Week

28

Stories To Read From FNArena

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Microcap Rising Stars - QMastor

(This story was originally published on July 1st. It has now been re-published to make it available to non-paying members at FNArena and readers elsewhere).

By Greg Peel

Microequities is an Australian financial adviser specialising in in-depth research of listed "micro caps" - those companies of low capitalisation too small to register on ASX indices or to attract research coverage from leading stockbrokers. In June Microequities hosted its Rising Stars conference, at which selected companies presented their wares. FNArena was invited to attend, and over a period of time is providing conference highlights. This is the second in the series.

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QMastor ((QML)) presented at this year's Microequities conference, but the company also presented at last year's conference. To that end, readers unfamiliar with QMastor are directed to Micro Cap Rising Stars - QMastor (2008) published this time last year, for an extensive company profile. What follows is an update.

In the first half of FY08, as noted in its 2008 presentation, QMastor posted earnings of 0.93c per share on a profit of $373,000. Its order book was full, and its confidence strong. In the first half of FY09, QMastor posted earnings of 2.66c per share (up 187%) on a profit of $1.07m. A 1c dividend was paid.

This time last year, bulk commodity price contracts had just been renegotiated for the greatest price jumps in history. All commodity prices were strong, and the Reserve Bank had hastily increased its cash rate in an attempt to quell runaway Australian economic growth. Iron ore producer Fortescue Metals was arguing with BHP Billiton and Rio Tinto about being provided with access to their precious Pilbara rail lines, and east coast coal producers were shackled by a lack of rail cars and bottlenecks at the ports. There were empty coal ships lined up from Newcastle to Palm Beach.

In July 2008, the commodity bubble burst when the oil price peaked and began to fall. By September, the whole world had fallen apart as the US-centric credit crisis became the Global Financial Crisis. Commodity prices collapsed. The coal ships stopped coming. Smaller mining ventures went to the wall.

QMastor's vision is "to be the leading bulk materials management information systems and services provider to the global mining, port, power generation and other bulk commodity industries". QMastor sells mining and material management software and provides ongoing service. One might be forgiven for assuming FY09 would be a shocker for the company, and that its positive growth story of FY08 would take a severe hit. But instead, QMastor has increased earnings per share by 187% year-on-year in the first half.

One of the reasons there is growing confidence in an economic recovery across the globe, hopefully beginning later this year, is due to general inventory management. Once upon a time recessions were exacerbated, or even caused, by an excess of inventory in the economy. Widget sellers would be forced to keep several days or weeks of inventory on hand in order to cope with vagaries of demand, and also to stay ahead of inflation in the boom times. When the economy turned, retailers, wholesalers and producers were stuck with widgets they could not sell. This meant orders stopped and discounting of existing stock followed, creating deflation.

With the exponential growth in computing power, software creation, and the instantaneous global information network created by the internet, inventory management has since become a fine art. Widget sellers boast of their "just in time" inventory management systems, in which orders are satisfied expediently without the need to carry excess stock. From the raw materials to make the widgets, to the production process, to

transportation and sale, widget stock management has been efficiently streamlined. This means that while rapid destocking was occurring across the globe in late 2008 and early 2009, inventory levels have been rapidly reduced to a minimum. This has given economists confidence that the shocking global GDP contraction numbers of the first quarter will not be repeated. Retailers, wholesalers and producers will have to start placing orders again, and data already suggest this is happening.

The business of digging rocks out the ground, processing them, putting them on rail cars for port and then on a slow boat to China, has not, however, kept pace with the evolution of widget management. For many mining operations, logistics management has only moved from pen and paper to an Excel spreadsheet purpose built for each operation. It's not just about inventory management, it's about the whole supply chain. A widget is a widget, but not just any old rocks can be sent off to Chinese customers, or anyone else. And the rocks have to be "handled" several times. Coal, for example, must meet certain specifications to satisfy global contracts. The industry estimates that 20% of all coal marked for export does not actually meet such specification. And that's just about inefficient management.

In short, QMastor provides purpose-built software for bulk material management which is 80% generic and 20% tailored to specific customers. QMastor provides mining companies with the opportunity to cast off their old piecemeal logistics systems like a clapped out back-hoe and move into the twenty-first century of the efficient management of rocks. Qmastor systems are now contracted to manage over 550 million tonnes of global bulk commodity movements per annum, which is more than all of the Australian coal industry.

Having moved out of its R&D phase last financial year, QMastor's plan was to expand its range of service and its global footprint. To that end, the company has sold its first port management software and its first software to a major US mining operation over the course of FY09.

New sale highlights in FY09 include sales of software to both the Newcastle and Dalrymple (Mackay) coal ports on Australia's east coast, and to two large iron ore ports in Western Australia. Software has been sold to the Vale Inco nickel operation in New Caledonia, and to Jim Walter Resources in the US. QMastor is confident the latter will provide the much needed window into the lucrative North American market. QMastor has opened new offices in Perth, Mackay and South Africa and they are all producing revenue.

FY09 has also seen the launch of QMastor's new Horizon advanced planning and scheduling software, used for processing plants, vessel/berth scheduling and transportation and stockyard scheduling. The software has only been available for three months, but has already been adopted by OneSteel, the Newcastle coal port, the two iron ore ports in WA and Jim Walter Resources.

The cost of "demurrage" - the scourge of every bulk material exporter - is the total cost of chartering a vessel not just to travel from A to B, but the time spent at A and the time spent at B. Those coal ships parked off Newcastle for weeks did so with the meter running. While the queues were caused by inadequate port infrastructure, the greatest part of additional demurrage cost is due to inefficient scheduling. In recent months, the port of Shanghai has witnessed Newcastle-style queues as ships laden with iron ore and copper jostle for an unloading schedule slot.

This time last year, QMastor had no debt and held plenty of cash in the bank to exploit potential acquisitions while at the same time bursting with organic growth. In FY09, the company has made a significant acquisition in Coal Link Australia, previously recognised as the country's leading coal management system provider. The acquisition cost $3.5m, leaving plenty of cash in the tin to foster organic growth. QMastor recognises the need to push for scale, and to make the company "sizeably bigger". However, further capital raising will only be considered for the purpose of an opportunistic and accretive acquisition.

While QMastor has appeared to have weathered the GFC quite effortlessly, the second half of FY09 has featured a slowing of activity, prompting the company to also now look inward and "seriously" at costs. QMastor is nevertheless on track to meet previous FY09 earnings guidance of 3.25 to 4.0c per share.

No Imminent Move on ConnectEast Likely

By Chris Shaw

As toll roads go ConnectEast ((CEU)) has had a somewhat disappointing beginning as traffic numbers have consistently fallen short of expectations, a trend that continued in June as headline traffic of 153,800 ADT fell short of market expectations. Stockbroker Austock, for instance, had a forecast of 159,000 ADT prior to this week's release.

As a result earnings expectations have been adjusted down slightly across the market. Though investors have to take into consideration that the road remains in ramp-up phase and is not actually generating positive income, thus the actual earnings implications are minimal at this stage.

What remains as an issue is the pace of traffic ramp-up as it pertains to the group's debt levels. Macquarie analysts note the revenues being generated are still not enough to cover the group's interest expense. This leads to a likelihood further equity will need be raised, the broker estimating anything from $200-$350 million could be required depending on what revenue assumptions are used.

Austock disagrees however, taking the view the company may not need to raise equity or at worst may look to raise around $300 million, though much will depend on whether or not it can get traffic levels up to breakeven of around 172,000 ADT before it needs to refinance around $800 million in debt by late 2010.

The debt issue means there is also scope for distributions to be suspended, GSJB Were suggesting such a change could come in FY11 and may continue through to FY15 as the company attempts to get its balance sheet and debt issues in better order than is currently the case.

Another issue for Macquarie is the group cannot begin repaying its debt early given a dispute with Leighton Holdings ((LEI)) over early completion clauses in its construction contract and with this issue seemingly not near a resolution at present the broker suggests any share price re-rating remains unlikely.

What could prompt a re-rating is speculation of a takeover for the stock by Transurban ((TCL)) given significant expected synergies from combining the two groups, synergies Austock estimates could total $25-$30 million annually. As well, Macquarie suggests at current levels there is some relative value in Connect East that Transurban may find appealing.

Austock agrees, estimating Transurban currently trades on an equity internal rate of return (IRR) of 13.4% against Connect East at 17.9%, which suggests significant value accretion if Transurban could acquire ConnectEast at 31c per share. Given this is unlikely the broker has done a similar comparison based on Asset IRR and estimates a similar Asset IRR for the two groups would imply a ConnectEast price of around 54c.

As such an analysis doesn't factor in synergy benefits, the broker estimates Transurban could pay up to an additional 14c per share at a stretch, giving a price somewhere around the 65c level. Such a price would see Transurban shareholders lose much of the synergy benefits though and so the broker argues a price closer to 55c is more likely, particularly given TCL's CEO, Chris Lynch, is unlikely to pay top dollar..

It notes any such offer from Transurban would be a scrip-based one given the group's balance sheet only has around $300 million available for acquisitions at present, GSJB Were arguing such a move remains unlikely given even a scrip offer would not address the potential need for an equity raising to reduce the debt levels within Eastlink and would be yield and potentially value dilutive for Transurban shareholders.

Given GSJBW views a takeover as unlikely, the broker persists with its Sell rating, while Macquarie is at Neutral

and Austock rates the stock as a Buy. Overall the FNArena database shows five Buys, three Holds and only GSJB Were with a Sell rating. Austock is not included in this tally. The average price target on the stock is $0.476, down from $0.511 prior to the release of the June traffic numbers.

Shares in ConnectEast today are unchanged at 31.5c as at 12.40pm and have traded over the past year in a range of 25.5c to $1.10.

A More Favourable Risk-Reward Balance For Qantas

By Chris Shaw

First it was higher oil prices and then lower demand as the past 12 months or so have marked a tough time for Qantas ((QAN)), particularly as these themes have played out at a time when competition in the airline's marketplace has been intensifying.

Macquarie takes the view much of this is now priced into the stock and so the broker has upgraded to a Neutral rating from Underperform previously, arguing the group's outlook is actually showing some signs of improvement and the earnings impact of lower yields is now being appropriately recognised.

The broker takes the view the recent improvement in measures such as business sentiment and some consumer numbers is likely to create a gradual lift in demand for Qantas's services. This will flow through to improved earnings but only slowly in the broker's opinion given excess capacity remains on a number of the Flying Kangaroos' international routes.

The airline also recently announced the deferral of some aircraft orders and this plus an enhanced frequent flyer program has strengthened the group's balance sheet on the broker's analysis, while with free cash flow likely to return to positive levels in FY10 there is an increased chance of a dividend being paid, something the broker currently hasn't penciled in.

There is also scope for Qantas to lock in a greater portion of its FY10 oil requirements at lower prices given the oil price looks to be weakening. The broker sees this as another potential positive for earnings. To reflect these factors Macquarie has lifted its earnings per share (EPS) forecast for FY09 by 8.8% to 3.7c, with an increase to 4.7c forecast in FY10 and to 13.2c in FY11.

By way of comparison, the FNArena database shows consensus EPS forecasts of 6.8c this year and 13.6c in FY10, which suggests Macquarie may still be too conservative with its numbers. Bank of America Merrill Lynch is one of those more bullish as its EPS forecasts are currently 5.1c this year, 20.2c in FY10 and 23.4c in FY11.

The broker suggests the entry of Tiger Airlines into the Sydney-Melbourne market will actually have a minimal impact on earnings of about 2% as Tiger is chasing price sensitive passengers and not the schedule sensitive passengers on which Qantas makes higher yields.

As well the broker points out Qantas' budget airliner Jetstar is offering more flights at lower prices than Tiger anyway and even allowing for this Qantas group is still generating a solid yield advantage over the likes of Tiger. BA-ML sees nothing in the move to cause significant concern for Qantas.

Based on its earnings forecasts the broker has a $2.15 price target on Qantas, while the average target according to the FNArena database is $2.23. Given the stock is trading around 30c below that level there is enough value to justify a Buy rating on BA-Merrill Lynch's view, while the database shows a total of five Buys, four Holds and one Sell.

The latter comes from RBS Australia, which argues tickets pricing remains weak and is likely to remain so for some time, which would keep earnings under pressure. As well, recent updates to the broker's oil price and Australian dollar forecasts meant minor downward revisions to earnings forecasts, supporting its negative view.

Shares in Qantas today are slightly higher and as at 12.00pm the stock was up 3.5c at $1.885. This compares to a trading range over the past year of $1.38 to $3.75.

The Banking Wrap - Week Ending July 9

After a month of global stock markets trending sideways the greater than expected monthly US unemployment figure was enough to rekindle nervousness. Suddenly commodity prices looked rather overdone in their rally. Oil had risen 125% from US$32/bbl to US$72/bbl and was overdue a correction. The 14% fall in a week is not astounding, but it has reintroduced uncertainty nevertheless.

In the US, this has meant a stock market which has seen some rapid switching out of risk sectors such as energy, materials, industrials and consumer discretionary, and back into defensive sectors such as consumer staples, healthcare and utilities. The net impact on indices has not been significant, however, given such switching has not meant a wholesale divestment of stocks as an asset class, as was the case in late 2008, but rather a realignment of portfolios into a more cautionary stance.

In between lies the financial sector. Despite US banks having rallied 100% as a sector since early March, the impact on bank stocks in this week's correction of sorts has not been significant. After two years of turmoil, it seems banks are no longer the top of the risk trade ladder. And when it comes to Australian banks, there continues to be a growing belief that perhaps things are not going to be quite as bad as analysts had earlier resolved themselves to assume. This week the not-so-bad Australian jobs number and another mighty consumer confidence number have made the GFC seem all a bit like a storm in a tea cup.

The ASX 200 fell 3.3% this week (ended Thursday) while the Big Four banks lost only 0.4% on average. Within the group, National Bank ((NAB)) rose 2.7% while its peers all fell. Arguably deemed the most risky bank when analysis was at its most dire, NAB has suddenly become flavour of the month as quietly views have begun to change. NAB is trading at the greatest valuation discount within the Big Four given its UK exposures and collection of toxic assets left over from the original "subprime crisis".

NAB was thus afforded two broker upgrades this week. BA-Merrill Lynch analysts are still wondering exactly what NAB's toxic CDOs might really be worth, but now believe a 25% discount to their valuation is too much to warrant an Underperform rating. Merrills has taken NAB back to Neutral, and at the same time UBS has quietly moved its rating from Hold to Buy.

Fuelling the UBS analysts' newfound enthusiasm is the bank's appointment of one Peter Thodey as specific head of divesting the troublesome assets. UBS suggests NAB will separate the "bad bank" from the "good bank" and in so doing address a below-peer return on equity, leaving a slimmer model better leveraged to economic recovery.

This week research house Aspect Huntley decided to lift its rating on Westpac ((WBC)) from Hold to Accumulate. For the purposes of correlation FNArena groups Accumulate as Buy, although Aspect Huntley does have an ultimate Buy rating within its five tier system.

The offset to Merrill Lynch upgrading NAB to Neutral (Hold) on the basis of its discount under apparently "less bad" Australian economic conditions is to downgrade Commonwealth Bank ((CBA)) to Underperform (Sell). The analysts have not changed their fundamental view on CBA as a larger and less risky proposition (alongside Westpac) than the smaller NAB or ANZ Bank ((ANZ)), but they have joined the pack in suggesting the stock is now overvalued.

Thus we have four ratings changes this week, resulting in NAB moving into equal second place with Westpac on the FNArena table of net Buy/Hold/Sell recommendations among the major brokers. ANZ keeps first spot, but CBA, which continues to outperform and remains the only major still trading ahead of its average broker target price, has lost further ground to a 0/5/5 ratio. Ratings changes this week have taken the Big Four back to a net 7/10 Buy/Sell ratio from the 5/10 of the last couple of weeks.

As Australian economic data continue to provide "less bad" results, cementing a long-held view that Australia will fare much better through the GFC than other developed nations, bank analysts are becoming more convinced that the riskier and less valued pairing of the smaller NAB and ANZ are not as much of a risk after all. GSJB Were sees the stock market as having moved into a "consolidation phase", and a significant catalyst is now needed to move the index either up or down. Weres analysts favour the upside in the belief data will continue to positively surprise.

To that end, Weres has reassessed its model equity portfolio, deciding its longstanding Underweight on the banking sector is looking like a potential cause of underperformance. Weres has been a leader in a growing trend among analysts to "look through" not only likely poor FY09 earnings results, but through an uninspiring FY10 as well. As an FY11 price-to-earnings proposition, Weres, among others, believes value has begun to show.

Citi has this week addressed one potential party spoiler, being the likelihood of increased government regulation of the banking sector in the wake of the GFC and particularly in the wake of government deposit guarantees. Yet now that Australian bank capital levels "appear sufficient", Citi suggests that the loss of profit potential due to stricter rules will not have too significant an impact.

With the exception of a still wary RBS, the major Australian broking houses are quietly becoming a lot more favourable towards the big banks. Be warned - if RBS also turns there may be a major correction afoot.

FNArena also notes Credit Suisse upgraded Westpac shares to Neutral on Friday morning.

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

FNArena closely monitors views and recommendations by RBS Australia (formerly ABN Amro Australia), Aspect Huntley, Citi, Credit Suisse, Deutsche Bank, GSJB Were, JP Morgan, Macquarie, BA-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 available.

Korea Looks To Buy Gold

By Greg Peel

Last night on Wall Street the markets opened weaker, led down by falling commodity prices. Commodity prices are now considered to have run too far too fast and there is little surprise in a pullback. In a wider sense, commodities are a proxy for the general global economy, which has yet to confirm the faith global stock markets have placed in an impending recovery.

The fall in commodity prices and the stock market sparked a rush back into the US dollar. It is the feature of any return of risk aversion that funds flow back into the reserve currency. Commodities are sold for US dollars. Stocks are sold for US dollars. Emerging market investments placed by US funds are sold for US dollars. There are no two ways about it - the US dollar is simply the well-entrenched global reserve currency.

But it is also a reserve currency poised to lose its value as soon as risk appetite returns with a level of confidence. (See The US Dollar's Downward Path published yesterday.) With the cash rate in the US now at zero, the US dollar provides the perfect funding mechanism for investment into dollar alternatives - real commodities, gold, emerging market stocks, commodity currencies such as the Aussie dollar. The world agrees that when the global recovery comes, it will feature a very slow turnaround in developed economies as the deleveraging process continues, but a potentially rapid turnaround in emerging economies which have little deleveraging to achieve and significant upside in domestic economic growth. This dichotomy implies that global recovery will only result in endemic weakness for the reserve currency. Just as Japan has experienced over the past two decades, the US dollar has become a carry trade currency.

The expectation of ongoing potential weakness in the US dollar is further supported by America's US$4 trillion of national debt - a figure that grows monthly and will continue to do so until stability is confirmed in the US economy. This historically unprecedented and almost unfathomable total is the reason why emerging economies, many of which carry current account surpluses, feel they should not be hindered by massive reserve currency debt. Thus the move is on across the globe to quietly diversify foreign currency holdings out of the dollar. At present, some 70% of global foreign currency reserves are held in US dollars.

But the operative word here is "quietly". Given 70% of all foreign reserves are held in US dollars, any move to dump dollars will only be self-defeating. It is thus understood that the dollar will remain the reserve currency for some time yet. That hasn't stopped emerging economies persistently stating their desire for a more diversified reserve currency to take over one day. And such statements continue to make currency markets jumpy. There is a G8 meeting in Italy this week, which will also be attended by various non-G8 representatives. US investors have been worried that the BRICs and co will use the opportunity to again push for reserve currency diversification. But last night opinion swung the other way, and now support for the greenback is expected. In the latest round of to-ing and fro-ing from Chinese officials, the Chinese vice foreign minister stated in Rome:

"The US dollar is still the most important and major reserve currency of the day, and we believe that that situation will continue for many years to come. You may have heard comments, opinions from academic circles about the idea of establishing a super sovereign currency. This is all, I believe, now a discussion among academics. It is not the position of the Chinese government." (Reuters)

If only that were to be the last word. One presumes a vice foreign minister has diplomacy on his mind, whereas most of the dollar criticism stems from the finance department.

Such affirmation quells the fear of dollar traders, and further comments in Rome from the likes of European central bank president Jean-Claude Trichet that it is "extremely important" the US stay committed to a strong

dollar suggests a certain level of solidarity among the G8. (Incidentally, it is China that makes the previous G7 now a G8). But leave it to France in particular to undermine a committed stance. France's economy minister stated in Rome:

"We should explore a better coordination of foreign-exchange policies, which would raise the question over the medium term of the balance of exchange rates and the role of currencies that have changed both as a result of the crisis and the role played by emerging market countries." (Reuters)

Pass me the Freedom Fries. Yet France is only stating the bleeding obvious, and G8 meetings are famously all about handshakes, smiles and "united we stand" platitudes when in reality each nation then leaves to go and do whatever it damn well pleases.

And it pleases India - to date relatively silent among the BRICs in the reserve currency debate - to diversify its foreign currency surplus away from a heavy weighting in US dollars. India holds a high percentage of its reserves in dollars, and "this is a problem for us," said the chairman of India's Prime Minister's Economic Advisory Council over the weekend. It is now India's intention to alleviate that problem to some degree.

One way to do so is to buy newly issued IMF bonds as a substitute for US bonds. The IMF bonds - available only to sovereign authorities - are denominated in a basket of currencies and have already attracted buying from the likes of China, Russia and Brazil. But let's face it - the basket contains 40% US dollars anyway, as well as euro, yen and pounds. Legacy "Western" currencies are not exactly an encouraging investment solution in the current climate. But then, what is?

Enter gold. If ever there was a "commodity" which offers an alternative to all "currencies" then it is gold. But there are a couple of problems with gold. And those problems explain why, despite all this talk of reserve currency diversification, gold has managed to reach towards US$1000/oz in 2009 but has since stalled.

Firstly, unlike sovereign bonds, gold provides no income return. (It can to a small degree if "lent" but that is not important for this discussion.) Secondly, gold is also the global inflation hedge and the general panic safe haven - or the hedge against all paper financial instruments.

As an inflation hedge, gold will not distinguish between currencies but rather focus on the reserve currency. Emerging markets may be due for a rise in inflation as they look to build their domestic economies but the "West" is still very much in the grip of deflation. The world might be concerned about ultimate inflation stemming from all the quantitative easing going on around the globe at present, but until deflation is conquered such strategies are simply not a threat. Thus while the bulk of analysts still see gold hitting US$1200/oz some time in the future, it won't be tomorrow.

As a safe haven against general economic meltdown, gold has already served its purpose. It is agreed by most now that the world has successfully avoided such a meltdown, and as such those who leapt into gold in fear are now divesting of those holdings as they look to re-establish risk trades in stocks, commodities and so forth. Indeed, given we are currently between jewellery buying seasons, analysts also believe gold could drop below US$900/oz before it again tackles US$1000/oz at some later date.

This hasn't stopped emerging economies addressing the fact that they are pitifully underweight in gold among their surplus holdings. Most of the world's gold held by central banks is held by the US, the IMF, and the legacy nations of Europe. Everyone else is comparatively underweight gold, and that even includes the gold-producing nations of Australia, Canada and South Africa. China was also very underweight gold as a percentage of its surplus holdings, but China has also recently become the world's largest producer of gold. This fact wasn't lost on the Chinese authorities, who spent last year quietly amassing 454 tonnes of the stuff from their own domestic market without the rest of the world even noticing.

Now it's South Korea's turn to address its gold situation. Korea is one of those economies which is considered "developed" but still with a hint of "emerging". Like Japan, Korea punches above its weight on the economic front, and boasts the world's sixth largest holding of foreign exchange reserves. Yet as a holder of gold, Korea comes in a distant 56th. Korea has not bought any gold for eleven years, and China's recent purchases means it

now has 32 times more gold than its neighbour.

Korea is currently undertaking a review of its foreign reserve policy, looking ahead to 2010. A Bank of Korea official suggested last week:

"The bank has begun to set up a plan to manage foreign exchange reserves for next year. It has also closely watched central banks in other nations and trends in the global gold market. Given the changing global financial environment, the bank's management plan is critical." (East Asia Daily)

This was not an official statement of policy, and the BoK has officially remained coy about whether it will actually start buying gold or not. But with gold representing a mere 0.19% of Korea's reserves the gold market is happy to assume the strategic review will result in Korea going on a "gold buying spree".

This is good news for gold investors, but don't expect such purchases to be made in the open market in a frenzy. Korea will likely become a quiet accumulator of gold over time rather than the immediate catalyst for the next assault on US$1000/oz. Indeed, if the BoK needs a willing off-market seller it need look no further than the IMF, which has been given approval to sell a significant portion of its vast gold reserves in order to fund all the bail-outs of basket-case economies it has either already implemented or stands ready to implement soon. The IMF has an agenda to sell gold over a five year period within the Washington Agreement quota, so as not to upset world gold markets. Maybe Korea will prove a perfect recipient, leaving the open gold market with little net effect.

No Changes In U3O8 Prices

By Rudi Filapek-Vandyck

Last week was shorter than usual for the spot uranium market due to Fourth of July celebrations in the US. It can hardly be a surprise thus industry consultant TradeTech left its weekly spot price indicator at US$51/lb after making a last minute change just before the end of the month (as reported last week, see Spot U3O8 Shows A Bit More Weakness).

TradeTech's long term price indicator equally remained unchanged at US$65/lb.

This has again opened up a schism between the two leading price benchmark setters for the industry as Ux Consulting has elected to keep its own weekly price at US$52/lb, while retaining a long term price benchmark of US$65/lb.

Commodity Prices Vulnerable To Short Term Correction

By Chris Shaw

As the market enters the new quarter and in Australia the new financial year, expectations have been re-shaped, in particular among analysts covering the commodities markets as they update price expectations to account for a marking-to-market of commodity market conditions for the end of the June quarter.

As an example Macquarie has lifted its prices forecasts for copper by US6c per pound entering the FY09/10 period, at the same time increasing its estimates for aluminium by US1c per pound and nickel by US2c per pound. Despite the changes, the broker notes spot prices are currently tracking above its estimates, which would suggest a strong quarter.

But the broker is in fact cautious on the short-term outlook given the Chinese re-stocking and liquidity driven speculative buying of the commodities in the June quarter that saw prices rally sharply, has left prices looking vulnerable to a correction in coming months.

Supporting its view the broker estimates Chinese primary imports of many of the metals are likely to fall in coming weeks, while there is also significant idle capacity in the likes of the Chinese nickel and aluminium markets that can quickly add to global stockpiles of the metal and sate some of China's import demand.

National Australia Bank is cautiously optimistic in its outlook, expecting prices for the base metals will gradually track higher in the medium-term after what may be something of a correction in coming months as seasonal factors and a traditionally weaker demand period in China undo some of the gains of recent months.

UBS agrees, the broker taking the view a correction is now overdue in the short-term, especially on the back of the recent rally in prices in the base metals in particular. But any correction stands to be relatively short-lived as it notes leading economic indicators are starting to improve, which points to a recovery getting underway in the current half year.

To reflect this view the broker has lifted its price forecasts for the base metals significantly, copper increasing by 43% to US$2.50 per pound, nickel by 33% to US$7.00 per pound and zinc by 23% to US$0.80 per pound. The only metal to have its price forecast lowered was aluminium, which the broker cut by 6% to US$0.80 per pound.

Deutsche Bank is not as positive on the industrial metals outlook however, the group taking the view there is scope for a sharp slowdown in Chinese fixed asset investment growth and if this occurs the impact will be felt most heavily in the base metals sector and in the copper market in particular.

Also, the broker takes the view as the US economy begins to recover it will be aluminium that benefits at the expense of copper as the weak fundamentals are already priced into the former whereas there is more downside in the latter from any slowdown in Chinese buying.

Longer-term though the group suggests the fundamentals in the copper market are enough to make it the number one exposure as there is limited scope for any quick increase in output. It is forecasting a price of US$2.01 per pound in 2010 for copper, while its nickel price forecast of US$5.50 per pound is well below that of UBS given any sustained increase in prices from what it views as currently overpriced levels will require a re-stocking in the stainless steel market.

Deutsche Bank takes the view production cuts in the zinc market have worked well in offsetting what remains weak demand to leave just a modest market surplus but as demand recovers there is the issue of additional capacity that can be quickly brought to market. Concentrate supply constraints will help limit the market

surplus next year to only slightly higher than what is expected for this year and the broker is forecasting a 2010 price of US$0.65 per pound.

As with the other metals, the fate of the aluminum price is in the hands of the Chinese and here there are signs of oversupply given domestic capacity restarts. While the broker notes the exact level of domestic inventories are difficult to determine given much of the metal is held offmarket, it expects supply will outweigh consumption in 2010 and so it is forecasting a price next year of US$0.65 per pound.

Where there is a general level of optimism in price outlook is in the bulk commodities, Macquarie taking the view there is something of a free option on prices for iron ore and coking and thermal coal given the cash costs of Chinese producers will underwrite prices to some extent.

Again UBS is similarly positive on the bulks and coal in particular given in relative terms there is increased attraction thanks to the broker's expectation of weaker base metal prices in the coming quarter, while it has also made some modest increases to its price forecasts.

Deutsche suggests the pricing outlook for iron ore remains squarely in China's court while the volume and shipments outlook appears relatively stable. Given expectations Chinese domestic capacity will re-emerge in coming months and with spot prices not far off contract prices, the broker sees a fairly conservative trading range of between US$55-$65 per tonne in the near-term and rolling over of prices next year when contracts are again negotiated.

With respect to coal there has been a recent uptick in demand that is something of a surprise in the broker's view, but with some question marks over the sustainability of this demand and with contracts already settled a few months ago it isn't expecting anything too significant in terms of price changes in coming months and a roll-over in contract prices next year.

In the gold market Deutsche Bank suggest short-term price weakness could present an opportunity as the macro-economic environment remains broadly supportive as real interest rates in the US are negative and global equity markets are still somewhat skittish.

Upside seems a longer-term propostion however as the broker expects prices to ease to around US$825 per ounce in 2011, so the stocks to look at for exposure are those offering rising production profiles. In contrast UBS expects prices may rise in the coming year and is forecasting a gold price of US$1050 per ounce in 2010 before an easing to US$975 per ounce in 2011.

National Australia Bank tends to side with the UBS view as it suggests the beginning of a recovery in the global economy should prove supportive to the gold price in the latter stages of this year and into 2010 as it should spark solid demand from both China and India. Also, it suggests the current lack of any clear policies for the removal of quantitative easing measures is likely to offer support to prices given it creates some risk of inflation picking up. The bank expects the gold price will finish 2010 at US$1,071 per ounce, rising to US$1,123 per ounce by the end of 2011.

In terms of how investors should best play the commodities markets UBS argues overall exposure is best achieved via Rio Tinto ((RIO)) compared to BHP Billiton ((BHP)) as at current levels the former offers better value. Elsewhere the group likes the coal plays and has Macarthur ((MCC), Centennial ((CEY)), Gloucester ((GCL)) and Whitehaven ((WHC)) as Buys, the former being upgraded from a Neutral rating. Alumina ((AWC)) and Murchison Metals ((MMX)) are the broker's other Buys, while Fortescue ((FMG)) has been downgraded to a Sell from Neutral following the latest review of the sector.

While Deutsche Bank agrees on Rio Tinto and rates the stock as one of its top picks, it differs with its other choices, which include PanAust ((PNA)), Independence Group ((IGO)), Mirabela ((MBN)) and St Barbara ((SBM)) as top picks given attributes such as low costs of production. PanAust, Independence and St Barbara have all been upgraded to Buy ratings following the broker's latest review.

At the other end of the scale the broker rates Equinox ((EQN)), Macarthur, Mincor ((MCR)) and Minara ((MRE))

as Sells, the rest of the stocks in its resource universe scoring Hold ratings. Of those, Centennial and Energy Resources of Australia ((ERA)) have been upgraded from Sells, reflecting the latest changes to forecasts.

Weaker Baltic Dry Index Suggests Weaker Commodities Demand

By Chris Shaw

The Baltic Dry Index (BDI) is seen as a good measure of global commodities demand as it indicates how much cargo is being shipped around the world, so the almost 400% rally in the index over the first half of 2009 suggests the worst of the global recession is now behind us.

Analysts at Barclays Capital highlight in a research report this morning the rally in the index was driven by Capesize vessels, noting this portion of the index had gained 450% by the end of the second quarter on the back of stronger Chinese buying of iron ore in particular. The result was increased congestion at China's ports, which flowed through to greater waiting times elsewhere, with Australia's coal ports a good example as average waiting times rose to more than 12 days for the first time in more than a year.

The analysts question whether the rally in the index in recent months can be sustained, especially given the northern summer is traditionally a period of weaker demand for commodities.

Barclays notes there is already evidence of some slowdown as in recent weeks there have been reports of cancelled iron ore tonnage in China. Now Chinese buying of coal and iron ore appears to be slowing down.

Supporting its view, the group notes in the first week of the current quarter Capesize rates have fallen by a little more than 16% and the BDI overall has eased by around 10%. This weakness in Capesize rates may quickly spread to other sectors of the index in the analysts' view as there is evidence port congestion levels are falling off their highs of a few weeks ago.

One thing the recent moves in the BDI does make clear in the group's view is the outlook for freight demand is squarely tied to China's appetite for buying commodities, and in particular its demand for steel. In that sense nothing has changed, as commodity prices are primarily being driven by Chinese demand and this is likely to continue to be the case for some time.

Is Gold Or Silver The Better Precious Metals Exposure?

By Chris Shaw

In the view of GSJB Were, the current correction in commodity prices is just that and so investors are being given another opportunity to add to their holdings in the sector.

The broker suggests the re-stocking process in China appears to have run its course for the time being and with the northern summer underway, metal prices should be in for a quiet run for a couple of months until the summer holiday period is over.

But any further downside in metal prices during such a hiatus should be modest in the broker's view and so it suggests using the current weakness to lift exposure on the expectation of relative outperformance over the next 12 months or so.

The broker prefers copper among the base metals but also suggests maintaining an exposure to gold, a suggestion that supports a common argument among analysts that the level of financial stimulus applied around the world in recent months as the world dealt with the global financial crisis could develop into inflationary pressures going forward, which would in turn be supportive of gold prices.

UBS also likes gold, preferring it to base metal exposure at present as it now sees scope for US dollar weakness to continue through 2010 and beyond, which in turn implies higher gold prices. Previously the broker had expected gold would peak some time this year.

To reflect its more positive view the broker has lifted its gold price forecasts in coming years and now expects the metal will average US$1,050 per ounce in 2010, up from its revised estimate of US$950 per ounce this year. Its long-term price estimate has also increased to US$825 per ounce from US$650 previously, reflecting both its revised outlook for the US dollar and profitability issues for the industry at its previous long-term forecast level.

Citi however expects silver will continue its recent trend of outperforming gold in relative terms and so favours the junior metal from an investment perspective as it expects gold will range trade between US$850-$1,000 per ounce over the next 18 months given investment demand appears to be moderating.

In the broker's view the reason for the weaker demand is essentially a shift in investor perception away from a fear of systematic risk back to the more traditional drivers of the potential for a weaker US dollar and concerns over inflation globally given the amount of stimulus injected into a number of economies.

There is evidence to support the broker's view that demand for gold has weakened as it notes in the first quarter of this year while gold mine supply was steady, scrap supply rose 55%, while over the same period jewellery and fabrication demand fell by 24% in year-on-year terms and industrial and dental demand was down 31% on a similar basis.

This weaker demand has allowed the silver price to outperform in relative terms so far this year, a trend the broker expects will continue given there are some early signs of improvement in leading economic indicators. As silver demand has a strong correlation with the state of the global economy this trend is expected to be followed by stronger buying for the metal.

Given such an outlook the broker sees the gold/silver ratio returning to its longer-term average of 55-60 as economic conditions return to more normal levels compared to the current ratio of about 69. Such an outcome would mean the relative outperformance of silver against gold would continue.

The broker has lifted its price forecasts for both metals in coming periods and now expects year end prices of US$900 per ounce for gold and US$13.50 per ounce for silver, up from US$850 and US$12.50 respectively. By the end of June 2010 it expects gold to be at US$1,000 per ounce and silver at US$16 per ounce, up from US$14.70 previously, while its end of 2010 forecasts of US$850 per ounce and US$12.50 per ounce respectively are both unchanged.

With little way to gain direct exposure to silver on the Australian market the broker recommendations related to these views tend to focus on the gold stocks and here UBS prefers Lihir ((LGL)) over Newcrest ((NCM)) and has upgraded Dominion Mining ((DOM)) to a Buy recommendation.

GSJB Were has Buy recommendations on a number of gold stocks including Lihir and Newcrest while it also likes Dominion, Sino Gold ((SGX)) and Avoca Resources ((AVO)).

Playing The Copper Price Impact On Forex Markets

By Chris Shaw

Standard Chartered expects the recent strong upswing in copper prices to stall in the coming six months as the price premium on the Shanghai market looks to be falling on the back of weaker Chinese orders given weaker seasonal demand and as the supply side of the market shows signs of improvement.

But any downturn is not expected to continue too far into the future as the group sees the upward trend in prices resuming in 2010 and remaining above historical average prices for an extended period as the supply side struggles to keep pace with increasing demand, so keeping inventories low.

While such a view has implications for the copper price, and Standard Chartered is forecasting an average price of US$4,750 per tonne in the September quarter, US$4,250 per tonne in the three months to the end of December and US$4,688 per tonne for 2010, it also has implications for the currencies of the major copper producers.

Chile is far and away the world's top copper producer as it accounts for around one-third of global supply, while Peru produces about 8.1% of global output, the US around 8.5%, China at 6.0%, Russia at 5.0% and Australia at 5.7%. The importance of copper to many economies can also be seen by looking at what proportion of a nation's GDP its copper output accounts for, and here again Chile is near the top of the list as almost one quarter of its GDP comes from copper mining, well above the one-twelth of GDP for Peru.

Standard Chartered has extended the analysis to include the correlation between the local foreign exchange unit and the US dollar and the copper price to determine those currencies that stand to benefit from higher copper prices, its research showing the Chilean peso is the number one candidate as it has not only a relatively significant correlation but also a relatively stable one. Following are the Zambian kwacha and the Peruvian sol, with all three currencies a chance of appreciating in 2010 if the group's view on copper prices comes to pass.

For the peso, the group estimates it could appreciate against the US dollar by as much as 4.5% over the next year, which relative to the one-year forward rate implies outperformance of as much as 14%. The kwacha and sol are also tipped for gains of 6% and 8.5% respectively compared to their one-year forward rates.

TD Securities Recommends Shorting The Aussie Dollar

By Chris Shaw

According to TD Securities, the Australian dollar is overvalued against its US counterpart at current levels and so there are both fundamental and tactical reasons to go short the Aussie at levels around US79c.

Fundamentally the group suggests in relation to commodity prices the Aussie dollar is simply too high as since early June the CRB index has gone through an 11% correction, which if translated literally to the currency would imply a dollar rate of below US75c.

Also, the group argues interest rate differentials and long-term trends support its view the Australian dollar is overvalued at present, especially as the dollar is presently about US10c above its long-term average of just over US70c.

Tactically there are also reasons to go short, as TD Securities points out while the market is incorporating some expectations of an increase in interest rates by the Reserve Bank of Australia (RBA) sometime soon, given solid consumer sentiment and retail sales data recently, the house view is a weak corporate sector will flow through to investment and the labour market and so inflation will not be a threat for some time.

This implies the next move by the RBA will be a further lowering of rates rather than a rate hike and as this outcome is priced into the market there is the risk of currency weakness.

Given the group's view, it has gone short the Aussie dollar against the US dollar at US79.6c, with a target of US76c and a stop loss at US82c.

Inflation Undershooting RBA Targets In Australia

By Rudi Filapek-Vandyck

The TD Securities-Melbourne Institute Monthly Inflation Gauge rose by 0.4% in June, following a 0.3% decline in May and no change in April. In the twelve months to June, the Inflation Gauge has now risen by 1.4%. This marks a fresh record low for the series as well as the second consecutive month that annual inflation has printed below the bottom of the RBA target band.

The economists remind investors the annual increase in the Inflation Gauge in June 2008 was 4.8%.

Contributing most to the overall change in the Inflation Gauge in June were price rises for private motoring, insurance services, and fruit and vegetables. These price rises were offset by falls for books, newspapers, and magazines, alcoholic drinks, and meat and seafood. The price of fuel rose by around 5% in June, although it remains 20% below its level of a year ago. The price of dwelling rent was unchanged in June, after three consecutive monthly falls.

The trimmed mean of the Inflation Gauge rose by 0.1% in June, following a fall of 0.2% in May. In annualised terms, the trimmed mean rose by 0.2% over the three months to June, following a 2.2% decline for the three months to May. In the twelve months to June, the trimmed mean rose by 2.0%.

Excluding volatile items (automotive fuel, fruit and vegetables), the core inflation measure increased by 0.2% in June and was 2.5% above the level of a year ago.

Annette Beacher, Senior Strategist at TD Securities, believes the current persistent disinflationary trend in Australia must be a concern to the Reserve Bank with Beacher predicting inflation in Australia is likely to continue undershooting the RBA's inflation target at least until mid-2008. Beacher says the RBA has a symmetric view of the inflation target, implying the Reserve Bank would regard an under-shoot of inflation as big a problem as an overshoot.

Co-creator of the gauge, professor Don Harding, is quoted in the official release as saying that, â€œOn the basis of the June Inflation Gauge we see no reason to modify the forecast made last month in which the ABS June quarter CPI is expected to essentially remain unchanged rising by just 0.09 of one per cent, yielding an annual rate of inflation of 1.06 per cent.â€

"The RBA will be well satisfied with these numbers, there is enough evidence of core inflation to suggest that fears of deflation were overdone for Australia at least but there is insufficient evidence of emergent inflation to warrant consideration of tightening - yetâ€.

Oz Internet Job Ads Disappoint In June

By Rudi Filapek-Vandyck

ANZ economists report the ANZ Job Advertisements Series showed the total number of jobs advertised in major metropolitan newspapers and on the internet fell by 6.7% in June to a weekly average of 127,346 per week. This follows a 0.2% fall in May. The total number of advertisements in June was 51.4% lower than 12 months earlier. In trend terms, the total number of job advertisements fell by 4.5% in June to be 52.1% lower than 12 months earlier.

The survey has also shown the number of job advertisements in major metropolitan newspapers increased by 0.9% in June to an average of 8,192 per week. This follows a 1.0% drop in May. Newspaper advertisements are now 50.7% lower than in June 2008. In trend terms, the number of newspaper job advertisements fell by 2.0% in June to be 53.9% lower than a year ago.

ANZ reports the rise in newspaper job advertisements in June was driven by increases in Victoria (7.0%), Western Australia (3.6%), Northern Territory (2.2%), Queensland (1.2%) and the ACT (0.3%). In contrast, Tasmania (-12.2%), South Australia (-4.9%) and New South Wales (-1.2%) experienced falls in newspaper job advertisements in June.

The number of internet job advertisements fell by 7.2% in June to average 119,154 per week. They were 51.5% lower than 12 months earlier. In trend terms, internet job advertisements fell by 4.6% in June to be 52.0% lower than in June 2008.

ANZ Head of Australian Economics Warren Hogan, labels the June survey "a disappointing result" following signs of stabilisation in recent months. He points out all of the weakness was due to a large fall in internet ads, which fell 7.2% in the month. Internet job advertising is now down 51.5% over the past year, a new low point in the current cycle and the weakest annual reading since the series began in 1998, he highlights.

Newspaper job ads posted a minor recovery but even so, says Hogan, newspaper advertising is still half the level of a year ago.

Hogan also points out that just about all of the increase in the unemployment rate in Australia has thus far been driven by labour force growth -due to both high participation and rising natural growth- and not because of job cuts. As such, the level of total employment in Australia, recorded as 10.79m people in May 2009, remains close to the peak seen in October last year of 10.82m.

ANZ expects employment to fall by 32,000 in June and the unemployment rate to rise to 5.9% when the ABS releases the Labour Force report on Thursday. Just about all leading indicators of employment, including business surveys and the ANZ Job Ads series point to declining employment levels over the second half of the year, the bank points out.

Steady As She Goes For The RBA

By Greg Peel

The Reserve Bank today left its cash rate on hold at 3% for the third month running. It was April when the board made its most recent cut from 3.25%.

One is in need of a magnifying glass to attempt to spot the difference between this month's accompanying statement from RBA chairman Glenn Stevens and last month's. Once again Stevens acknowledges the global economy appears to be stabilising, and China is leading the turnaround. A turnaround in developed economies will be slow, Stevens reiterates, and this month special mention was made of a still struggling Europe.

Last month Stevens noted "The Australian economy has been contracting". This month this particular statement was replaced with "Economic conditions in Australia have to date not been as weak as expected a few months ago". But once again Stevens goes on to point out capacity utilisation is back at average levels and labour cost pressures continue to diminish. Housing finance demand remains buoyant but business credit demand continues to decline. Once again, weak inflation conditions give scope for further easing if necessary.

Credit conditions remain tight, Stevens notes, but this month he made special mention of the ease with which corporations are raising secondary capital in order to repair balance sheets.

Finally, Stevens yet again pointed out that monetary policy has been eased "significantly" in recent times and such policy changes still need sufficient time to do their job: "Much of the effect is yet to be observed".

An easing bias nevertheless remains in place and, as usual, the RBA is closely monitoring the situation. Low inflation leaves room for further cuts, but not this month.

The bulk of economists still believe the RBA will cut again before the year, possibly to 2.5%. A small group, however, believe the next move is up as the Australian economy will recover faster than expected. The RBA will await further data, such as this week's monthly jobs figures, before deciding to take any further drastic measures.

Read the statement here.

Oz Consumers Surprise Friend And Foe

By Rudi Filapek-Vandyck

The Westpac Melbourne Institute Consumer Sentiment Index increased by 9.3% in July from 100.1 in June to 109.4 in July.

Westpac economists, in reaction to the July outcome, talk about "unquestionably a stunning result". Last month had already generated the second largest increase in the Index since Westpac and the Melbourne Institute started measuring the Index in 1974.

The Index has now printed an increase of 23.2% over the last two months. The economists point out this the largest two month increase in the Index since the survey began in 1975. Tt is also the largest increase by a substantial margin, as the second largest two month increase was 18.8% in March 1992 when households were finally convinced that the Australian economy was coming out of recession.

The Index has now reached the highest level since December 2007 - 38.5% above its level a year ago and at 109.4 optimists decisively out-number pessimists for the first time since December 2007.

In trying to explain July's "stunning result", Westpac economists suggest it appears the first tranche of the Australian government payout may have been too narrowly based. Maybe those receiving the payments were initially cautious given the avalanche of disturbing information associated with the global financial crisis, the economists ask. They add no such criticism can be levelled at the second tranche. It has now been almost fully disbursed and has resulted in an instant boost to retail sales and supported an apparent surge in confidence.

Maybe the unexpected resilience of the employment figures has also played a role? The economists also note that over the last two months the unemployment rate has remained steady. As of June, the Westpac-Melbourne Institute measure of job security has improved by 12% since its low in February, although it is still 20% lower than a year ago, say the economists.

No US Rate Hike Imminent

By Chris Shaw

Over the past few weeks the US market has begun to price in the possibility of the US Federal Reserve lifting interest rates some time in the next few months, but in the view of TD Securities global strategist Stephen Koukoulas such an assumption is incorrect as the Fed remains a long way from increasing rates.

According to Koukoulas there are a number of indicators supporting his view rates will remain low for some time including the employment ratio, which is the percentage of the population actually employed, as it suggests interest rates should be even lower to account for the rate of job destruction the US economy has experienced as part of the global downturn.

This indicator has to turn before there is any threat of an increase in interest rates in Koukoulas's view, while he also suggests the fact capacity utilisation is presently at an all-time low means inflation is currently no threat as a low capacity utilisation figure always coincides with a low inflation figure.

The fact nominal GDP is also declining at the moment suggests little upward pressure on prices, while Koukoulas notes the CPI (consumer price index) itself is also low, having fallen significantly over the past 12 months.

All this leads Koukoulas to argue the next (and first in a new cycle) rate hike from the US Federal Reserve is so far into the future it is not worth worrying about at present.

Worst Past But Recovery To Be Slow and Fragile

By Chris Shaw

ANZ Banking Group chief economist Saul Eslake is of the view the worst of the global financial crisis has now passed as quarter-on-quarter growth is likely to turn positive in the second half of this year, but he remains far from optimistic in the sense he expects any recovery to be slow and fragile.

One positive is he doesn't expect the stimulatory fiscal policies put in place by governments around the world to provide much of a boost to inflation, so while suitable exit strategies from these policies will be needed they won't be required anytime soon, in Eslake's view.

Over the past year Eslake notes the sequence of the downturn was the large scale destruction of household wealth from falling equity and property prices led to a dramatic decline in household spending, which created a spike in inventories that was difficult to work through given the freezing of credit markets. This caused production of "big ticket" items in particular to fall.

Lower production and demand for such goods meant global trade fell heavily and this has had the effect of dragging exporting nations such as Germany and Japan into the downturn after they escaped much of the initial impact, the result being the recession has been felt harder in these countries than those such as the US and UK where the crisis first reared its head.

The good news in Eslake's view is this cycle appears to have largely run its course, especially in Asia where industrial production levels are recovering, but this is countered by the not so good news of a lack of any sign of a self-sustained strengthening in demand, especially from the household sector.

The implication here is the current expansionary economic policies in place around the world are likely to remain in play for some time yet, a fact Eslake suggests the various governments appear to understand far better than do market participants pricing in expectations of rate hikes or other restrictive measures.

As an example of this Eslake points out in December last year the US 10-year bond yield had dropped to 2.0%, which meant investors were implicitly pricing in some deflation over the next decade. The US Federal Reserve subsequently introduced quanititative easing measures that have since seen bond yields increase by enough to factor in inflation of 2.0%, which is exactly in line with the Fed's target and so shows their quantitative easing policy is working.

This is especially the case as the current policies aren't likely to create a situation of sharply rising inflation given the excess capacity in the US economy.

Looking at the Australian outlook, the bank's economist Riki Polygenis notes the Aussie economy so far has been the only advanced economy to avoid two quarters of negative growth as aggressive and pre-emptive policies have helped insulate various sectors of the economy from the worst of the downturn, while the nation's exposure to Chinese demand for raw materials in particular has also provided significant support.

Polygenis expects GDP growth will be basically flat in 2009 and limited in 2010 at around 0.5% thanks to lows levels of business investment, before returning to a trend rate of growth of 3.25% in 2011. The key remains the health of the labour market as this provides the main link between the spending and re-leveraging of households and the ongoing consolidation process of many businesses.

The news so far has been solid, Polygenis noting while employment has come to a halt it has not started to weaken appreciably as has been the case in previous downturns. Forward indicators suggest the labour market

has further to weaken in coming months and so this remains a concern, but on Polygenis's numbers any falls are unlikely to be as severe as in the last two recessions.

With respect to New Zealand, the bank takes the view the economy is rebalancing away from its domestic centred model of the past 20 or so years to one where greater importance is placed on exports, savings and earnings. Such a process will take time in the bank's view and so is likely to last for the next several years, though a short-lived upturn is expected in 2010/11 as the combination of policy stimulus, pent-up demand the pending rugby World Cup impact.

Similarly any recovery in Asia is not expected to be swift, while the bank also points out it also won't be uniform across the region given different levels of effectiveness of policy stimulus measures and export dependency. In other words, China excepted, a recovery in Asia will need to come from a combination of existing momentum, fiscal stimulus measures and foreign demand, which means stronger buying from US and European consumers in particular.

In timing terms the bank expects a gradual recovery to get under way later this year, building through 2010 and a return to trend rates of growth in 2011. Risk remains to the downside, meaning any recovery to such trend rates could take longer than the bank is presently forecasting.

Such an environment would be positive for the Asia ex-Japan currencies and the bank sees some upside here given such currencies are beneficiaries of investors taking on additional risk, though it advises caution given expectations of continued volatility as the recovery gradually takes hold.

For the Australian dollar specifically, the bank notes relative yields are offering support at present, as are relatively high commodity prices. Given the Aussie currency's traditional role in terms of leading the global economic cycle given its bias to commodity prices, the bank takes the view at around US80c at present it is not too far from fair value levels.

Longer-term the trend looks supportive as there appears to be something of a structural shift occuring as stronger commodity prices imply an improvement in Australia's terms of trade and such an outcome would support higher equilibrium prices for the Aussie dollar, especially if once the financial crisis has played out the US currency returns to its declining trend.

Short-term risks include further bouts of risk aversion and a correction from the rally in recent months, one that could be aided by any further cuts to interest rates by the Reserve Bank of Australia. The bank doesn't see this as preventing further rises in the Aussie dollar though as they forecast a rate potentially as high as US90c by year's end.

Triumph Of The Realists

7th July 2009

"Genius is only a greater aptitude for patience." - George-Louis Leclerc de Buffon.

If it was Wednesday, then it had to be The Dorchester, where Citywire held their latest wealth management forum. Keynote speaker was Elroy Dimson, Professor of Investment Management and a Faculty Governor at the London Business School. Students of the markets will also know Dimson as a co-author of the magisterially weighty "Triumph of the Optimists: 101 years of global investment returns" (Princeton University Press, 2002) alongside LBS colleagues Paul Marsh and Mike Staunton. You can read the 2009 updated commentary here.

The 21st Century has not, so far, been kind to equity market investors. Real returns across the major markets over various long terms can be seen below:

We "know" that over the long run, equity markets reward the patient investor. An investor in US stocks would have enjoyed average annual real returns of 6% over the course of the 20th Century.

But an investor in almost every major market since 2000 is currently staring unbelievingly at an alarming succession of losses. The worst bear market in history stands as the Wall Street Crash of 1929-1931, where the world index fell by 54% in real, US dollar terms. Even more extraordinarily, we are still within a whisker of that loss. As Messrs DMS point out,

"The peak to trough real return during the current banking / credit crash stands at -53%. If the current remission falters and we hit new lows, it could yet become the worst bear market on record. In its short nine-year life, the 21st Century already has the dubious honour of hosting two of the four worst bear markets in history."

We can debate the identities of the guilty parties (bankers ? real estate salespeople ? regulators ? lobbyists ? ourselves ?) indefinitely. What we cannot, or should not, do indefinitely is try to avoid some of the more telling conclusions.

Spoilt by the "golden age" of the 1980s and 1990s, the modern investor is still overly obsessed by the allure of common stocks. This is a theme we have reiterated at each of our last two summer investment seminars, as shown in the chart below:

The chart is explicit and compelling. Arranged by two-decade periods since the start of the 18th Century, the history of the UK stock market looks more or less like the proverbial bell curve of economic theory (and myth, as regards the fat tail volatility of real investment world returns). After inflation, the 20 year returns from the stock market cluster either side of zero. There are, worse still, numerous 20 year periods when stocks delivered negative real returns. But every cloud.. Standing stark and alone at the right side of the chart is our old friend 1980-1999, the one huge outlier period when the market delivered 20 years of annualised real returns of between +8% and +10%. Such performance may happen again, but it has certainly never happened before.

Investors extrapolating from the recent past as they entered the new millennium were, let's be honest, pre-destined for a world of disappointment.

Independent but related to this conclusion is the next common-sense investment strategy: don't keep all your eggs within any one asset class basket. That holds whether the basket in question holds property, stocks, bonds or anything else. Outside the context of a full-blown deflationary depression, Messrs DMS also point to the

paucity of returns that come from sheltering in either Treasury Bills or cash:

The chart is instructive. Over the admittedly long run, bonds lag behind stocks in each country. Treasury Bills lag behind both, and in a number of incidences were wealth-destructive over a very long period. (Don't entrust your assets to the government, Mrs Worthington.)

The figures cited by Messrs DMS above all relate to indices. But as is widely known, active fund management comes with its own risks. As Yale Endowment CIO David Swensen has written,

"Most mutual funds do not produce even minimally acceptable results because of the conflict between the mutual fund company's profit motive and the mutual fund manager's fiduciary responsibility. Mutual fund companies profit by gathering assets, charging high fees and churning portfolios. Mutual fund managers produce superior investment returns by limiting assets, assessing low fees and trading infrequently. In case after case, profits trump returns. The mutual fund manager abrogates fiduciary responsibility for personal gain."

All of which does not necessarily invalidate the managed fund proposition, rather it requires discernment and a degree of due diligence to discriminate between those fund management groups with the potential to add value to a balanced portfolio and those charging egregiously for performance (either historical or prospectively with a high likelihood to be) inferior to an index. It may, furthermore, not be rational to pursue the index if active management offers the potential to moderate losses - easy to say, admittedly, in the aftermath of the last decade's lamentable performance by common stocks. But if nothing else it absolutely reinforces the requirement for fund managers to be competitive in pricing their products - which tend to be aggressively promoted rather than necessarily actively sought.

But there are pockets of light amid the gloom. The choice for the open-minded investor is wider than it has ever been, and now includes products such as low cost exchange-traded funds which offer cheap investible access to index returns. And the UK regulator, via the Retail Distribution Review, has just sounded the death knell for commission-heavy products. Within the not too distant future, fund managers will have to justify their existence through performance rather than bribes to distributors. Perhaps most important of all, however, is following a path that is likely less well travelled: ignore the indices but embrace asset class diversification and build your portfolios from the bottom up, following the principles of deep value in pursuit of capital preservation and absolute returns. One obvious response to the DMS data is to assume that since the post-2000 period has been such a bust for traditional investments (specifically, equities), the outlook now is bright. It is still impossible to say, but that looks like a premature if not dangerous conclusion to draw. To paraphrase Keynes, markets can stay bearish longer than you can stay patient.

Realism wins.

Tim Price Director of Investment PFP Wealth Management 7th July 2009. Email: tim.price@pfpg.co.uk Weblog: http://thepriceofeverything.typepad.com Bloomberg homepage: PFPG <GO> Important Note: PFP has made this document available for your general information. You are encouraged to seek advice before acting on the information, either from your usual adviser or ourselves. We have taken all reasonable steps to ensure the content is correct at the time of publication, but may have condensed the source material. Any views expressed or interpretations given are those of the author. Please note that PFP is not responsible for the contents or reliability of any websites or blogs and linking to them should not be considered as an endorsement of any kind. We have no control over the availability of linked pages. Copyright PFP Group - no part of this document may be reproduced without the express permission of PFP. PFP Wealth Management is authorised and regulated by the Financial Services Authority, registered number 473710. FP 1045/09/JD

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Rudi On Thursday

(This story was originally published on Wednesday, 8 July. It has now been re-published to make it available to non-paying members at FNArena and readers elsewhere).

There are easier things in life than trying to look two years ahead for the share market, in an attempt to determine which companies have the best growth prospects, and then relate this information back to calculate what the intrinsic valuation is behind today's share prices.

Usually I would not recommend anyone to look much further than 18 months into the future - and that would be the absolute maximum. History shows both investors and analysts have a lousy track record when it comes to anticipating what lies beyond the next six months. It's all made easy when markets are in the midst of a strong and clearly established trend, which allows for continuous extrapolation, but the overall picture blurs quickly under all other scenarios.

Let's be honest: we humans are very bad in determining whether a trend will change, and when.

But rules are meant to be broken -at well-chosen moments in time- and as far as I am concerned this is probably one of such times. Because we are still only in the very early stages of what ultimately will be labeled "the economic recovery", the short term outlook for corporate profits and for equity markets is much more uncertain than the medium term outlook.

Over the weeks past I have argued corporate profits in FY09 and FY10 are likely to mark the bottom in this global economic downturn, so to establish true value one would have to look past these years into FY11. The problem with this is that FY11 is still such a long way ahead, and the further we move beyond the next six months, the less reliable anything becomes in terms of forecasts.

While all this is true, we should never treat analyst forecasts as an absolute given. Instead, we should look upon them as simply one extra tool we have at hand to do our research, to build an opinion and to mould our view, and to assist when making investment decisions.

It is okay for some investors to chase the day-to-day, or the week-to-week share market momentum, but this certainly does not suit everyone. And as all types of investors have found out over the past 18 months: when there's no longer a strong medium term uptrend carrying the markets, the price at which you purchase your stocks of choice does matter; and it can matter BIG time.

I believe the prospects for share market returns over the medium term (let's call it the next 12-18 months) are positive. I have noticed an increasing number of highly regarded experts is expressing a similar view. Some won't stretch their view beyond the next twelve months, others talk about two years-ish. Market strategists at BCA Research talk about a positive undercurrent on a five-year horizon in their latest market update.

Most of these experts agree defining any concrete forecasts for the short term is a mug's game. The rally since March was predominantly headline driven, why would the subsequent correction be any different?

As long as prospects for FY11 remain positive, share markets will not succumb to new lows. It's always good to keep this in mind. This is why, for instance, the above mentioned BCA strategists won't totally exclude the fact that equity markets may well revisit the lows carved out in March at some point in the months ahead. They remain adamant though, if markets do it'll be a platform for the next rally.

So how does a longer term investor look through the short term hubris?

Priority number one, one assumes, is trying to determine which companies look good on a see-through-the-trough basis, immediately followed by priority number two: to reduce the chances one is about to overpay for what looks like a good company to own.

Because I believe we are likely in the middle of a 1962-1981 type of share market environment -with similar index levels at the beginning and at the end of the period- investors should pay attention to sustainable dividends. Dividends are no longer a luxury, but should be considered a necessity for anyone with a longer term view in this type of market.

These are the three core elements I have taken into account during my research in the weeks past: projected growth, Price-Earnings ratios and dividend yields. And instead of trying to determine what levels should be considered "just" or "desirable" for each of the three components, a decision was made to compare everything on a relative basis: from stock to stock to stock.

The research completely ignored FY09 and focused on FY10 and FY11 instead, ASX200 only.

Outcome number one is a firm confirmation of what we all should know already: investors don't like companies facing troubles, not with debt, not with assets or regulators, certainly not with asset valuations, not with anything really. So any company dealing with any such problems is readily abandoned. That's why any research that tries to determine where the most value is located in today's market by default ends up with names such as DUET (DUE)), Transpacific ((TPI)) and Babcock and Brown Infrastructure ((BBI)). On pure valuation metrics, these stocks look like once-in-a-lifetime bargains, but there is a reason why they are trading well below intrinsic valuations and stockbroker price targets: it's called risk.

Some companies look boring, they should pay a relatively high dividend, but there are still risks and their valuation is an almost perfect reflection of this: modest, if not sober. A company such as Goodman Fielder ((GFF)) trades on an implied dividend yield of 8%-something, and its projected annual growth and PE ratios are similar. Boring thus, but when it comes to relative value Goodman Fielder shares seem to present a relatively good opportunity. The same goes for Corporate Express ((CXP)) and for media stocks APN News and Media ((APN)) and PMP ((PMP)); even though one could easily argue the latter should be considered in the high risk category.

Non-surprisingly, ACCC-threathened Cabcharge ((CAB)) equally ranks high on the relative value ladder of today's share market, as does agri-tax scandal-impacted Bendigo and Adelaide Bank ((BEN)).

So far, the research hasn't generated any surprises. Beaten down and/or abandoned stocks always offer the most upside potential because investors push down share prices too far, just like they push share prices too far up when they get excited. That's why investors who can stomach the higher risks are attracted to these stocks. As such, one could say, my research has simply generated the statistical evidence behind the concept.

But scroll down the list and gradually the risk factor seemingly becomes less of an issue.

Immediately after Cabcharge we find Telstra ((TLS)). Sure, Australia's most loved-to-hate blue chip is facing the threat of operational split and of possibly missing out on participating in the key National Broadband Network, but if anything, its shares are cheap (relative to the rest of the market) and if I can rely on stockbroker opinions in this matter, further downside for the share price, no matter what scenario the future might hold, should be negligible.

Note that on current forecasts, and at the present share price, Telstra shares yield a 9.5% dividend payout in FY11.

Stocks that end up in the slipstream of Telstra include Bank of Queensland ((BOQ)), Tatts Group ((TTS)), Sigma Pharmaceuticals ((SIP)), Boart Longyear ((BLY)) and Qantas ((QAN)).

Regarding the Flying Kangaroo, it has to be noted that the research only includes what we know right now. If the price of crude oil goes to US$300 per barrel in two years' time (as predicted by some bullish hedge funds)

then Qantas shares will most definitely end up looking very, very expensive at current share price levels. But none of the stockbrokers in Australia has currently penciled in any such scenarios.

Similarly, this also explains why commodity and energy stocks are presently among the most expensive in the share market. Prior to Wednesday, BHP Billiton ((BHP)) had been among the most expensive -both on historical and on a relative basis- constituents of the ASX200 index. Continuous losses for BHP shares have softened the relative comparison with the rest of the market, but the shares are still relatively unattractive - unless, of course, present forecasts for the likes of copper, iron ore and crude oil prove too conservative.

Even then, BHP shares are still trading on 12.8 times forecast FY11 EPS - and this is after a fall from around $38 per share to circa $32 now.

Shares in Rio Tinto ((RIO)) have equally shared in recent correction pains, but with an implied FY11 PER of below 10 and not much of a difference in projected dividends, the medium term value proposition looks much, much better at Rio. Again, this is on the basis of what we know now, and without taking into account that Rio Tinto arguably still faces some risks that are completely absent over at BHP Billiton.

Investors in banks are probably pleased to read that all banks look better value than either BHP or RIO, with each of the Big Four in Australia expected to achieve double-digit EPS growth in FY11 again. And this week saw National Australia Bank ((NAB)) overtake ANZ Bank ((ANZ)) as the relative best medium term value on offer. Courtesy of 32% projected EPS growth at a present multiple of less then 9 plus 7.6% in implied dividends by FY11.

The biggest surprise of the whole exercise was finding out that CSL ((CSL)) still doesn't represent relative value, even though the shares have completely missed out on the share market rally.

With these thoughts I leave you all this week,

Till next week!

Your editor,

Rudi Filapek-Vandyck (as always firmly supported by Greg, Andrew, Chris, Rob, Grahame, George, Joyce and Pat)

P.S. I - the FY11 project I have been mentioning a few times now is definitely in its final stages of development. FNArena is likely to proudly announce the new service on its website soon.

P.S. II - The two things that seem to be on everyone's mind these days are Chinese imports of base metals and rapidly deteriorating technicals underneath global equity markets. Regarding the first factor, the big question is how much of the buying in the first half has been speculator-driven and whether the strategic reserves are now completed, or not? Regarding the second factor, half of the analyst community seems to be focused on the fact that indices around the world, including the S&P500 in the US and the ASX200 in Australia, have been carving out what appears to be a head-and-shoulders formations on price charts. I have written in the past that if confirmed such a pattern usually indicates a reversal in trend.

To mitigate any fears about a pending slaughter-fest, I happily point out that gold charts have repeatedly been showing head-and-shoulders since Q1 this year and the price has simply gone nowhere. That is: not to new depths. Gold has simply stopped trending higher. That is a reversal in trend too.

P.S. III - Analysts at Standard Chartered reported this morning their gauge of global risk appetite has again retreated into Risk Adverse territory. Not that we hadn't noticed already, but it adds another bearish signal to the many posted over the last week or so.

An Introduction To: Trading FX Markets

(This story was originally published on July 2. It has now been re-published to make it available to non-paying members at FNArena and readers elsewhere).

A short intro to FX Markets

By Greg Peel

Once upon a time proprietary foreign exchange trading was the realm of the merchant banks, conducted by those traders who had a reputation of being the "cowboys" of the market. The cowboys' counterparties were other merchant banks and commercial banks and, occasionally, actual corporate clients with foreign currency exposure.

Once upon a time global currencies were "pegged" to gold, implying banknotes issued were redeemable for a specific amount of gold held by the central bank of that country. Relative values of currencies were determined only by equivalent values of gold, and hence there was no "market" for currencies as such. In 1946 the US dollar became the global "reserve" currency. All other currencies were pegged to the dollar, which in turn was pegged to gold, which the US held in reserve at Fort Knox.

In 1972, the Gold Standard, as it is known, was abandoned and currencies were no longer pegged to anything, except another currency. (The Australian dollar was pegged to the US dollar until 1983). This type of currency is known as "fiat" currency, and implies the value of a banknote is only as valuable as the economy of the issuing-country is strong. Gold is gold, but economic strength is a far more esoteric concept.

One way to compare currencies is to look at something called "purchasing power parity (PPP)", which one might call the "litre of milk index". Let's assume for the moment it costs one US dollar to buy one litre of milk in New York, and it costs one trillion Zimbabwean dollars to buy a litre of milk in Harare. The difference in face value is representative of the strength of the world's biggest economy against the basket case that is Zimbabwe's economy.

But PPP is really not that simple, given vagaries of local milk supply and so forth. Indeed, foreign exchange rates rarely reflect anything like an accurate PPP balance. What they will reflect, however, is interest rate parity.

The value of one currency will move in relation to the value of another currency dependent on comparative economic strength or weakness. A foreign exchange rate is simply a relative measure. We know, for example, that Australia's economy is heavily weighted towards the export of natural resources. The US also boasts vast resources, but its economy is weighted to the "service" industry, such as banking and computer software. When commodity prices are strong, the Australian economy is strong.

And when the Australian economy is strong, the Reserve Bank raises its "interest rate", being the level at which it will borrow or lend cash overnight to market participants. This "cash rate" is then reflected in interest rates applicable further up the maturity curve, all the way to ten-year government bonds. The higher the cash rate, the higher the bond rate.

The RBA raises its cash rate in boom times because it fears inflation. If the economy is strong, and everyone is making lots of money, they can afford to pay more for goods and workers demand higher wages. This leads to an inflationary spiral, and an unmanaged boom can quickly turn into a devastating bust, as we may have recently noticed. The RBA, and central banks around the globe, attempt to keep economies from becoming runaway trains by making the cost of finance more expensive - by raising interest rates.

If the RBA raises its cash rate, the interest rate (yield) on a AAA-rated government bond will also rise, making them an attractive investment for offshore markets. But one can only buy Aussie bonds with Aussie dollars. An American investor wishing to buy Aussie bonds must first exchange his US dollars for Aussie dollars. Thus a growing foreign demand for Aussie bonds (or Australian stocks, or property, or any other Aussie-dollar denominated asset) will force up the value of the Aussie dollar against other currencies, just as increasing demand for oil increases the oil price.

The relative value of currencies was clearly exemplified in the period in early 2008 when commodity prices were running rampant. The Australian economy appeared strong due to misperceived Chinese commodity demand, and in response the RBA raised its cash rate to 7.25% in March. The US economy, on the other hand, was in all sorts of trouble and the US Federal Reserve had lowered its cash rate to 2.25%. This effectively meant you could borrow US dollars at 2.25% and invest at 7.25% in a AAA-rated security. You'd do that all day, wouldn't you?

Well no - you wouldn't necessarily, because at the same time the Aussie dollar rose from being worth only US$0.50 not many years earlier to being almost worth US$1.00. What an American would gain on the swings of the interest rate differential, he would lose on the roundabout of exchange rate movement. Thus exchange rates should reflect "interest rate parity" such that no arbitrage is available.

(Note that exchange rates reflect both the size of the underlying economy and the amount of currency on issue. The fact the Aussie almost reached "parity" with the greenback last year does not imply the Australian economy became almost as large as the US economy. Nothing could be further from the truth. It's just that 20 million Australians don't need as many banknotes as 300 million Americans, so there aren't as many Aussie dollars about. Just the same as the larger BHP trades at a lower share price to the smaller Rio Tinto - it comes down to the number of shares on issue.)

It's never quite a perfect world however, and disparities do occur, particularly where the yen is involved. But that's a story for another day. Suffice to say, exchange rates move in relation to interest rate differentials, which in turn reflect relative economic strength or weakness. Exchange rates will nevertheless move swiftly from minute to minute, while it takes central banks sometimes months to bring their interest rates into line, opening up the opportunity for frenetic intra-day trading.

Foreign exchange represents far and away the highest turnover financial market of all, as investors move money across borders and the day to day business of international trade is conducted, all requiring the exchange of currencies. But in reality, about 95% or so of every day's trading will be closed out at the end of a trading "session", in a rolling move around the globe.

Most proprietary foreign exchange traders simply open from scratch each day, play the market, and then square off at the end of the day having either won or lost. It is about a 95% zero sum game. While this knowledge might raise the hackles of those with a bone to pick about "cowboys" controlling a country's currency, it is the liquidity provided by the forex market which ultimately allows, for example, BHP Billiton to achieve the best US dollar price for its iron ore exports or Harvey Norman to achieve the best US dollar price in importing flat screen televisions.

Note that the US dollar comes up in both examples above, even though BHP might be exporting iron ore to China and Harvey Norman importing televisions from Japan. This is because the US dollar is the "reserve" currency which, in the post Gold Standard era, means the rest of the world trusts the currency of the world's largest economy to be the safest benchmark. You wouldn't want to be trying to sell iron ore to China in Zimbabwean dollars for fear of hourly changes in rate.

Thus we consider the "value" of any currency to be best determined by its relative value to the US dollar. While an Australian traveling to London will be interested in the value of the pound in Aussie terms, we "quote" the Aussie as being a value in US dollars. The Aussie is currently worth about US$0.80.

Another way to look at this is as AUD/USD, or "what's one Aussie dollar worth in US dollars?" It is a ratio. We could, if so inclined, make just as accurate a valuation of the Aussie in terms of the US dollar, such that one US dollar is worth A$1.25. This would be USD/AUD, but that is not the convention adopted by the market.

The Aussie adapts the English system of considering the pound in terms of dollars (GDP/USD), whereas the Americans preferred originally to think of their dollar in the terms of another currency. The yen, for example, is quoted as USD/JPY. This leads to a lot of confusion given inconsistencies.

The overnight movement of the US dollar is often quoted, on business television networks for example, as most relevant against four different currencies - the yen, the euro, the pound, and the Swiss franc, or USD/JPY, EUR/USD, GBP/USD and USD/CHF. Note the first and last exchange rates are quoted one way around and the middle two are the other way around (as in the AUD/USD convention). Thus if the US dollar were to rise overnight against all four currencies, the first and last exchange rates would be higher and the middle two lower.

That's just one confusing aspect of what is, for the novice retail investor, potentially a very confusing and risky market. Yet in recent years, foreign exchange trading has become very popular amongst retail investors as another market to play in. While one is merely "exchanging" cash from one currency to another, as soon as an investor becomes exposed to a currency other than the investor's domestic currency, that investor is exposed to ongoing exchange rate movements. Hence market parlance is that one might "buy" or "sell" US dollars, and thus live or die by exchange rate movements up or down. An investor will either receive more or less Aussie dollars back again at the end of the trade.

Forex trading is no longer just the realm of the "cowboys".

Given the popularity of retail forex trading, FNArena has invited Matthew Corbett from yourtradingroom.com to provide a cursory introduction to the mechanics of the market.

Currency Markets: No Longer For Cowboys Only

By Matthew Corbett, yourtradingroom.com

With all the recent media coverage of government bail-outs, market crashes and tightening credit conditions, one market - the largest market on the planet - has tended to remain under the radar. That market is the global foreign exchange market, commonly known as the "forex" or "FX" market.

The foreign exchange market is simply a place whereby banks, financial institutions, official agencies and individual investors buy and sell various foreign currencies. Currencies are quoted in pairs - GBP/USD (Great British pound/US dollar), EUR/JPY (euro/Japanese yen) and AUD/USD (Australian dollar/US dollar) are a few examples.

When business is conducted outside of one's own borders, then there must be a mechanism for providing payments in an acceptable form to the foreign person/business. Thus there is a need for "foreign exchange transactions" to occur.

In simple terms, an "exchange rate" is simply the ratio of one currency valued against another currency.

Let's use the AUD/USD (Australian dollar vs United States dollar) exchange rate as an example. In foreign exchange, currencies are always quoted in pairs. The first currency (AUD) is the known as the "base" currency and the second currency (USD) is known as the "quote" or "counter" currency. When you wish to "buy" USD , the exchange rate at the time will tell you how much AUD (base currency) you will need to "sell" in order to "buy" USD (quote currency). Let's use an example to illustrate:

If you want to exchange Australian dollars (AUD) for United States dollars (USD) then you have to "sell" or "exchange" Australian dollars to "buy" US dollars. If the exchange rate is AUD/USD 0.8000, then you "exchange" $1.00 Australian to "buy" $0.80 US. And vice versa - if you're travelling from the US to Australia then you "exchange" $0.80 US to "buy" $1.00 Australian.

Movements in the value of currencies are recorded in "price interest points" or "PIPs". 100 pips is equal to1 basis point. Let's use an example: if the AUD/USD is trading at US$0.8000 (80c) then a move in the value of that currency pair to US$0.8001 is a move of 1 pip. If the pair moved in value to $0.8100 then that is a move of 100 pips or 1 basis point, thus the Australian dollar is now worth US$0.8100c (81c).

The number of "pips" a currency pair moves will determine how much profit or loss a trader will make on a position.

Like any other market, the price of a "currency pair" (AUD/USD) is determined by the interaction of buyers and sellers in that market. A trade only occurs when there's a coming together of two parties - a buyer and a seller. But what does this really mean? If everyone was of the same opinion about the price of the AUD/USD then we wouldn't have both buyers and sellers to create the market. Thus the "market" as such, whether it be foreign exchange, stock market, options market etc, is driven by the sentiment/emotions of all the participants in that market. The exchange rate between two currencies (AUD/USD) is determined by the actions of institutions, banks, official agencies and individual investors in the marketplace.

The diverse selection of execution venues such as internet trading platforms has also made it easier for retail traders to trade in the foreign exchange market. There are no restrictions in the foreign exchange market as to "short-selling" a pair. The underlying principle of "short selling" is to sell at a higher price and buy back later a lower price. This is the opposite of most people's investment philosophy of " buy low, sell high". Let's run through an example:

If you believed that the Australian Dollar will depreciate (go down in value) against the US dollar because of, say, weaker economic conditions here in Australia, then you could "short" the currency pair AUD/USD.

So the trade would be - short (sell) AUD/USD at 0.8000. One month later the Australian dollar has indeed fallen in value versus the US dollar.

The exchange rate is now 0.7900 - thus the Australian dollar has fallen 100 pips or 1 cent in value relative to the US dollar.

Therefore to close the trade you "buy back" the AUD/USD at 0.7900 (0.79c)

Profit = Sold at 0.8000 - Bought Back at 0.7900 = 100 PIPS (one US cent) Profit

Traders are able to participate in the forex market by trading in "contracts" or "lots", as they're known. The standard forex contract or lot has a face value of A$100,000. Typically, a one pip move equals US$10. Thus, in the above example a 100 pip profit on the AUD/USD short would equate to US$1,000 profit. Leverage on forex contracts give the trader the opportunity to make a greater percentage return per capital deployed. The flip side of this is when it goes against you! How many of you could sustain a couple of 100 pip (US$1,000) losses in a row?

To allow the "man on the street" to trade foreign exchange, foreign exchange brokers offer "Mini FX Contracts". These Mini Contracts have a face value of A$10,000 and one pip equates to US$1.00. Therefore a 100 pip loss would only be a US$100 loss. The benefit for novice traders is that as they build their trading accounts they can start trading multiple Mini Contracts, eg two Minis (face value A$20,000 - one pip move = US$2.00), up to three Minis (face value A$30,000 - one pip move = US$3.00) and so forth. Trading Mini FX Contracts allows people to control their risk by trading smaller contract sizes versus the amount of trading capital they have. Even someone starting out with say A$10,000 as their initial capital would be able to trade one Mini Contract and limit their capital at risk to say 1-2 % a trade.

The cost of trading forex is the "spread". This is where the foreign exchange broker makes his money, as typically you don't pay brokerage. The "spread" is the difference between the bid (buy) price and the sell (ask) price that the foreign exchange broker offers you. BHP shares might, for example, be quoted on the exchange at $34.40-$34.50, meaning one can buy at $34.50 or sell at $34.40. Similarly, a foreign exchange might quote for you to buy AUD/USD at US$0.8095, or sell AUD/USD at US$0.8091. The difference between the buy and the

sell price is the "spread", and this is how your foreign exchange broker makes his money. Typically you don't pay brokerage when you trade forex, you pay the spread. In this instance, the difference between getting in and getting out is four pips. Thus if you went "long" (bought) the AUD/USD at 0.8095 then price would need to move beyond that level by four pips for your position to be at breakeven. Spreads on currency pairs can be confusing for the new trader, but with time they are easy to understand.

Delving deeper into the cost of trading in the foreign exchange market, it is also important to remember that there are no government fees, clearing fees or exchange fees to pay either.

So why trade ?

People trade foreign exchange for many reasons but for traders its primarily to capture the fluctuating value of one currency versus another currency. For instance if you believed the US economic outlook was weaker compared to its European counterparts, you could buy the EUR/USD. By doing this you buy the EUR (euro) in anticipation of it appreciating against the USD. Any move by the EUR versus USD is measured in pips. If the buy price is 1.4000 and the EUR appreciates as expected to 1.4040, then that is a profitable move of 40 pips for the trader. Alternatively if the price of the EUR/USD fell to 1.3960 then the trader has suffered a loss of 40 pips.

[Note that when you choose to trade in a third party currency pair you must still get it and out of Aussie dollars, meaning you are crossing two spreads - Ed.]

Unlike the Australian Stock Exchange which has a physical presence in Sydney, the forex market has no fixed location and is a 24 hour market. At anytime, five and a half days (Monday - Early Saturday Morning) a week, you can participate. The foreign exchange market is an OTC (over-the-counter) market, in which brokers/dealers negotiate directly with one another and not through a central exchange.

The forex market literally follows the sun around the planet. Given the International Date Line is in the Pacific, New Zealand and Australia start the trading day followed by Asia, the Middle East, Europe and the US. Then a new day begins and the cycle starts again. London is the largest forex market (approx 34% of all forex turnover comes out of London) as its straddles the Asian afternoon session and the morning trading session of the US.

With the foreign exchange market being open 24 hours it also means people can trade at any time during the day. Unlike traditional stock markets which have definitive opening and closing times, the forex market allows Australian traders to participate at all hours of the day. Major economic news and events (unemployment levels, interest rate announcements, government intervention, retail sales, speeches by various heads of Central Banks etc) can be all "drivers" of price movement and many traders closely watch these announcements. Many people use sites such as www.forexfactory.com to track these events.

The foreign exchange market is dominated by several major currencies representing the major economies of the world. They are the USD (United States dollar), EUR (European Union euro), JPY (Japanese yen) and the GBP (Great British pound). The most actively traded currency pair is the EUR/USD. It accounts for approx 25% of daily global turnover. The USD/JPY is the second most traded pair in the world with 13%, followed by the GBP/USD with approximately 12% of turnover. The USD is the most heavily traded and most widely held currency on the planet.

Following the major three pairs listed above, the next most actively traded pairs are: AUD/USD, USD/CHF (Swiss franc), USD/CAD (Canadian dollar), EUR/JPY, EUR/GBP and EUR/CHF.

According to a 2007 Bank of International Settlements survey, the US dollar is involved in over 80% of all foreign exchange transactions. Average daily turnover in foreign exchange markets rose to US$3.2 trillion in April 2007. That's the equivalent of more than US$450 in foreign exchange market transactions every day for every man, woman and child on the planet! In comparison, the New York Stock Exchange has a daily turnover between US$30-$60 billion a day in recent times. Thus you can see how enormous the foreign exchange market really is.

Closer to home, the Australian stock market on any one trading day will turnover anywhere between A$2-8

billion in value.

Global foreign exchange daily turnover is more than ten times the size of the combined daily turnover on all the world's equity markets. Foreign exchange trading increased by 38% between April 2006 and April 2007 and has more than doubled since 2002. This is largely due to the growing importance of foreign exchange as an asset class and an increase in fund management investment, particularly from hedge funds and pension funds.

Investors choose to invest on the foreign exchange market for several reasons. First of all it's the only truly "global market", is massively liquid, and with the average daily turnover mentioned earlier its not possible for any one group to corner the market. Secondly, as it's a 24 hour market it allows traders opportunities around the clock to make money.

Now with trading any financial instrument, there are a couple of points which most traders seem to ignore, and they're trading account subsequently suffers! They are risk/money management and trading psychology. When people buy a stock - say BHP - the thought process in their head is usually "I'm going to buy BHP low and sell it at a higher price". Most people never think "How will I get out of BHP if the share price starts to go against me?". When you enter a trade your trading psychology should be, "How much can I lose on this trade?" and then a relative "stop loss" order should be placed (reversing the trade on a given price trigger). We don't willingly enter a trade knowing we could lose money, but we need at ALL times to have a stop loss order in the market to protect our trading capital if the trade goes against us.

We as humans don't like to admit we're wrong, but as we all know the market will do its own thing and trades will go against us from time to time. Most people hold onto losing trades because they don't want to close the position and realise the loss, and subsequently admit the fact that they got it wrong! Smart traders, especially in the forex market place their stop losses in the market as soon as they enter a trade. They know what their maximum loss is and are prepared to risk a certain amount to make a certain amount. This is known as the risk/reward ratio.

The foreign exchange market can move very quickly either up or down and a stop loss order if used properly will protect one's account from being wiped out. Remember it's a 24 hour market so there are always other trading opportunities.

As mentioned earlier, major news announcements/events around the world on any given day have an impact on the value of individual currencies and therefore provide traders with potential opportunities. Of late, the consensus has been that Australia is in a better economic state than some of the other First World nations. The proof of this has been the value of our Australian dollar rising in value against the US dollar from US$0.63 on March 10 to US$0.81 at the time of writing. What this means is that the Australian dollar has strengthened against the US dollar.

If we cast our minds back to before December 1983, the Australian dollar wasn't "floating" at all. By that I mean its value wasn't determined by the foreign exchange market, much like a company's share price is determined by the stock market. At the time, the value of the Australian dollar was regulated by the Australian government. Floating the dollar allowed the "market" to decide what it is worth. Nowadays, the value of the Australian dollar rises and falls with the good and bad economic times, global geopolitical events, monetary policy changes and so on.

So why aren't more people trading in the largest and most liquid market?

Traditionally, most Australian investors have been more comfortable trading/investing in something they can relate too, such as buying shares in Woolworths, Commonwealth Bank and BHP. There are some 2,000 shares listed on the Australian Stock Exchange, whereas there are only 4-6 major currency pairs to follow. So do you think it's easier to follow, say, six currency pairs rather than the ASX100? Do you have to time to follow say the Top 20 listed securities or could you follow say four currency pairs?

Recently, retail foreign exchange houses such as IBFX, FXCM, Gain Capital and FX Solutions have all reported increasing transaction volumes, new account openings and record growth year-on-year as more people realise

the trading opportunities available in the forex market.

As more retail forex brokers establish operations in Australia, the growth of forex trading looks set to increase much the same as the CFD (contracts for difference) market did some years ago

Combined with its massive liquidity, the ability to trade multiple currency pairs, ease of stop loss order placement and a 24 hour time frame in which to trade, foreign exchange trading is set to be looked at more closely by traders than it has in the past...

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The US Dollar's Downward Path

(This story was originally published on 6 July. It has now been re-published to make it available to non-paying members and readers elsewhere).

By Greg Peel

"Over time, the USD remains a fundamentally weak currency. By end 2011 we forecast values of EUR/USD 1.50 [currently 1.39] and USD/JPY 90 [95]. The currencies of the strongest emerging economies, includingChina, as well as commodity-exporting countries are likely to appreciate significantly."

This is the view of the UBS currency analysts, expressed last week. But by no means is UBS alone in its outlook. Most economists agree the US dollar will continue its current decline, albeit with peaks and troughs along the way, as the world's reserve currency fights to overcome the extent of its national debt and the fragility of its economy. On a relative basis, the developed economies of the "West" will also struggle, leaving the door open for emerging market economies to stamp their growing influence. UBS believes the currencies of Europe and Japan will perform better in relative terms than the US, but the currencies of China and friends will be the real stars.

While Australia is considered a developed world economy, its fortunes now lie more squarely with emerging markets. Thus the scenario painted by UBS implies significant appreciation in the Australian dollar ahead.

The following graph shows the US dollar index has declined from a peak of 120 around the time of 9/11 to 80 today. That's a 33% fall. The decline began when US monetary policy was eased substantially post the tech-wreck and 9/11, and then exacerbated as Americans used cheap credit to suck up imports from Germany and Japan, and then ever cheaper imports from China, leading to a record trade deficit. Cheap credit also led to an asset bubble which ultimately burst and created the GFC.

As the US consumer now reels in spending, and household balance sheets are repaired, the US trade deficit is on the decline. But the debt imbalance established by the trade deficit is only being replaced, and extended, by debt used to bail out the US banking, insurance, mortgage and auto industries and to stabilise the economy in general. Thus there has been no effective turnaround in the US dollar's trend.

Looking further back in time, the US dollar index has halved in value since its peak in 1985. Yet if one were to remove the spike from 1980-88, and the spike from 1995-2005, then the dollar index has simply trended down from 120 as it entered the seventies to 80 today.

The US entered the seventies in a boom of consumerism which already had inflation running high as US households clamoured to buy houses, cars, furniture and appliances. By the end of the seventies inflation ran wild due to the Arab oil shocks. It was only at this point central banks began to realise they needed to keep inflation in check. Interest rates were finally raised, sending the US dollar skyward, but eventually ushering in a recession in the early eighties - a recession which many an observer prefers to use now as a benchmark for the current recession. The sharp fall in the US dollar then established a commodities boom until the recession in the early nineties. Then came the tech boom and another period of central bank monetary tightening, which pushed the US dollar to its final peak, before then Fed chairman Alan Greenspan made what he now admits was a mistake. Following 9/11 he quickly cut the interest rate to 1%, and the next great boom was on - particularly in commodities.

Commodities boom every time the US dollar weakens because global commodity trade is conducted in US dollars. There still needs to be demand, but that is guaranteed when low interest rates in the world's largest economies spur consumers into spending sprees. Exploding Chinese commodity demand in the period 2004-07

merely reflected its export market. Thus the Chinese boom was a reflection only of rampant Western spending. Only now have China, and India, and Brazil and others, turned inward to stimulate their latent domestic economies - economies fuelled by the power of population.

Thus while the US dollar may be on the decline again, and the US interest rate at zero, this time it will not spark another US spending spree in a hurry. A rise in commodity prices will always accompany a fall in the reserve currency, but only if demand is awakened. The West is now deleveraging and will be deleveraging for years yet. Demand can only come from emerging markets.

If the value of the US dollar index continues to decline, it won't be a reflection of emerging market currency strength directly. The US dollar index is a basket of euro, yen, pound, Swiss franc, Swedish kroner and Canadian dollar, representing America's traditional major trading partners of Europe, Japan and neighbouring Canada. No emerging markets here. Moreover, the value of the Chinese renminbi is linked to the value of the US dollar by virtue of strict central bank management. The renminbi can only appreciate at a pace determined by the Chinese themselves. To date, China has kept a tight rein on currency appreciation for fear of destroying its export market. But with its export market now in tatters post the GFC, and the focus on building a solid domestic economy, China may not need to be quite so vigilant.

There is nothing stopping the Aussie dollar appreciating against the US dollar if emerging market economies succeed in growing domestically.

As the first chart above shows, never has the US dollar been as volatile as it has been from mid 2008 to now. The sudden surge in the dollar brought about the collapse of commodity prices. The reason the US dollar surged was because the fall of Lehman Bros resonated around the globe. Up until that point, the economies of Europe and Japan and the emerging markets were considered relatively decoupled from the credit-crunched US economy. Nothing would prove further from the truth. In June 2008, suggest the analysts at Standard Chartered, the US dollar was "massively" undervalued against the world's major currencies.

The US dollar index quickly found a new level of tenuous equilibrium in the high 80s following realistic adjustments among all developed currencies. The subsequent evaporation of emerging market export markets saw the Aussie "adjust" from near US$1.00 to US$0.63 in a big hurry. But as the US printing presses were switched into overdrive under the new administration, the US dollar again began to wane. The US, UK, Japan, and Switzerland all lowered interest rates to near zero and commenced quantitative easing, and the EU adopted its own "unconventional" measures, but the US fiscal deficit ensured a national debt in the trillions.

"The combined impact," notes Standard Chartered, "of soaring oil prices, the housing market slump, and the global credit crisis have hit the US consumer hard, resulting in the deepest US recession in decades". US GDP has contracted for three quarters in a row. Standard Chartered expects the June quarter will also show contraction before the September quarter brings a turnaround. The analysts are forecasting negative 3% GDP growth for the US in 2009, which would be its worst result since 1946.

By contrast, Australia has not yet strung together two consecutive quarters of negative growth.

In July 2008, at the peak of the oil price, US CPI inflation peaked at 5.6% annualised. In May this year it was negative 1.3% annualised, implying deflation. The Fed nevertheless prefers to follow a measure of inflation known as the personal consumption expenditure (PCE) deflator, which fell to 1.7% in May - below the Fed's 2% comfort zone. Standard Chartered expects the PCE deflator to fall to only 0.5% by mid-2010. On that basis, the US is free to keep printing money and the Fed is free to keep buying US bonds (quantitative easing) without risking an inflation explosion. However, as risk appetite returns, Standard Chartered expects investors to use the cheap US dollar as the funding currency for higher risk investments, particularly in emerging markets. This implies any "global" recovery will only result in a weaker greenback.

We have already seen the evidence. In the past month or so, every time the US stock market rallies the US dollar index falls, and vice versa. A strong stock market implies greater risk appetite, which also encourages offshore investment and divestment of the reserve currency.

The first tentative steps have been made towards diluting the value of the US dollar as reserve currency. But any move to usurp the dollar will take many years. (See The Longest Journey Begins... published last week.) But in the meantime, money will flow to where the growth opportunities lie. Emerging market economies will bounce out of the GFC much faster than the legacy economies of the "West". Standard Chartered believes the US dollar index is currently fairly valued. But in terms of emerging market economies, the US dollar is overvalued. This opinion matches that of UBS above, which suggests the US dollar will decline against the euro and yen but most dramatically against emerging market currencies.

In forecasting the fate of the US dollar in the period 2007-11, Standard Chartered draws upon the experience of the period 2001-05. While the recession following the tech-wreck and 9/11 was not nearly as dramatic as the GFC, there are similarities in that what started as a US-centric scenario soon spread around the global economy.

The tech-wreck and 9/11 occurred in 2000-01, but the subsequent dollar decline did not commence until 2002 as the Fed responded with monetary policy easing. The accompanying fall in the US dollar reflected increasing monetary supply in a lag effect. The Fed began to tighten again in 2005 as commodity prices surged, and at the same time China began to tighten its own (limited) monetary policy as the Chinese economy began to overheat. Yet the US dollar turned down again in 2006, despite the Fed not lowering the interest rate again until August 2007. The still huge supply of dollars had eventually "told on" the value of the currency, Standard Chartered suggests, and it began to weaken. Every time the global monetary supply increases, the US dollar eventually weakens.

When the global monetary supply began to contract rapidly in late 2008, the US dollar strengthened. It will take time for monetary policy easing to have its effect in the "West" as it fights ongoing deleveraging, but eventually it will have an effect, Standard Charted notes, and global money supply will begin to grow again. And on the basis of recent experience, the US dollar index will thus decline again.

But emerging markets did not mire themselves in nearly as much debt as developed economies ahead of the GFC, and thus will not need such a lengthy deleveraging process on the way out. Developed economies do not have much immediate need to fear inflation, but the threat of inflation looms large for emerging markets, Standard Chartered suggests.

"In 2009," the analysts note, "the focus in emerging markets will remain on supporting growth and securing sustainable economic recovery. However, in 2010, that focus will gradually switch to inflation and when it does emerging market central banks may have more of an incentive to let their currencies appreciate in order to temper rising price pressures."

Somewhere in between lies Australia. At 3%, Australia's current cash rate is among the highest in the developed world. Even Canada now has a rate of only 0.25%. The high cash rate reflects the fact Australia has not yet suffered two quarters of negative growth, let alone three. The RBA is presently "on hold", balanced between the effects of falling credit demand, rising bad debts and rising unemployment on the one hand (not to mention a housing bubble that has never really burst) and China's seemingly rapid return to strong economic growth on the other.

Clearly Australia's economy will be saved from deep recession if emerging market economies return to strength. But it may come at the cost of a soaring Aussie dollar as the US dollar weakens, commodity prices recover, and the RBA is forced to quickly consider raising rates again rather than cutting them. (Probably a 2010 consideration, not 2009). A strong Aussie dollar will be nice for overseas travel and cheap flat-screen televisions, but not for commodity exports and variable home loan rates.

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