sellers are finding it increasingly difficult “to liquidate any sizeable amount of their material”. It is not difficult to see why prices are tumbling lower.

UxC is offering little comfort to the remaining speculators in the sector as the sharp drop in spot prices doesn’t seem to attract any buyers. This, the consultancy believes, may indicate potential buyers are expecting prices to fall further still.

Stable Steel Prices Expected For Rest Of 2007

By Chris Shaw

Global steel prices fell by more in July than industry consultant MEPS had expected but the group sees prices as likely to stabilise leading into 2008.

Prices will vary from region to region however, MEPS expecting increases in the North American market as the current de-stocking period draws to a close and the market returns to a better balanced supply-demand position.

Offsetting these gains are expectations of lower prices in the EU as prices there return to more normal levels after moving too high early in the year as the seasonal slowdown takes hold.

Later in the year there is a risk long prices in the EU region fall further, as winter weather will bring about a reduction in construction activity.

Asian prices should be fairly flat through to the end of the year in the group's view, as solid market conditions are offset by the threat posed by current oversupply in the Chinese market.

Early in 2008 the group sees scope for prices to push a little higher on the back of higher input costs and increased consumption, but as always China remains the swing factor given potential increases in production capacity in coming months.

Assessing The Resource Majors

By Greg Peel

If there's one thing you can say about global diversified resource giants BHP Billiton (BHP) and Rio Tinto (RIO), it's that they're almost banks in themselves. The resource boom has provided the two with extraordinary amounts of free cashflow, rendering the raising of any debt capital very much a quality-end concern. It's understandable that highly leveraged dodgy lenders should be trounced in a credit crunch, but why the resource majors? Only five minutes ago they were the darlings of the market.

It could be pointed out that Rio bought Alcan on a stretch at what might now be considered the top of the market, and as such still has capital issues to deal with. BHP has done well, in retrospect, by not diving into Alcoa or someone else as was expected. But the deal was never going to be a major risk strategy for Rio. There were no junk bonds to be issued, no risky leverage.

But there are at least three reasons why the resource sector has copped it in sympathy:

(1) Those stocks had been the star performers. In any time of doubt, best to lock in your profits as quickly as possible. The bigger they are...

(2) The stocks are extensively held both locally and internationally, by small investors and large funds alike. Many, many of those investors will have leveraged to some extent to include resource stocks in the portfolio. That leverage is now leading to margin calls which force the selling of the stock to cover. In the case of hedge, quant, balanced and other funds, they cannot sell their distressed debt portfolios, so they have to sell even their quality equity positions to cover redemptions or just stay alive. The stocks are spiralling.

(3) The credit crisis, US housing crisis and simple crisis of confidence is now leading the world to fear the US economy may go into recession. If American consumers don't buy a new fridge, the Chinese factory that actually manufactures the fridges (under a US badge) won't need to buy as much steel, copper, and whatever else they put in fridges. Ergo commodity prices fall, and resource company earnings fall.

In the case of (2), and in watching the Australian market spiral precipitously for a second day running, it is clear that virtually all leverage will have to be removed from the market before we can truly find a base. Margin calls beget margin calls when the "called" knock down the price by selling the stock and get called again. There will probably be an overshoot, and some sort of mid-correction bounce, but that won't necessarily signal any return to normal programming.

In the case of (3), the analysts at JP Morgan have been doing some number crunching.

JPM has called the liquidity crisis and subsequent response Factor X. The analysts then assume in their modelling that Factor X will cause a "dramatic collapse" in metal, energy and bulk commodity prices. (They're not saying this will happen, they are simply modelling such an outcome). They assume a pullback to long term commodity price forecasts which, on their present forecast price curve, kick in after 2011. On the modelled curve they will be reached by March, 2008.

Long term forecasts in a bull market are always much lower than spot for an number of reasons, including the assumption of reversion to a mean over time (although including a step-jump for China) and for the sheer fact that the further out in time, the bigger the effect does a price have on present valuation.

The good news is that Rio is already there. In other words, the 23% fall in the share price from the high translates to a correct price revision for the "dramatic collapse" the modelling assumes.

BHP, Zinifex (ZFX) and Oxiana (OXR) still have a way to go. Iluka (ILU) has hardly moved, but then it already had. Alumina (AWC) has the least to fall given aluminium price forecasts are little higher now than

the long term forecast. Hence Alumina should be a "safe haven".

So what does this mean? Start buying Rio and get ready to buy the others? Not necessarily. For as JPM points out, we're collapsing on confidence now but if commodity prices do dramatically fall, there'll need to be further share price downside before it's really safe to go into the water. Factor X must yet be fully reflected.

Of course if you don't believe Factor X is likely, then over to you.

Prepare For Opportunities In Commodities Sector

By Chris Shaw

As last night's shakeout in precious metal prices highlights, commodity markets have been unable to avoid any impact from the current chaos in global markets but where there is uncertainty there is also opportunity according to Barclays Capital.

The group suggests once markets settle down fundamentals should again come to dominate the commodity markets and this will present some attractive options to investors.

Barclays makes the assumption that as long as the current financial market crisis doesn't impact on the outlook for global growth further price downside is actually quite limited in a number of the commodity markets as demand should remain strong.

Highlighting just how strong demand has been the group notes among the base and precious metals and energy commodities only oil has so far experienced lower demand in 2007 than was the case in 2006, largely as a result of the mild northern winter last Christmas.

In contrast, demand for gold has risen 25% year-to-date against a fall of 3.7% last year, aluminium is up 10% against a 5.5% increase in 2006 and copper is up 5.5% against a 2.5% increase last year.

It hardly needs saying China has been the driver of this demand growth, accounting for more than 100% of the increased demand for lead and nickel (consumption elsewhere in the world has fallen), 90% for aluminium and 65-70% for copper, zinc and oil.

Other fundamentals too support a recovery across the commodities sector, with the group seeing scope for crude prices to push higher short-term as there are signs global demand is recovering at the same time as OPEC is focussed on reducing inventory levels, meaning the market should tighten and so limit any price downside.

Similarly in the base metals suite lead, tin and zinc markets continue to tighten and so leave these markets as well placed for a possible bounce, though short-term there is downside risk to copper in the group's view from rising stock levels.

Aluminium prices should continue to range trade while higher stockpiles from ongoing de-stocking in stainless steel markets suggests nickel prices will move lower in coming months before recovering later in the year.

Fabrication demand for gold is now expected to remain positive throughout the year, with additional support in the group's view from expected oil price strength and US dollar weakness. Offsetting factors are a likely fall in de-hedging and a smaller than expected shortfall in central bank sales, meaning a new catalyst is needed to push gold prices to new highs.

In terms of price forecasts the group sees the oil price as measured by West Texas Intermediate (WTI) as averaging US$72.10 per barrel this quarter and US$70.00 per barrel in the December quarter, while for gold it expects averages of US$650 per ounce and US$645 per ounce respectively.

Among the base metals the group is forecasting average prices for aluminium of US$2,600 per tonne in the September quarter and US$2,700 in the fourth quarter, for copper US$6,500 per tonne and US$7,500 per tonne and for lead of US$2,800 and US$2,850 per tonne respectively.

Nickel prices are forecast to average US$35,000 per tonne in the September quarter and US$38,000 in the December quarter, while for tin the group's quarterly per tonne estimates are US$14,500 and US$15,500

and for zinc US$3,800 and US$3,200.

Oz Business Conditions Strong, Confidence Dips

By Greg Peel

The first thing that National Australia Bank wants to point out with regards to its monthly business survey is its timing. The survey was conducted between July 25 and August 2. The first big falls on the Australian stock market started on July 27 but by that point three quarters of respondents had already submitted their reports. Perhaps the August survey may provide some different results.

Nevertheless, business confidence did dip - by 3 points to +12 - while the trend turned lower as well. NAB explains this as largely some growing concerns that commodity prices had peaked (affecting mining, particularly in WA) and that an interest rate rise (which we ultimately got) would affect retail.

In terms of business conditions, however, it was full steam ahead to a new record of +20 points, up 4. NAB started taking the survey in 1997. Surging sales and profitability (up 7 to +31 and up 7 to +20) were again the major drivers with employment slipping by 1 point but remaining strong at +10. It's still all a domestic story notwithstanding, given export sales fell another 7 points. Domestic demand growth has accelerated to 4.5%pa.

Capacity utilisation rose 0.2% to 83.3%, stock levels returned to a lower +5 reading and wages growth remained stable at 5.1%. Purchase cost inflation edged down to 3.5% and retail price inflation remained steady at 2.1%.

On a sector basis, most sectors improved modestly but wholesale, transport and construction led. Retail turned around the weakness of June. Regionally, WA was a dampener on the results given peaking property prices and concerns of a US economic slowdown, while NSW failed to follow through on last month's improvement. SA and Victoria were the winners.

NAB suggests the figures overall are consistent with non-farm GDP growth of 3.5% in the year to July. The economists have not changed their forecasts, although they do warn of the very real risk the US could tip into moderate recession. At present, they forecast 4.0% GDP growth in 2007 falling to 3.75% in 2008. Inflation will be 3.0% in 2007 falling to 2.6% by the end of 2008.

The economists note the RBA should now be on hold following the August rise but that the bias is to the upside with a chance of another hike by early 2008.

Australian Home Renovation Market Still Strong

By Chris Shaw

The Australian housing market may be struggling with issues such as affordability and availability in some regions but there appears no stopping the home renovation market according to a study by BIS Shrapnel.

The group's 'Home Improvements Market in Australia, 2006' report shows a total of 59% of Australian households undertook some form of home improvement during the year, which equates to a total of 5.3 million such projects.

This figure is actually down from the 5.8 million such projects undertaken in 2004/05 according the group's previous survey, but BIS notes the value of such improvement projects has risen by 9% since 2003 as a result of higher costs. For 2006 the group estimates the total value of the home renovation market was 75% of the value of new dwelling commencements.

This puts the market at about five times the size of the Australian Bureau of Statistics' (ABS) estimate for additions and alterations, BIS attributing the difference to the fact the ABS only collates those projects worth more than $10,000 that subsequently require council approval.

BIS figures estimate the average renovation project is worth around $4,548, with New South Wales having the highest average project cost at $5,495, followed by Victoria at $4,313.

Around 27% of the total renovation market is home addition projects where ground or upper floors are added or expanded, these projects being worth an estimated $6.49 billion last year. Internal renovations such as new kitchens or bathrooms accounted for $7.11 billion or 29% of the market.

Of interest, a survey of households done by the group showed only 3% of renovation projects were done with a specific eye to capital gains, while more than one-third commenced projects as a response to an increase in family members and 22% wanted more entertaining and general living space.

Have Central Banks Simply Postponed More Pain?

By Greg Peel

Steak n Shake is an Indianapolis-based fast food chain. It has found that its third quarter same-store sales have fallen by 4.3%. The company issued a statement on Thursday suggesting "Some segments of Steak n Shake consumers continue to be sensitive to high gasoline prices and mortgage interest rates".

MetroPCS Communications is a Dallas-based mobile phone company. It said last week that it is feeling the pinch from customers facing foreclosure.

These two statements (reported by Bloomberg) may not seem of significant consequence, given the world's current focus on a global banking industry rapidly freezing and subsequent multi-billion dollar liquidity injections. But don't be fooled. These two statements are a testament to the future state of the US economy.

Bloomberg also reported on the case of Peter Herbert's client. Herbert is a Houston-based mortgage broker who last week attempted to find a mortgage for one self-employed client whose credit rating put him just above what's considered subprime. On his third attempt, Herbert was offered 10.5% with attached penalty provisions. Last year he would have been offered 7.99% with no provisions. Herbert attempted to lock in the rate nevertheless, but at the last minute the lender changed its mind and pulled out.

Herbert's experience is a microcosmic representation of what is now a macrocosmic problem. The problem started in February, when problems in the US subprime mortgage market came to light. At the time there was popular analogy going around, which suggested there was one house on fire on one street. Firemen were working to contain the fire, but there was a risk it would spread to houses either side. No one expected such, but there were further concerns that if the fire spread, the whole street could go up.

What has actually transpired, despite early reassurances, is that the entire city is ablaze in an inferno reminiscent of London in 1666. Just as the London fire had the positive effect of wiping out plague-ridden houses, so too did authorities see the benefit of a subprime-inspired credit crunch ridding the market of underpriced debt and excessive leverage. But the authorities underestimated the fire's ferocity. Last week they had to call in Elvis the water-bombing helicopter.

Local US mortgage lenders are now too scared to issue mortgages. Banks are reluctant to finance lenders. Last week global investment banks Goldman Sachs, Lehman Bros and Merrill Lynch insisted that hedge funds to whom they had lent money - and global investment banks are the source of hedge fund credit - must pay back a greater proportion of their debts by day's end than they had previously been required to do under a margin call. Other banks were said to have followed suit.

At the same time all banks and financial institutions across the globe became suspicious of lending money to each other overnight. In Europe the focus was on Germany's corporate lender IKB which had to be rescued by the Bundesbank, and on BNP Paribas' hedge funds that had to be frozen. In the US the focus was on Goldman Sachs' US$400m Alpha Fund which, despite being considered "market-neutral" with respect to its debt security investments, closed its doors. Bank's were not willing to risk their overnight funds in a market where more bad news was being issued every day. Hence, they stopped being willing and accommodating lenders and suddenly the liquidity in the global banking system was disappearing.

With little capacity to borrow money, hedge funds had but one option - they had to sell assets. The only problem is that the whole crisis was triggered by debt assets, so there are no buyers. That meant the only course of action was to sell any other assets that still attracted a price. The most obvious choice was equities. That is why equity markets tumbled across the globe on Thursday and Friday.

Suddenly the world's central banks - those institutions which had spent five months sooling the world with definitive statements that the subprime crisis would be contained, and that there would be little contagion

- were forced to do what central banks are there to do. They had to dump water on an out-of-control fire, and they did so in the form of massive liquidity injections. Despite the ECB's biggest ever injection on Thursday, it had to follow up with another significant injection on Friday. It has told European banks it will provide whatever liquidity it has to. The US Fed injected twice its average daily amount on Thursday, only to find that cash was still trading at 6.00% and not the targeted 5.25% on Friday. An even larger injection was needed.

It is now clear that talk of containment, and talk of it being merely a healthy development that underpriced risk be returned to more relevant measurement, was misplaced. It is not just the over-leveraged hedge funds that have suffered. Some of the hardest hit funds have been the quantitative funds. These operate on statistically-driven models of balanced debt and equity investment. While normally the funds would adjust when the value of debt securities fell by selling those securities and replacing them with equities. But last week quant funds couldn't sell any debt, so they actually had to sell equities instead.

Everyone is caught in the fire.

But although the moves by global central banks were clearly necessary, will they prove to be moves that settle the market long enough for fear to dissipate and stability to return?

Michael Kosares of Centennial Precious Metals in Denver has suggested to USAGold.com that the central banks have set a dangerous precedent.

"One of the points made repeatedly in the financial press today is that no one in the banking industry or the central banks knows the extent of the [mortgage security] losses. Take it a step further and you have to assume that no one knows the extent of the ongoing bailout either.

"What the press has failed to point out in its treatment of the financial crisis is that the actions of the Fed, the European Central Bank, and the Bank of Japan last week amount to printing money."

When one country prints massive amounts of money, it devalues that country's currency against all others. But here we have a case of money being printed in all major currencies, and hence there are no major relative currency moves. What must happen, however, is that all currencies will devalue against global goods and services. This means that if the bailouts needs to continue, there is a chance the cost of living is about to erupt to levels much higher than expected. On this basis central bank fears of inflation remain very well placed.

Now Mr Kosares is a gold dealer, and the first good or service that is likely to jump in price under his scenario is gold. But his comments are not worth dismissing for that simple reason. There is a growing divide amongst traders and economists who believe that central banks will be forced to ease interest rates lest the banking liquidity crisis becomes a solvency crisis, and those who believe they simply won't do it.

Former Fed chairman Alan Greenspan was quick to lower the US cash rate after the LTCM collapse and after 9/11. But Lombard Street research economist Gabriel Stein told the London Daily Telegraph:

"Greenspan was a serial bubble blower who never saw a rate cut he didn't like, but Bernanke wants to curb inflation and wring the excesses out of the system. We're looking at a very different kind of Fed."

Danske Bank economists believe a liquidity crisis has to be met with liquidity, as is the case, and not with monetary policy easing.

"While it cannot be ruled out that the turmoil could eventually force the Fed to cut rates, we view this as a low-probability outcome. The Fed will not cut rates unless systemic problems accelerate markedly or become long-lasting and/or signs of a significant negative impact on growth show up or become overly likely. We do not change our forecast of the Fed keeping interest rates unchanged at 5.25 % in the coming quarters."

Similarly Danske believes the ECB will still deliver a rate rise to 4.25% in September, although it may be forced to adopt a wait and see approach. The Bank of Japan was expected to raise its rate on August 23, and Danske continues to believe it will go ahead, although it may be affected by carry trade unwinding pushing up the value of the yen.

We have only this month had an interest rate rise in Australia, and by all indications from the latest RBA statement of monetary policy, there is more to come.

If inflationary pressures continue to make rate hikes inevitable, or at least preclude any thoughts of easing, then where does this leave Steak n Shake? It will only suffer further sales declines as the American consumer begins to shut up shop. And when the American consumer shuts up shop, the ramifications spread across the globe.

There are two elements to this "subprime crisis" that are definitely not over. The first is the US housing slump which started the ball rolling. The second is the extent of known losses within financial institutions due to loans made to mortgage lenders and hedge funds.

In the case of the former, Bloomberg notes the inventory of unsold US homes in May was the largest since records have been taken. Defaults and foreclosures are only likely to increase due to the US$1 trillion in adjustable-rate mortgages that are scheduled to reset this year, peaking in October. The average US house price will fall year-on-year in 2007 - the first time this has happened since the Great Depression. Housing and related industries generate almost a quarter of US gross domestic product.

There is little doubt the US economy will slow, the only point of contention is by how much.

In the case of the latter, regulatory agencies in both the US and UK have been forced to move into Wall Street brokerage firms and check to make sure they aren't hiding losses. The problem with mortgage-backed CDOs and other securities is that they cannot be marked to market when no market exists. Revaluations are dependent on marking to an assumed price, and it is undeniably likely that some firms are yet reluctant to admit just how low that price may be. A lot of people will be hanging on to see whether the dust can settle, and as such a market can return for the securities. For to announce serious losses now could well be extremely damaging, particularly to share prices.

The fact that authorities have seen it necessary to take such steps indicates their suspicions that the whole story is far from known. That the ECB is prepared to turn on its liquidity tap for as long as it takes also has traders very worried that the central bank is not letting on something it knows about the crisis.

There are plenty of analysts around the world who are screaming out that equity market collapses are offering a golden opportunity to invest in now undervalued stocks, particularly financial stocks. They point out further that the markets are still only down about 6% from the highs - hardly a major bout of panic. But there are few that disagree that this crisis still has to work itself out, and that this will take time.

In the meantime, CNNMoney reports that "big-money" institutional investors have turned more risk averse than at any time since August last year, taking positions they typically do not reverse quickly, State Street data showed on Friday. State Street said its clients, who keep some US$13.04 trillion with it as a custodian, have moved into what it called a "safety first" regime. This is characterized by moving from emerging to developed market equities, embracing bonds and unwinding currency "carry" trades. The firm said that since September last year investors had been taking positions reflective either of abundant liquidity or leverage opportunities.

Such a change in attitude is a good indication of how global pension funds are now likely to react. High risk, high-yielding assets will be replaced by low risk, quality assets across the debt and equity spectrum. When the "event shocks" are over, when all the bad news eventually has come out, this should prove a strategy to respect. But again, it will take time.

How Central Banks Deal With A Liquidity Crisis

By Chris Shaw

The move by central banks around the world to inject liquidity into the system has stabilised (at least for now) global markets, but the action probably means little to the average investor. Noting this, Danske Bank has come to the rescue and outlined just how central banks actually operate and explains their role as liquidity providers to the general banking system.

As Danske Bank points out, the normal course of action for a central bank, be it the Federal Reserve in the US, the European Central Bank (ECB) or the Reserve Bank of Australia, is to adjust the level of liquidity in the banking system.

In the case of the ECB this is done via once-a-week pre-scheduled auctions and monthly tenders, with the level of liquidity being provided based on what the central bank in question estimates will be needed to keep interest rates at or around official levels.

In between these auction days individual banks adjust their liquidity levels by borrowing or lending more money between themselves through what is known as the interbank market, or by getting additional liquidity from investors through the repo market. Repo here stands for repurchase agreements and traditionally take the form of overnight loans but can be of any duration, so in Australia think of overnight deposits and bank bills.

In the interbank market the interest rate is set by the vagaries of supply and demand, as well as by the perceived risk between the banks involved. As Danske notes and the last couple of weeks have demonstrated this, as financial volatility increases the risk of an associated liquidity squeeze also increases, meaning banks want to increase their levels of highly liquid holdings to counter any potential risk to their financial assets.

At the same time they lend less to other banks in the system as the perceived counterparty risk has now increased, meaning very quickly the situation becomes one of higher demand but lower supply.

This forces interest rates higher, as evidenced last week when the announcement BNP Paribas was freezing three investment funds sent European overnight interest rates to 4.6% compared to the 4.0% refinancing rate.

To counter this, the ECB stepped in and injected additional liquidity into the system, in this case to the tune of 95 billion euros. While the injection addressed the liquidity issue, Danske Bank points out the second factor of perceived higher counterparty risks remains and is likely to linger until the crisis has fully passed.

According to Danske Bank an important distinction to make is to not confuse a credit crunch in the interbank market with a general credit crunch, as the latter involves tightening lending to companies and individuals.

While there has been significant evidence of such a tightening in lending in the US housing market and much commentary suggesting it will be far more difficult and/or expensive to borrow money in Australia (aside from the latest increase in official interest rates), the same trend has yet to emerge in the EU thanks to solid company and consumer balance sheets.

But given the global liquidity issue appears far from over, the bank does accept this is a potential development investors should keep a close eye on.

As another point of note, Danske Bank suggests the liquidity issues being felt should not impact on the monetary policy actions of central banks as the aim of central banks at present is to steer interest rates to

a level they see as appropriate for controlling inflation.

Market commentator Dennis Gartman makes an interesting point in this regard, suggesting while the injection of funds was the correct action the key will be how this additional liquidity is subsequently withdrawn from the market at the appropriate time. If these funds injected are allowed to remain in the system more or less permanently Gartman argues it would be a highly inflationary development, so gold would likely gain and the US dollar would likely come under further pressure.

Countering this, Danske Bank points out at present it is simply impossible to know whether the injections globally have been enough to stabilise the respective banking systems as there is no way of knowing just how much risk each bank has taken.

As a result, Danske sees scope for further action to be needed from central banks before the current crisis has fully run its course, so news of further capital injections and other policy decisions would certainly not surprise in coming weeks. The best approach in the bank’s view? Keep a cautious approach and focus on risk management.

Rudi On Thursday

If you listen very carefully you can probably hear the prayers of the professional stockbrokers behind their desks: God, give us one strong rally on Wall Street, please God, one strong rally on Wall Street.

Those long enough in the trade know from first hand experience there's nothing as bad as falling share prices. Negativity feeds on negativity, but if indications received today are correct, a strong rally on Wall Street may be just the cure needed to prevent this market from tumbling into serious trouble.

Those who have been reading the technical analysis stories provided by our own Tech Wizard will have noted that the market has sunk below its key support level today.

After the market closed I called the Wizard on his mobile. For the first time in four weeks he sounded remarkably subdued. Nothing's lost, he assured me, tomorrow might still bring a bounce and take the index back above the support line. Maybe Wall Street can help us a little overnight.

Our Tech Wizard will be keeping his fingers crossed when Wall Street starts trading later today.

If today's assessment by some local stockbrokers proves correct, a positive trading day on Wall Street would be the main, if not the only salvation left for the local share market on Thursday.

Today's/Wednesday's break below key technical support is expected to attract more selling by the opening bell on Thursday. However, the main selling pressure is expected to come from margin calls on retail investor market positions. Some predict tomorrow will see the market flooded with such margin calls selling.

It's the same sort of selling that is believed to have greatly contributed to today's 3% decline. If anyone knows, it would be the retail advisors at the local stockbrokerages.

Last week, before the real carnage set in, and before central bankers surprised the markets by providing additional liquidity to the global banking sector, a few of these retail advisors sent out emails to their clientele.

There was one in particular that caught my attention.

The Australian market is full of cash looking for a home, the advisor argued. Moreover, he seemed to blame independent internet news services, such as FNArena I assume, for most of the "confusion" among retail investors.

He wrote: "What we are really suffering from is a crisis of over-information. The web has enabled the transfer of information global and instantaneous. Unfortunately, it has made the transfer of misinformation just as global and just as instantaneous."

Of course, 24 hours later BNP Paribas released its now infamous statement and the world changed in an instant. Investors in share markets never looked back and headed for the exits. The result is that we are now experiencing an official share market correction.

Up until the BNP Paribas statement, most stockbrokers kept their clientele entertained with claims that the turbulence in global share markets was opening up "buying opportunities".

And what exactly did those "mis-information" spreading independent news providers do?

Alan Kohler's Eureka Report advised its readers at the end of July not to jump into bargain hunting just yet but to wait and see how the global credit crunch would develop first. Up until today Kohler and the Eureka

Report have kept to this advice.

Macus Padley, who is closely connected to one of the stockbrokerages but also runs his own daily newsletter, wrote in one of the national newspapers last weekend: Don't buy for the short -or long term yet- unless you love gambling. If you are worried about individual positions, sell them. What do you sell? All the crap. The message is, THIS IS NOT OVER (his emphasis).

At FNArena we don't engage in providing investment advice, but I would like to think that our warnings have been early, plenty and unambiguous. (And I regard the emails we received over the past few days from readers and subscribers thanking us for this as the ultimate proof).

So who has the bad scoring card here?

Which brings me to a comment made a few weeks ago by one observer whose name I don't recall (yes, it was on the internet): if the financial system itself is unhealthy, how healthy can global financial markets remain?

What we are witnessing right now probably speaks for itself.

Two weeks ago I wrote a weekly editorial which can be accessed here:

http://www.fnarena.com/index4.cfm?type=dsp_newsitem&n=214B7BAE-17A4-1130-F55A9FCC099221D6 (If the link doesn't work simply copy it in your browser)

The reason I am referring back to this story is because I have been receiving quite a lot of questions from subscribers about what exactly is happening in the markets and what is my view about it. Gradually, I came to the conclusion that most questions could be answered by re-reading my Rudi on Thursday story from the 1st of August. In fact, and balancing on the risk of being perceived as smug, I think my story from two weeks ago reads even stronger after the events that took place since then.

I'll leave the closing remarks for this week's story to one of the highly respected expert voices in the Australian market, CommSec's chief equities economist Craig James.

"This shakeout is likely to extend over weeks rather than days, increasing the appeal of defensive investments.

"There is a tendency to call everything a "crisis". And while we can debate whether the shakeout on credit or debt markets is a "crisis" or not, it does have further to go. While bank balance sheets are strong, at present worries focus on issues like liquidity and contagion. Markets have a tendency to overshoot and this appears to be a classic case with fear rather than fundamentals taking the driver's seat.

"Simply, the good economic times bred over-confidence and investors are getting a new-found appreciation of the concept of risk. The change in mood is well demonstrated by the narrowing gap between the ASX 200 and All Ordinaries index. On August 1 the All Ordinaries index was 48 points above the ASX 200 – the biggest gap on record (15 years). But investors are swinging away from small companies to large companies, and the gap now stands at just 8 points.

"CommSec has upgraded the Utilities Sector to Overweight and downgraded Materials to Indexweight. The Australian sharemarket is expected to reach 6,400 by end-2007."

Till next week!

Your proud to be part of one of the internet mis-communicators Editor,

Rudi Filapek-Vandyck (As always supported by the absolute fabulous team of Greg, Chris, Terry, Pat, George, Joyce and Graham)

Correction Or Crisis?

By Chris Shaw

Given share prices have been in an uptrend for a number of years and returns in annual terms have been exceptional for the past few years, many investors relatively new to the market have possibly never experienced a major correction or financial crisis.

With this in mind it is time for an economics lesson on how a financial crisis is created in the first place and subsequently unfolds and what brings it to a conclusion, the lesson coming courtesy of economists Hyman Minsky and Charles Kindleberger in a report on the current market situation provided by Danske Bank chief strategist Teis Knuthsen..

Minsky notes the first requirement of a crisis is a displacement event, which is an exogenous and positive shock to the financial system. He suggests the shock to the system this cycle is either globalisation or the improvement in financial markets over the past decade or a combination of both, as the two factors have contributed to the boom of the past several years.

At some point the boom becomes a state of euphoria, Minsky noting at this time investors are simply speculating rather than investing on any fundamentals. An example here could be the growth in hedge funds in recent years and the runs enjoyed by speculative stocks in the uranium sector of the Australian market in the earlier part of the year despite many of these companies have no possible way of producing unless various state government laws are changed.

Kindleberger notes at the peak of the boom there is almost a balanced state, as insiders are cutting positions, think the float of Platinum Asset Management (PTM), and new speculators are trying to catch up on what they have missed out on.

The next step is a period of financial stress, followed by a rush for liquidity as investors look to dump assets in favour of cash or cash-like investments. Here you can think of the sub-prime crisis and its impact on market confidence.

This rush wakes up the speculators, who on realising the market can't go higher join the crowd and dump their holdings, forcing a general and widespread sell-off – think equity markets over the past couple of days.

Kindleberger calls the next stage of the crisis the revulsion stage, when banks simply stop lending on the collateral of assets such as stocks or securities. This continues until finally prices fall low enough to bring out bargain hunters in less liquid assets, trade is cut off by limits being set on the size of any decline or the lender of last resort convinces the market there will be enough cash available to meet any requirements.

It could certainly be argued the central banks of the world are attempting the latter at present given the amount of liquidity they have been injecting into their respective banking systems.

So this is the theory behind a financial crisis, but how does this fit into what is going on in markets at the present time?

A week ago Danske Bank had speculated the drawdown on carry trade positions was coming to a close and that investors would soon return to their previous position of seeking and accepting risk in the search for returns.

As Knuthsen notes, that view could hardly have been more wrong as markets are now exhibiting some signs of a secular change with respect to the appetite for risk of investors.

If this is the case it implies the correction will take longer to work its way through the financial system than the bank had previously expected, if indeed it proves to be only a correction and not a financial crisis.

Supporting evidence it is more than a simple correction emerged last week, Knuthsen pointing to the fact what was a sub-prime lending issue has extended into other sectors and is generating major cause for concern, particularly as it has spread into something akin to a run on the banking sector.

The fact the crisis has extended beyond the sub-prime market supports his view it will take longer for some level of confidence to be restored to the market, particularly as while central banks have done their part in adding liquidity to the system the fact remains many investors have leveraged into assets and there is currently (and suddenly) no market for these assets, so there is no way to ascertain what they are worth or for investors to de-leverage their positions.

Knuthsen notes the market is now acting in accordance with Kindleberger's theory in that there has been rush for cash, banks are refusing to lend when the collateral is financial assets and central banks are pumping in liquidity. The only thing left is assets falling to levels suggesting long-term value, but this is yet to happen in foreign exchange markets in his view.

Even allowing for recent unwinding of the carry trade, Knuthsen notes currency markets have simply returned to their long-term trend levels, so excess has been removed but value has not yet been created.

An example of what could happen if we in fact are in a crisis and not simply a correction can be seen in the Australian dollar-US dollar market, where the current spot price is 83c but purchasing power parity (PPP) suggests a value of 70c. (Purchasing Power Parity is the equalising of exchange rates such that someone in either country could purchase the same basket of goods). As Knuthsen notes this represents a deviation of 18%, so at the peak of 88c last month the Aussie dollar was at its most expensive level ever against the greenback in PPP terms.

Assuming this is being unwound, and Knuthsen notes currencies tend to trade in big cycles from cheap to expensive and back, it would require a further 41% decline in the value of the Australian dollar before it was again cheap compared to the US dollar.

Knuthsen points out PPP on its own is not enough for accurate analysis of currency valuations but it does give a pointer as to what could happen, though again the key is are we in a correction or a crisis?

Assuming the former the currencies that have peaked this year against the US dollar such as the Aussie and Kiwi dollars and the British pound should return to previous highs, but if not there is plenty of scope for further significant falls.

The market may be calling for rate cuts in the US in particular to re-fire up valuations and bring back the boom times, but as Knuthsen notes the central banks may in fact prefer to see value return to markets and assets. If so, the current correction appears far from over.

Rudi On Thursday (Extra Edition)

Let's start with some positive news. I am sure that after the past two trading days, which saw the local market lose more than 4% in value, and after the market sunk as deep as minus 5.3% at some point on Thursday, most readers, subscribers and investors are up for a healthy portion of positive adrenalin.

The market is likely to move up tomorrow, Wall Street permitting.

The predicted flood of margin calls and technical selling hit the local bourse on Thursday, and most of it will have been absorbed by now. In fact, I have a suspicion that the wave of forced selling petered out in the early afternoon and this allowed the bargain hunters to move back in and reduce the day's losses.

At some point today the Tech Wizard sent me a chart showing how the market had fallen to what is regarded a key technical support line (50% retracement between low and high earlier this year for the tech heads) and how it swiftly bounced back. This is a major, major support line, the Wizard assured me. I won't replicate the chart as it was of an awful graphic quality, but it clearly showed how the S&P/ASX200 index had moved in a V-pattern between the opening and the closing bell. The deepest point of the V was near the technical support line.

Another factor that will be mentioned in tomorrow's newspapers is that the bourse authorities decided to shut down the futures market for about 1.5 hour today. The official mantra from the ASX is: "hardware rectification". According to sources in the local community this accelerated the selling as brokers were no longer able to hedge their equity positions. Given the shaky state of the market they swiftly decided to sell more equities (as they couldn't hedge they didn't want the risk either). With the reopening of the futures market also followed the upper leg of the Wizard's V-form for the share market.

Another element of good news is that the Australian equities market –some 11% off its high point earlier this year- has now landed in cheap valuation territory. Several commentators had pointed out that the losses until Wednesday had wiped away the valuation premium that had been built up during the bull market of the past few years. The loss of the premium made the Australian share market all of a sudden "fairly valued".

Pure logic then tells us that another 5.3% off the market by Thursday afternoon had pushed the market from fair value into cheap. Considering that many stocks, even large caps with no link to credit or debt, have lost more than the market's average over the past few weeks, the cheap value label probably still applies. Wall Street permitting, bargain hunters are likely to have a feast on Friday.

After all, just like share prices don't climb every day in good times, they don't continuously fall in not-so-good times.

If you're not in the game of trying to make a quick buck out of speculating whether Macquarie Bank (MBL) might bounce (just one example, though an obvious one), it's probably best to look for large, solid companies. Think solid balance sheets, a proven business model, experienced management and a solid track record – no fancy, exotic, or even less exotic financial or debt constructions. And please, no exposure to US housing, US consumer credit or any leverage of both.

This is the message I am picking up from experts and commentators across the market. Defensive/conservative is the new key term. Remember: tomorrow might make for a better day but the world has changed between now and last week, and quite considerably so.

Time to move to the not-so-good news. This whole process of risk adjustment is far from over. Simply dismiss every story that starts with "subprime" from now on, because that is no longer the problem (it already stopped being the problem quite a while ago). What we have experienced over the past eight days was a swift breakdown in trust and confidence. That's why banks stopped lending to each other. Something they were used to do on a daily basis. All of a sudden they stared at each other and thought: are you going

to be the next one?

That's what makes the current global credit squeeze quite special in its own way: it's not that there is shortage of cash in the system, but those who have plenty of it are no longer willing to provide it.

This confidence has still to be restored and many people are looking into the direction of the Federal Reserve to do so. Are US interest rates about to be cut? The answer is probably yes, but it is far from certain when and whether this will happen. It all depends on how much longer central banks need to continue providing additional liquidity and how much more bad news will come out into the public arena over the next few days.

As we've all experienced since last Thursday, the rhythm of bad news announcements can accelerate very quickly and hit the markets where it is least expected. Now banks in Japan and Canada have joined the ranks of BNP Paribas, Macquarie and Bear Stearns while problems at local RAMS Home Loans seem to get worse on an almost daily basis.

Let there be no mistake: more bad news will follow. And believe me, that is a rather easy statement to make.

Time to focus again on the global economy and it seems but logic to take into account that the current "crisis" (let's not beat around the bush, what other term can be used when central banks are forced to pump billions of liquidity into the banking system and corporate lenders cannot get any credit anymore?) will start having an impact on what is oft described as the "real economy".

Everyone who tells you otherwise is either ignorant or not telling you the full story.

As pointed out by some experts in the US, the current credit squeeze is already affecting corporate America. It probably is already impacting on day-to-day banking operations across the globe as well.

But most importantly, and this is an element that has been pushed to the background amidst all the headlines about hedge fund troubles, falling share prices and widening credit spreads, is the fact that US home owners will soon face higher mortgage payments. Not all, but many of them. Earlier this week I stated so-called ARM loans ("adjustable rate mortgage") with a combined value in excess of one trillion USD are about to kick in from next month onwards. According to some sources, the real figure is about US$ 2 trillion of such loans over the next 18 months.

(These loans typically allow for smaller monthly down payments at first but at later reset dates the interest and thus monthly down payments move up. The effect is obviously larger when the Fed has raised interest rates in the meantime).

It still dumbfounds me that only few economists and share market experts mention this in their forecasts for the US economy. Taken from this perspective, I found it quite remarkable that highly regarded David Rosenberg, employed as economist by Merrill Lynch these days, made the following statement in one of his market commentaries this week:

"We believe the economics community is underestimating what the impact on aggregate consumer spending is going to be now that the home-buying public is going to have to put up a much higher down payment going forward."

Another factor you will be hearing more about in the weeks and months ahead is Chinese growth. Official statistics, released during the recent share market carnage, showed Chinese industrial production grew at an annualised rate of 18% in July. That is still a very high number. It is nevertheless down from the 19.4% registered in June.

Proof the Chinese economy is cooling down? We'll have to wait and see.

Another term you will start hearing more often is "food inflation". While you were all watching Australian shares go down George Weston Foods has raised its bread prices by close to 3% "to recoup record high commodity costs". This is the third raise in a little over twelve months. One can expect Goodman Fielder

(GFF) to soon make a similar announcement.

To conclude this extra bulletin on a positive note, I happily refer to a recent study done by the bond market team at Deutsche Bank. Taking lessons from history, the study concluded that share market corrections usually run their full course before the Fed jumps into action. If the economy subsequently stays healthy this usually opens the door to rising share prices.

What this means, says Deutsche, is that once current market turbulence settles to less extreme levels the local share market could well see some “decent returns”. For all we know, Friday may well be the first day of such turnaround.

Till next week!

Your happy I am finally able to write a more upbeat story editor,

Rudi Filapek-Vandyck (as always supported by the fabulous team of Greg, Terry, Chris, Joyce, Pat, Grahame and George)

The Bull Rally In Reverse

This story was first published two days ago in the form of an email sent to registered FNArena readers.

By Rudi Filapek-Vandyck, editor FNArena

About ten days ago something extraordinary happened. The FNArena Bear/Bull Indicator, which measures the underlying market sentiment by balancing Buy recommendations by ten major experts in the local market against their Neutral and Sell ratings, fell through the bottom of its measuring frame.

The Indicator works counter-intuitively, so the higher the amount of Buy recommendations, the lower its reading. Some of our readers were quick in notifying us: Hey FNArena, the needle of your Indicator needs fixing! We added another compartment.

Within days the Indicator fell further to reach again the bottom of its extended measuring frame, where it still is today, so it remains possible we have to add another compartment at the bottom of the framework soon.

In the five years we have observed and analysed the recommendations of the major local experts in the share market this had never happened before. So it is that I can now announce there have never been as many Buy recommendations in the Australian share market as today, at least not during the past five years.

To put this in perspective: the ten equity experts we monitor daily combine a total of 2126 recommendations on individual ASX-listed stocks. Close to 42% or 891 of these recommendations are currently Buy, Outperform, Accumulate or Overweight.

When we had a closer look at these recommendations this week we discovered that out of the total of 479 individual stocks covered by these experts combined no less than 347 stocks are rated as Buy by at least one of them. This is more than 72%.

Allow me to rephrase that last paragraph for you: 2.25 out of every three stocks covered is currently rated Buy at least once. We have no historical data to prove it, but we believe this must be another record.

Last week we calculated the average gap between share prices and price targets for the Top 40 of highest recommended stocks was about 22%, an average 4% in dividend yield not included. We're pretty certain this is another record too.

Taking these figures into account, it is easy to see why some commentators and experts believe the current subdued environment for global equities is providing investors with excellent buying opportunities for the longer term. Hey, who wouldn't want a 26% return with 2.25 stocks out of every three to choose from?

But are investors in the Australian share market looking at a return of some 26% in the year ahead?

Not according to the strategists employed by these same ten local equity experts. Most would put the S&P/ASX200 index at around 7000 by mid-2008. This only implies 17% upside (plus dividends).

But even at 17% (plus dividends) with only 0.75 stocks out of every three to fail, why aren't investors piling up on Australian shares? Surely any diversified portfolio will diminish the impact of a few dog stocks that are included in the selection?

The problem is that all these recommendations and targets and the calculations that support them are, in effect, yesterday's figures projected into tomorrow. Securities analysts have been slow in catching up during the past four years when things were constantly improving. The result was that shares of the likes of BHP Billiton (BHP) and Rio Tinto (RIO) have been pushing ahead of price targets set by the experts, forcing

them to continuously catch up with the reality of the Commodities Super Cycle.

Now that developments in the global financial system have taken a turn for the worse, who is willing to guarantee things will be different? Are yesterday's assessments still viable tomorrow while the world is changing today?

A recent study by JP Morgan suggests investors have already drawn their conclusions, and they started doing so before the world awoke to central bank emergency operations (which arguably took most experts by surprise but also showed most had been underestimating the severity of the crisis).

JP Morgan found that between January and last month investors had started to sell high growth/high PE stocks in favour of more defensive low PE stocks as the gap between both groups of stocks has contracted over the past months.

Could the market be telling us something different to what is currently reflected in analyst forecasts? Will securities analysts have to play catch up again in the months ahead, only this time by cutting back instead of increasing their numbers?

Arguably, this process is already taking place. Earnings forecasts have been in decline for at least two months as a stronger Australian dollar has been put into valuation models and forecasts. Some analysts have started to delete so-called takeover premiums in their models. Others have started to account for higher borrowing costs for companies with debt.

What else could change yesterday's figures? The amount of experts who believe the Chinese economy is poised for slower growth in the months ahead is still increasing. What will be the effect on commodity prices? Traditionally the third quarter of the calendar year is the weakest for metals. The recent shake-out from the global credit crunch already had an impact on prices of LME listed metals. Technical chartists are now suggesting the sector seems on the verge of emitting a bearish signal.

The most severe adjustments would have to come from a slow-down in US consumer spending. So far, almost every expert is sticking to a positive script. However, some highly regarded market strategists, such as those at BCA Research, have already issued a firm warning to their clientele: avoid everything with exposure to US consumer debt and spending.

Higher prices for food. Higher costs for petrol. Falling house prices. Increased foreclosures on mortgages. Higher prices for imported products (as the US dollar is widely expected to weaken further). And the fact that mortgage payments with a combined worth of over a trillion US dollars will climb from low monthly costs to current market yields between next month and March next year. One can only conclude this cocktail makes for a very compelling scenario that sees US consumers hitting the brakes at some time. (This is not to say the US economy is inevitably steering towards a recession).

Macquarie Bank (MBL) shares have been sold off to $70. The average price target for the stock is currently $109.59 (Citi still has a target of $122.88).The shares never traded any higher than $98.64 at the peak, and actually only exceeded $95 very briefly.

Hands up everyone who thinks Macquarie Bank shares will rise 56.50% over the next twelve months.

Thought so.

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