Week

40

Stories To Read From FNArena

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Contents

Australia

1 Kathmandu A Preferred Retail Exposure
2 Good Guy Vibrations
3 You Can Bank On It
4 Good News Story Continues For Campbell Bros
5 News Flow For Mesoblast Remains Positive
6 Has Nufarm Turned The Corner?
7 Fletcher To Struggle With Crane

Commodities

8 Material Matters: Equities and Commodities, Plus The End For Nexus?
9 Volatility Hits Uranium
10 Material Matters: Commodities And Growth, The USD, Plus Bulks
11 Material Matters: What Are The Risks For Commodities Demand?
12 Material Matters: Copper's Supply Issues, Oil Price Expectations, Oz E&C Sector

FYI

13 Top Ten Weekly Recommendation, Target Price, Earnings Forecast Changes
14 Weekly Broker Wrap: Recession Is Coming

Weekly Analysis

15 What's Wrong With October?
16 China: More Than Meets The Eye

Kathmandu A Preferred Retail Exposure

- Kathmandu result solid given tough conditions - Earnings growth to be driven by new stores, refurbishments - Stock seen as offering value at current levels - Buy ratings continue to dominate

By Chris Shaw

Retail conditions have been tough for some time, so the fact Kathmandu Holdings ((KMD)) delivered a solid full year earnings result was well received by the market. Profit for the year of NZ$39.1 million was up 24.5% relative to the previous corresponding period, earnings being driven by higher inventory investment, favourable weather conditions and better performance from newly opened stores.

New store opening will be a key to earnings growth going forward, RBS Australia noting Kathmandu plans to open 15 new stores in FY12. This would equate to 13% store space growth, while product category expansion is forecast to be about 10% per year.

The new store rollout will require higher capex, Macquarie noting Kathmandu expects to double capex in FY12 and FY13 for both new store and refurbishments and re-branding of the existing store network. This investment is seen as critical for the longer-term health and growth potential of the Kathmandu brand.

The major risk for earnings in the view of UBS is pressure on gross profit percentage given the difficult retail environment at present and the fact weather conditions in FY11 were very favourable. On UBS's estimates, a 100-basis point change in gross profit percentage equates to a 5.6% change in earnings per share.

Given Kathmandu's result had been well guided and no specific earnings guidance for FY12 was provided, there are only modest changes to earnings forecasts post the result. In earnings per share (EPS) terms RBS has adjusted its forecasts for FY12 by just over 1%, while Macquarie has trimmed its numbers by 2% and UBS has made no changes.

Kathmandu reports in New Zealand dollars and EPS forecasts for FY12 range from NZ21c to NZ23c, while for FY13 the range is NZ$24-NZ$27c. This compares to the result for FY11 of NZ$19.5c.

Price targets in Australian dollars range from $1.90 to $2.20.

Post the Kathmandu result there have been no changes in broker ratings, the FNArena database showing four Buy recommendations and one Hold rating. The hold comes courtesy of UBS, the broker suggesting investors should look for a lower entry point into the stock given strong share price performance.

The Buy argument is in general a valuation call, as the brokers covering the stock accept retail conditions will remain tough for some time. Both RBS and Deutsche Bank estimate Kathmandu is trading on a FY12 earnings multiple of less than 10 times, which is attractive relative to the market.

Macquarie suggests current valuation for Kathmandu is not demanding, especially given the full year result delivered increased confidence in the business model and the positive medium-term growth outlook.

Credit Suisse agrees, seeing no reason why the factors that drove solid growth in FY11, which included store rollouts and refurbishments and solid sector trends, will not continue through the coming year. Management supports this view given a positive outlook for the year ahead.

The current share price implies upside of around 22% to the $2.08 consensus price target in the FNArena database.

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Good Guy Vibrations

- The Good Guys are up for sale - A chance for Woolies or Wesfarmers? - The business could bolster either's hardware chains

By Greg Peel

Come in a see the Good, Good, Good Guys / Pay cash and we'll slash low prices. Brain Wilson's poor old drug-addled mind must ache every time his iconic song is butchered on these remorseless ads, particularly given the publishing rights were sold out from under him years ago. The news is, however, that The Good Guys major stake holder Muir Investments has put this investment up for sale.

That TGG should be feeling the pinch in the current Australian retail environment should come as no surprise. Retailers of any form of electrical goods are struggling as price deflation and weak consumer demand offset any otherwise margin-positive benefit of a strong Aussie dollar. TGG's commitment is that the lowest ticket price for a product on offer elsewhere will be matched, and then a further discount will be offered if cash is paid on the spot. Good for cashflow – bad for profit margins.

On that basis, the analysts at RBS Australia don't hold out a lot of hope Muir will see an attractive multiple offered for its stake. Muir must first exercise the options it holds to buy out the remaining minority independent store operators for starters to complete the package before any corporate interest can be piqued. Realistically, surviving retailers of white goods (fridges, washers etc) and brown goods (TVs, smaller electrical appliances) should be hoping they can pick up some of TGG's market share if Muir struggles to unearth interested parties. JB Hi Fi ((JBH)) and Myer ((MYR)) have already chosen to exit the white good space. But then maybe they should also be very afraid.

An opportunity is on the table, RBS suggests, for either Woolworths ((WOW)) or Wesfarmers ((WES)) to snap up TGG in order to bolster the white goods offerings within their respective hardware franchises of Masters and Bunnings. Ownership would provide previously lacking bargaining strength with suppliers. TGG could be particularly attractive for Woolies given the Masters roll-out has only just begun and the franchise lacks the scale of the incumbent Bunnings. RBS believes Masters needs to beef up its growth prospects over the medium term if it is to be successful.

Just as Woolies has a corporate relationship with US retail giant Wal-Mart, TGG has a relationship with similar US operation Best Buy, even to the point a Best Buy representative sits on the TGG board. To that end, RBS suggests an obvious third suitor for TGG is Best Buy itself, given the franchise could become more competitive with Best Buy's global buying power and retail innovation.

Other white and brown good retailers should thus be afraid because a purchase by any one of the three prospects means trouble. A sale to Best Buy would likely mean a strengthening of TGG's position. And we know how independent retailers of petrol and alcohol fared when Woolies and Coles moved in to those markets.

Investors in Woolies may be excited about the prospect nevertheless, given the significant cost involved in taking on the well-entrenched Bunnings chain. Any kick-start would help. Investors in Wesfarmers may need to hope Woolies is headed off at the pass.

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You Can Bank On It

By Greg Peel

Bank analysts figured it out a while back, but unfortunately the market has not, particularly foreign investors in the Australian market. It took the local bank analysts a while, mind you, so we can only hope the market catches on eventually. The funny thing is that if you listen to market commentary, you'd swear the market had caught on. Yet day to day whipsawing of Australian bank stock prices would tend to suggest otherwise.

What am I talking about? I'm talking about the fact Australian banks have reverted to being the “defensive” stocks they have been throughout nearly all of history with the exception of the period 2003-07. That period represented the runaway credit boom which took us to the GFC in 2008, and to the same GFC in a different form in 2011. In that period, Australian banks stopped being defensive and became high-beta, cyclical stocks, with stock prices driven by economic growth which was itself credit-fuelled. Since then, banks have remained cyclical in terms of stock index movements largely because of the F in GFC. What has been the source of all the trouble since 2008? Banks – first US then European. So it stands to reason that Australian banks should also be sold off when things get volatile once more.

But actually it doesn't. The problem with Europe's banks at present is that they are undercapitalised vis a vis the level of toxic sovereign debt risk they are carrying on their balance sheets. If nature had been allowed to take its course, such that Greece would have defaulted long ago and possibly set off a cascade of defaults right through to Italy, then possibly all of Europe's banks would be bankrupt.

In 2008 the story was the same, except in that case it was US banks and toxic mortgage debt. The US banks have since been recapitalised by the public sector, and it would seem the same might be about to happen for the European banks. But what of the Australian banks?

Australia's big banks undertook extensive recapitalisation in 2009-10 via the private sector (albeit with a government deposit guarantee providing a safety net). In retrospect, given the fact Australia did not fall into recession, the extent of recapitalisation was probably over the top, and for the last two years Australian banks have been gradually bringing their unused provisions against potential bad debts back into their earnings pools. However they weren't to know this at the time, and given the collapse of global mortgage security markets they had to quickly find new loan book funding through expensive off-shore loans – the last of which will roll off mid-2012. Australian banks did not have any great exposure to toxic US mortgage debt (NAB had some but nothing too destructive) and they don't have any exposure of note to European sovereign debt.

The only exposure Australian banks have is to a renewed increase in offshore funding cost and a renewed increase in local bad debts due to a recession (and one can argue Australian ex-resources is already in one). Yet herein lie offsets. Credit demand in Australia has plunged but that means less offshore funding is required. Deposit demand has soared which, again, means less need for offshore funding. What this means is that Australia's banks are well capitalised (and exceedingly so compared to US and European banks) and are able to maintain reasonable net interest margins (a bank's source of earnings) through a period of sluggish loan growth. Such margins means Australian bank payout ratios are quite safe, which in turn means dividend yields will remain very attractive until such time as stock prices rally strongly once more.

And this is where the contradiction lies between the “what I say” and “what I do” attitude of foreign investors. Almost every commentator appearing on US business television, and plenty of them on Australian business television, will tell you investing in quality dividend stocks is the way to play this market right now. Australian banks fall into that category, yet every time Europe sneezes again Australian banks are dumped from offshore.

Of course, such episodes do provide opportunities for local investors, if they are prepared to hang on for the wild ride.

The previous FNArena Australian bank report was published on August 23, which was a point at which Europe had reared its ugly head once more after we'd all just got over the US credit rating downgrade and the market had tried to rally again. On August 23, our bank table looked like this:

Between then and now markets have suffered all sorts of extreme volatility, and none more so than in the last week and even as I write. Today's version of the table is as follows, with closing prices reflecting the 3.6%% rally achieved yesterday:

Spot the difference? Well there are certainly differences, but not to any great extent. ANZ Bank ((ANZ)) has suffered one broker downgrade to Hold from Buy which has it slip to third place in the FNArena database consensus table thus shifting Westpac ((WBC)) into second. None of Westpac, National ((NAB)) or Commonwealth ((CBA)) has seen a rating change since August 23.

There has been a little bit of movement in closing prices, but not much. There has been virtually no movement in consensus broker target prices, meaning not a lot of change to that still extraordinary upside to valuation. And those fabulous yields, shown here before applying 100% franking, remain fairly similar.

In other words, despite all the turmoil in the ensuing period which seems to have brought Europe to the brink, Australian bank analysts have just not seen any reason to change their tunes.

Indeed, bank reports in the interim period have remained relatively positive, in least in terms of highlighting defensive qualities and attractive yields in a period of acknowledged slow growth ahead. Goldman Sachs, for example, has suggested bank “dividend yields look sustainable”. Macquarie reiterates that the aforementioned offsets in operation mean income growth for the banks will “hover at or around the average level seen for the last 20 years”.

It isn't all beer and skittles however, with a couple of old habits reappearing to make bank analysts a little nervous.

Having surveyed the banks' senior loan officers, UBS finds that in the current environment of slowing credit demand the response has been to once again ease lending standards. As we all know, it was lax lending which brought us up to the GFC in the first place. Obviously, Aussie banks are not suddenly writing “NINJA” mortgages, but they are easing off on previously tightened mortgage requirements in the face of easing house prices and mortgage demand.

They are also loosening requirements for large corporations, but at this stage they've left requirements for small and medium enterprises (SME) as they have been post-GFC. The agriculture sector, the services sector, and some industrials are enjoying better access to loans, but the offset is a further tightening for anyone in retail and manufacturing – the two “dog” sectors of post-GFC Australia. In other words, banks are cherry-picking via their loan requirements as they let a bit more light in through the shutters. The conclusion drawn is that loan growth will improve over the next 12 months, but net interest margins will ease as a result.

UBS thus believes the Australian banks are “structurally challenged”, and will need to focus on cost cutting and processing upgrades. However at current prices, UBS believes valuations are fair.

In the meantime however, when it comes to mortgages the Big Four banks are “writing almost every new loan,” as research by RBS Australia has found. The Big Four currently hold 62% of the $1 trillion Australian mortgage market, with the balance spread across the smaller banks, foreign banks, credit unions etc and the (minimal) securitisation market. Prior to the GFC, the Big Four controlled 49% of mortgages.

It is perhaps not all that comforting, therefore, at a time when talk of a global recession is once again rife, to learn that Australian mortgage standards are being eased again in the face of falling demand. Nor is it all that comforting to find that the Big Four are once again discounting mortgages prices, as JP Morgan notes.

[As an aside – two of the great misconceptions in Australia are that mortgage rates bear any relationship to the RBA cash rate, and Australian banks are some sort of non-competitive cartel.]

NAB started it all off with its “breaking up” campaign, which proved not only cleverly irreverent and a real slag off at stupid politicians but also a great success. NAB has picked up quite a slice of the mortgage market as a result, ANZ's gains have been modest, while the offset is Westpac's losses have been modest and CBA has been the big loser. Given the extent of Big Four dominance in the mortgage market, and given the Big Four are writing almost every new loan, as RBS notes, it's all as good as a zero sum game.

Yet within the zero sum game, as JP Morgan has found, competition has led to mortgage discounting – again. But rather than competition being based in the standard variable rate (SVR) market as it usually has been, competition has hotted up in the fixed rate market. Fixed rates are now being offered below SVRs. How can that be?

Well, it's all about the first point I made above, being that multiple-year mortgage rates have nothing to do with the RBA overnight cash rate, as well they shouldn't given the duration gap. The average duration of loans on a bank's books sit around the 4-5 year mark, and the Australian yield curve has “slumped” of late given high demand for term deposits and expectations of an RBA rate cut. This allows the banks to lock in cheaper funding and thus offer cheaper fixed rate loans without the usual level of risk associated with not being able to move rates up and down with the RBA.

It's all good news for the home buyer, but for the bank stock investor it means greater pressure on those important net interest rate margins, which are what translate into earnings and dividends. JP Morgan thus concludes that earnings risk is now to the downside for banks, meaning the “slow” rate of earnings growth for Australian banks previously assumed will be even slower.

On that basis, we can conclude that while Australian banks have become “defensive” once more, despite still being the plaything of fickle foreign investors, they are not quite as defensive as, say, a utility or a telco, or even a supermarket. But then that is why Australian bank yields are currently at such historically high levels (even before we talk 100% franking). Nobody said there was no risk at all.

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Good News Story Continues For Campbell Bros

- Campbell Brothers (again) lifts interim earnings guidance - Upgrade reflects continued strength in minerals testing volumes - Brokers lift earnings forecasts - UBS and Macquarie see value at current levels

By Chris Shaw

Having previously guided to 1H12 net profit of $90-$95 million, management at Campbell Brothers ((CPB)) has now lifted guidance to an expected result of $100 million. The upgrade reflects stronger than anticipated trading for the five months to the end of August.

While all divisions are understood to have been performing better, Macquarie suggests much of the upgrade in guidance reflects strength in minerals testing volumes. Commentary at the AGM of Campbell Brothers indicated global mineral sample volumes were tracking more than 30% higher in the first quarter of FY12 compared with the same period of FY11 and Macquarie's view is volumes have risen even higher through 2Q12.

As well, Macquarie takes the view environmental volumes were strong in 1Q12 and this is also likely to have continued through the half year. This positive trend should remain the case through to December, before a traditional season slowdown through the first quarter of next year.

The other boost to earnings comes from currency moves, as UBS notes a weaker Australian dollar relative to the US dollar is acting as a positive earnings tailwind. Each 1c move in the currency equates to a 1% move in earnings per share (EPS) on UBS's numbers.

To reflect the update to guidance, both Macquarie and UBS have lifted EPS forecasts for Campbell Brothers. The increase for Macquarie is just 1% in FY12, while UBS has been slightly more aggressive in lifting its forecasts by 3% this year and by 2% in FY13. Consensus EPS forecasts for Campbell Brothers according to the FNArena database now stand at 279.5c for FY12 and 322.6c for FY13; these numbers might rise further as other stockbrokers go through a similar exercise of updating their estimates post management's revised guidance.

Earnings risk remains to the upside in the view of UBS, as if current growth rates are maintained through 2H12 this would mean a further 3% increase in full year forecasts for FY12. Margin improvement could also offer a boost to earnings, as UBS estimates a 100-basis point change in EBIT (earnings Before Interest and Tax) margins for the minerals business implies a 2% change in EPS.

The major risk to earnings is a sustained downturn that results in lower activity in minerals testing, but UBS notes Campbell Brothers is offsetting this risk by increasingly diversifying operations. As an example, the Ammtec and Stewart Testing acquisitions in recent months have added metallurgical testing and inspection services to the product offering.

This suggests earnings will be more resilient going forward, while UBS is also positive on the geographical expansion Campbell Brothers has undertaken by moving into new markets such as Latin America. Services in the South African and Canadian markets have also been expanded.

Macquarie's forecasts currently assume Campbell Bothers will grow revenues in the ALS minerals testing business by 20% in FY13, this reflecting organic growth only. If revenues were to be impacted by the current downturn and fall by 20%, meaning a 40% decline from current expectations, Macquarie estimates a fall of around 16% in EBIT for the ALS operations. This is an improvement from the 25% EBIT declines experienced during the GFC.

Having factored in the changes to earnings estimates, Macquarie sees the current valuation for Campbell Brothers as being supported by the earnings outlook. The yield is also relatively attractive, as on Macquarie's estimates Campbell Brothers will yield 4.7% in FY12 and 5.3% in FY13, franked to 50%.

This is enough for Macquarie to retain an Outperform rating, through the price target has been trimmed to $50.12 from $50.58. UBS also rates Campbell Brothers as a Buy, with an unchanged target of $52.00. The FNArena database shows three Buy ratings and three Holds for Campbell Brothers, with a consensus price target of $49.28.

Shares in Campbell Brothers today are higher and as at 11.30am the stock was up 74c at $41.50. This compares to a trading range over the past year of $32.50 to $57.00. The current share price implies upside to the consensus price target according to the FNArena database of around 16%.

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News Flow For Mesoblast Remains Positive

- Mesoblast has announced a new heart attack trial - Manufacturing alliance also announced - Both announcements are positives according to Bell Potter - Significant upside potential in Mesoblast at current levels - Bell Potter retains a Buy rating

By Chris Shaw

Back in August Bell Potter wrote glowingly of the prospects of stem cell technology group Mesoblast ((MSB)), suggesting the Mesenchymal Precursor Cell (MPC) technology being developed had significant potential (see: Mesoblast's Upside Significant, FNArena, 25/8/11).

Since then there has only been good news from Mesoblast, as Bell Potter notes a new trial to test whether MPCs can repair heart muscle damage post a heart attack was announced earlier this month. The 225 patient Phase II trial will test whether using MPCs soon after an attack can lower the subsequent incidence of heart failure. Pre-clinical data appear encouraging.

Assuming the trial is successful, the potential market is very large notes Bell Potter, as in the US alone there are around 700,000 heart attacks annually and a similar number of heart failures. Estimates suggest around one-third of heart attack patients move onto heart failure, so the test will see if MPCs may be able to reduce this number.

As well, Mesoblast has this week announced a global manufacturing alliance with Lonza, a Swiss contract manufacturer of biological products. The deal will see Lonza become the supplier of stem cells to Mesoblast, with the company also eventually setting up a purpose-built stem cell manufacturing facility Mesoblast will have the option to buy.

In Bell Potter's view, the deal should give the market greater confidence Mesoblast will successfully scale up to a commercial level of stem cell manufacturing. The fact Mesoblast will have control of this manufacturing process is a potential source of massive upside notes Bell Potter, as it is conservatively valued as being equal to a 20-30% royalty on the licensee's average selling price.

The agreement with Lonza follows on from the partnering deal Mesoblast struck late last year with US pharmaceutical company Cephalon. The Cephalon deal saw that company take a 19.99% stake in Mesoblast, as well as partnering in the development of heart failure, heart attack and bone marrow transplant applications of MPC technology. Cephalon will also provide funding for programs related to Alzheimer's and Parkinson's disease.

Not only was the Cephalon deal the first instance of an established pharma company committing resources to stem cell development, it also de-risked Mesoblast by providing funding for development programs. Cephalon has since been acquired by Teva but this is a positive in the view of Bell Potter as Teva has a history of generating growth through branded innovator drugs.

In total Mesoblast is currently either conducting or moving towards Phase II and III trials in eight different applications, most of them related to cardiovascular and orthopaedic issues. Results to date have generally been positive and Bell Potter expects other potential applications for MPCs will emerge.

One advantage for Mesoblast is the path to market for MPCs is fast, as the FDA in the US requires only one Phase II and one pivotal trial before approving a stem cell therapy. This suggests it may be only a relatively short time before Mesoblast begins to yield commercial revenues.

As further successful trial data emerge Bell Potter sees scope for Mesoblast to be a candidate for merger and acquisition activity, as Big Pharma is likely to be attracted to the long-dated patent protection Mesoblast enjoys. Any acquisition would also give the buyer first mover advantage, as Mesoblast is ahead of the pack in terms of trials of its MPC technology.

All of this implies value for Mesoblast shares, as Bell Potter's analysis has generated a base case valuation for the stock of $11.14 and a more optimistic valuation of $21.59. Price target has been set around the middle of this range at $16.00 and a Buy rating retained. In Bell Potter's view, Mesoblast is undervalued on the potential heart application for MPCs alone.

Shares in Mesoblast have traded inside a range of $2.29 to $9.95 over the past year.

None of the eight brokers making up the FNArena database offer coverage of Mesoblast despite a market capitalisation for the company of a little more than $2 billion.

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Has Nufarm Turned The Corner?

- Nufarm's earnings met previously lifted guidance - Forecasts and targets revised - Ratings on Nufarm remain split

By Chris Shaw

Earlier this month Nufarm ((NUF)) lifted full year profit guidance to a result of more than the $88-$94 million forecast in July and yesterday's result met this guidance as underlying net profit came in at $98.3 million. This equates to growth of 68% relative to the previous corresponding period.

The result was viewed as somewhat mixed by brokers covering the stock, Goldman Sachs noting while improved operating performance within the South American division has seen estimates for that region lifted, this is offset by cuts to expectations for the North American businesses and to a lesser extent the Australasian operations.

Company guidance also suggests a higher tax rate for Nufarm going forward, which supports the move by Goldman Sachs to cut earnings estimates in coming years. In earnings per share (EPS) terms forecasts have been cut by 14.8% and 14% respectively for FY12 and FY13.

Citi has reacted differently to the result, lifting earnings forecasts by around 5% in both FY12 and FY13 to reflect an improved product mix and a modest increase in margins. Citi expects above average operating conditions for Nufarm should continue for another year.

Deutsche Bank has also lifted forecasts by a similar level to Citi, but the broker suggests earnings risk at present remains to the downside. BA Merrill Lynch has sided with Goldman Sachs, trimming forecasts slightly to account for more normal conditions in the Australian market. Consensus EPS forecasts for Nufarm now stand at 41.9c and 49.3c respectively, which compares to the 33c achieved in FY11.

One key element in the Nufarm result according to BA-ML was an improvement in debt, as gearing has fallen to 30% from 35% in the previous corresponding period. This suggests the benefits of recent restructuring moves are starting to become apparent, so there remains potential for further margin expansion in coming years as the product mix continues to improve.

A further positive is Nufarm appears close to finalising a $600 million debt refinancing, an announcement BA-ML suggests will go a long way to allaying market concerns over existing debt. Citi estimates an amount of a little more than $600 million is a sustainable debt level for Nufarm going forward.

While market conditions for Nufarm are seen as favourable for the year ahead, Citi sees some growth constraints longer-term as conditions normalise. There is also scope for some market share losses thanks to rising import competition in Australia and stronger competition generally in chemicals markets.

This leaves brokers with mixed views on Nufarm at current levels, as evidenced by the breakdown of ratings in the FNArena database of four Buys, two Holds and two Sells. Deutsche has made the only rating change post the profit result, downgrading to a Sell on Nufarm on valuation grounds given the stock is trading at a 15% premium to the broker's valuation of $3.75.

The Hold argument from Citi is that while the stock appears fairly priced given reduced refinancing risks and favourable near-term conditions, there is a need to be cautious longer-term given the expectation of increasing competition in Nufarm's markets.

The Buy argument from BA-ML is that the evidence of restructuring benefits flowing through and reduced debt concerns makes the stock more attractive, especially given the expectation of another year of good operating conditions. The split in broker views is reflected in a wide spread of price targets, which range from $3.75 to $5.90.

The consensus price target for Nufarm according to the FNArena database is $4.89, up slightly from $4.80 prior to the profit result.

Shares in Nufarm today are weaker in line with the broader market and as at 11.15am the stock was down 16c at $4.16. This compares to a range over the past 12 months of $3.08 to $5.80. The current share price implies upside of around 14% to the consensus price target in the FNArena database.

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Fletcher To Struggle With Crane

- Analysts visit Crane Group assets of Fletcher Building - Integration going to plan but macro conditions have weakened - Potential for expected target timetable to slip

By Chris Shaw

Having recently acquired Crane Group, Fletcher Building ((FBU)) has held a site tour for broking analysts that has offered some additional insights into how the new assets are fitting into the group.

In the view of BA Merrill Lynch the integration of Crane Group has to date gone smoothly. This implies synergy benefits are being realised, Citi noting total annual realised synergies across the Corporate and Group Procurement operations are estimated at $16.6 million. Citi sees potential for further benefits to be achieved.

At the time of the acquisition management at Fletcher Building had set a target of 15% return on funds employed from the Crane Group assets, to be achieved by FY16. The site visit saw this target reiterated, as Deutsche Bank notes management are positive on the upside potential of the new businesses.

Increased earnings from the Pipelines and Tradelink businesses are expected to drive the achievement of this target, though Citi sees scope for some slippage in timing terms given macro conditions have worsened since the Crane Group assets were acquired.

As an example, Citi points out margin recovery in the Trade Distribution business is largely volume dependent. This is driven to a significant extent by residential and commercial construction levels, where the shorter-term outlook remains less than favourable. This will be offset to some extent by new supply contracts won in the Queensland Coal Seam Gas market.

According to BA-ML, the significant macro headwinds currently in place suggest Fletcher Building is unlikely to generate cost of capital returns from the Crane Group assets for at least the next four years. On BA-ML's numbers the assets need generate EBIT (earnings before interest and tax) of $129 million to meet the cost of capital, which compares to the $71 million achieved in FY11.

Allowing for the tough market conditions, BA-ML remains of the view Fletcher Building shares offer reasonable value at current levels given an earnings multiple of 13 times for FY12 and a solid balance sheet.

What drives the Neutral rating of BA-ML is a belief any recovery in building activity in Australia and New Zealand is unlikely before FY13. As well, the fact the New Zealand assets appear to have reached a terminal market position suggests it will be the Australian market where any organic growth occurs.

Deutsche agrees with BA-ML and rates Fletcher Building as a Hold on valuation grounds. Citi is more positive and retains a Buy rating on Fletcher Building, a share price target of NZ$9.35 implying an expected share price return of almost 24% relative to current trading levels.

Overall the FNArena database shows brokers are evenly split on Fletcher Building, with four Buy ratings and four Hold recommendations. The consensus price target according to the database is $6.80, unchanged from prior to the update.

Shares in Fletcher Building today are weaker and as at 1.00pm the stock was down 7c at $5.95. Over the past year Fletcher Building has traded in a range of $5.62 to $7.11. The current share price implies upside of around 14% to the consensus price target in the FNArena database.

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Material Matters: Equities and Commodities, Plus The End For Nexus?

- Disconnect between equity and physical commodity markets - Some evidence bulk commodity markets are close to cracking - An assessment of potential Oz economic downside - MD departure signals issues at Nexus

By Chris Shaw

Recent equity market moves imply both spot commodity prices and future expectations for these prices are sharply overdone, but this view is not shared by Macquarie. The broker continues to believe in at least a partial disconnection between the equity and physical markets, as the range of potential outcomes continues to broaden due to ongoing concerns about the future of European and US economic growth.

The key for Macquarie is how these events impact on Chinese raw material demand, as it is this that ultimately will drive commodity prices. Looking forward, Macquarie expects persistent Chinese inflationary pressures will ease in coming months, something that would allow for a relaxing of domestic credit tightening measures.

To factor this in Macquarie has revised its commodity price expectations, the biggest changes being sizable increases in Australian dollar, gold and silver price expectations. While copper price estimates have been trimmed from previously aggressive levels, Macquarie continues to see upside from current spot prices. The broker's long-run copper price estimate has been lifted.

Thermal coal forecasts have also risen but the increases have not been to levels above current contract levels. Other bulk commodity forecast changes are small, while Macquarie has lifted aluminium price expectations to account for lower US interest rate risk and increased nickel price forecasts from 2014 to account for nickel pig iron cost pressures.

For Macquarie, key exposures include BHP Billiton ((BHP)) and Rio Tinto ((RIO)), as the big diversifieds continue to offer strong long-term fundamental valuation support. This is especially the case given the expectation iron ore prices can be sustained at US$150-$190 per tonne through the next few years.

This positive view on iron ore prices also means Macquarie remains positive on the pure plays of Fortescue ((FMG)) and Atlas Iron ((AGO)). In thermal coal the key pick is Whitehaven Coal ((WHC)), while Macquarie likes Aston Resources ((AZT)) and Gloucester Coal ((GCL)) among the met coal plays.

In the base metals Macquarie continues to recommend Oz Minerals ((OZL)) at current levels, while changes to gold price estimates suggest Newcrest ((NCM)) and Perseus Mining ((PRU)) are now even more attractive at current levels.

All the stocks mentioned are rated as Outperform, while Macquarie also ascribes Outperform ratings to Alumina Ltd ((AWC)), Iluka Resources ((ILU)), Independence Group ((IGO)), Panoramic Resources ((PAN)) and OceanaGold ((OGC)). Paladin has been upgraded to Neutral from Underperform.

In contrast to Macquarie, BA Merrill Lynch reports there are accumulating anecdotes coming from the coal and property sectors in China increasingly suggesting bulk commodity prices are on the verge of cracking.

If these markets do in fact crack the implications for Australian investors would be significant, as BA-ML notes many investors continue to see commodities as a safe haven in the current downturn.

Most at risk from a stock perspective in the view of BA-ML would be the major miners, the juniors and the mining services stocks. With this in mind, the broker has looked back to what happened in 2008 to determine the best course of action for investors.

In 2008 the sequence was the major miners actually rose for a few weeks even after iron ore prices peaked, as investors switched from juniors to majors. BA-ML sees scope for a similar outcome this time around.

Junior miners fell first and experienced the largest declines, then were hit again with more selling as liquidity in markets blew up and getting out of positions became harder. Mining services stocks saw steady declines through the initial downturn, then kept falling even after junior mining stocks started to recover.

Given these guidelines, BA-ML suggests the appropriate response from investors is to go underweight the junior miners now, while adopting more of a wait-and-see approach with the majors. This is especially the case as valuations are not as stretched as was the case in 2008.

Finally, BA-ML notes mining services companies are unlikely to be immune to selling pressure, as while major miners have indicated projects won't be delayed, the impact on the services companies will be even greater when some projects eventually are delayed.

This week the International Monetary Fund (IMF) released new economic forecasts for global growth of 4.0% this year and in 2012 and Goldman Sachs notes these were broadly in line with its own expectations. But a key point is while financial markets are increasingly embedding in more pessimistic views for global growth, equity markets are not yet fully embracing the IMF's risk scenario.

The broker's analysis suggests the global MSCI price index could decline a further 15% from current levels if the 'risk scenario' was fully embraced. On the flipside, if current economic forecasts prove correct then global equity markets could rally by as much as 30% from current levels by the middle of next year.

For Australia, Goldman Sachs suggests despite the Australian dollar's fall below parity against the US dollar, the sharp fall in equity markets and the inversion of the yield curve implies materially weaker underlying economic growth next year than is currently being forecast.

The tightening of financial conditions in the past few weeks is consistent with a 2% growth rate in Australia in 2012, which Goldman Sachs notes is about 75-basis points below its own growth estimate next year of 3.5%. Preliminary calculations for Australia using the IMF risk scenario is economic growth in 2012 of 1.5%, a cut in the cash rate to 3.5%, an Australian dollar rate of US88c and unemployment around 6.75%.

This would be a better outcome than most other developed nations, but at the same time it would still post a number of challenges to policymakers and local asset prices. Assuming there was a shock transmitted to the Australian economy, Goldman Sachs suggests the most likely transmission channels would be via confidence levels and financial conditions and wealth.

Confidence levels in Australia have fallen more sharply than in other major developed nations in recent weeks, while even more concerning in the view of Goldman Sachs is the decline in confidence indicators over the past month.

On Goldman Sachs's numbers, net household wealth in Australia has likely fallen by 5% in year-on-year terms to the end of the September quarter, while household gearing is again approaching the high levels seen in the global financial crisis. This suggests savings rates will again increase, which is not a positive for consumer spending.

Other potential transmission channels according to Goldman Sachs are commodity prices and credit market paralysis. In terms of policy response, while Australia has good scope to cut interest rates, a cut of more than 100-basis points would be needed to bring conditions back to an expansionary level.

A discretionary fiscal package is also a possibility given relatively low levels of government debt, but Goldman Sachs sees monetary policy taking a lead role in supporting economic activity in Australia.

Finishing with a stock specific update, Nexus ((NXS)) has announced the immediate departure of its MD, an outcome stockbrokers suggest means prospects for the development of the Crux field are now far diminished from what had previously been assumed.

Developing Crux had been a key element of valuations for Nexus, so on the news of MD Richard Cottee's sudden departure both Macquarie and BA-ML have been quick to slash valuations. This is reflected in cuts in price targets, Macquarie halving its target to $0.20 and BA-ML lowering its target to $0.11 from $0.31.

The uncertainty with respect to the future for Nexus has also prompted Macquarie to downgrade its rating to Neutral from Outperform. BA-ML had already rated Nexus as Underperform given the uncertainty of the Crux development even with Cottee at the helm, so there is no change in its view.

Overall the FNArena database shows Nexus is rated as Buy once, Hold twice and Underperform once, though changes could come as Deutsche Bank and RBS Australia update their views on news of Cottee's departure.

Volatility Hits Uranium

By Greg Peel

It was a relatively busy week in the spot uranium market last week given industry consultant TradeTech reports eight transactions were completed totalling over a million pounds of U3O8 equivalent. It was all about speculation, however, with traders and hedge funds battling it out while utilities and producers watched on.

The spot uranium price has been quietly bouncing back from below the significant US$50/lb level in recent weeks as it recovers from the shift away from a nuclear energy focus among some developed economies. Last week began as no exception, with the spot price pushing up US50c to US$54.00/lb mid-week. However, Thursday night's action in global stock and commodity markets finally had an impact on a sport uranium market which has to date been relatively removed from panic over Europe.

One feature of Thursday night's trade was a capitulation dumping of commodity positions by commodity funds in oil, gold, base metals and softs. With speculators also dominating last week's trade in uranium, some crossover became inevitable. Hence by week's end the spot price had fallen back US$1.00, resulting in a weekly indicative price from TradeTech of US$53.00/lb, down US50c from the week before.

No doubt this week investors in uranium producers will be hoping there is some light at the end of the tunnel of European woe in the wake of last weekend's G20 meeting.

Material Matters: Commodities And Growth, The USD, Plus Bulks

- Commodity price outlook under a weaker growth scenario - Preferred resource sector exposures - Commodity prices and currency movements - Reviews of the iron ore and coal sectors

By Chris Shaw

With the global economic outlook deteriorating commodity prices have fallen recently and as Goldman Sachs notes, this suggests some downside risk to existing commodity price expectations. With this in mind, the broker intends to use the upcoming LME Week starting on October 3 as an opportunity to gauge sentiment from both producers and consumers.

Leading into this Goldman Sachs has attempted to determine what is an appropriate downside scenario assuming global economic growth falls below 3.5% in 2012 and stays below 4.0% in 2013. Weaker outlooks for Europe and the US contribute to such expectations and would imply weaker raw material demand in both economies.

With respect to China, Goldman Sachs continues to expect a relatively soft landing for the economy. This implies existing commodity demand expectations are already conservative, but for the sake of the analysis Goldman Sachs has factored in weaker demand as part of the potential downside scenario.

Under such a scenario all of the base metals would be in surplus in 2012 and 2013. While fundamentals remain strongest for copper, the metal has been trading a long way above cost support, so in a worst-case scenario there is potential to close what is still a US$1.50 per pound gap.

The mineral sands markets would remain in notional deficit, but Goldman Sachs suggests these markets would offer only muted potential for further price gains. Among the bulks, iron ore should remain in a notional deficit, while Goldman Sachs expects solid support given marginal production costs in China of around US$140 per tonne.

Similarly, Goldman Sachs expects thermal coal to remain well supported from a cost perspective, but there would be greater downside for metallurgical coal barring any fresh supply disruptions.

For the precious metals, Goldman Sachs expects gold to outperform thanks to its traditional safe haven role, while it appears unlikely platinum would trade at a sustained discount to gold. Palladium would likely perform worse than platinum as the market would be more likely to treat this metal as an industrial commodity rather than a precious metal.

This leaves Goldman Sachs's preferred commodities for the shorter-term as gold, mineral sands, iron ore and thermal coal. Medium-term, and assuming no major downgrades to 2012 growth expectations, copper, metallurgical coal, the platinum group metals, oil, zinc and the rare earths could be added to this list as these are among the more supply-constrained commodities.

Goldman Sachs continues to suggest avoiding pure play investment exposure to aluminium, alumina, nickel and uranium, as all of these commodities are seen as oversupplied in the market.

UBS has undertaken a similar analysis, comparing the current sell-off in commodity markets against what occurred during the GFC. Current price moves are modest in comparison to 2008 but UBS suggests GFC-lows offer an extreme floor scenario.

Marginal costs of production are also a key variable, as while spot commodity prices at present are still 75-180% above the GFC floor they are about 30% above the range of marginal costs of production.

Investors seeking a defensive position in the resources sector should look at the thermal coal, aluminium and gold sectors in the view of UBS, as downside appears most limited for these commodities.

Corresponding equity exposures include the diversified miners such as BHP Billiton ((BHP)) and Rio Tinto ((RIO)), Whitehaven Coal ((WHC)), Alumina Ltd ((AWC)), Newcrest ((NCM)) and Alacer Gold ((AQG)).

Assuming a recovery scenario then UBS prefers the commodities China seeks, which means copper, iron ore and zinc. Favourable equity exposures under this scenario include PanAust ((PNA)), Rio Tinto, Fortescue Metals ((FMG)) and Perilya ((PEM)).

One important point noted by UBS is resource company balance sheets are in much better shape now than was the case during the GFC, with many companies now enjoying net cash positions. Even allowing for scenarios of flat commodity prices going forward, the likes of Rio Tinto and BHP Billiton would still be on relatively attractive multiples.

The reduced downside risk seen for thermal coal prices would be expected to support earnings for Whitehaven, while earnings for Fortescue would fall more significantly given the company's current cost base and finance costs.

Given the sharpness of the recent falls in commodity markets, Macquarie has assessed the market to see how much of the price declines can be attributed to US dollar strength and how much is due simply to weakness in a particular commodity.

The analysis is timely as during most of August and September currency markets had been relatively stable, but in recent sessions the commodity currencies have weakened and there have been ever sharper falls in emerging market currencies.

For copper, Macquarie notes commodity currencies haven't been able to offset the price declines experienced since the start of August. Currencies have had some impact though, as the decline in Australian dollar or Chilean peso terms has been around half that seen in US dollar denominated prices.

It is a similar story in the gold market, as while the price has started to fall in US dollar terms, Macquarie notes prices have been relatively stable in Australian dollar terms and have actually risen in South African rand terms.

While iron ore prices are now looking more vulnerable given a weaker outlook for Chinese construction activity, Macquarie points out prices in Australian dollar terms are 10% higher since the start of August and almost 20% higher in Brazilian real terms over the same period.

This leads Macquarie to suggest if exchange rates were to hold around current levels iron ore prices would need to fall to US$161 per tonne for Australian producers to be worse off now than at the start of August. If such a price fall was to eventuate, Macquarie expects there would also be an impact on Chinese domestic supply.

Macquarie's finding is while looking at currency prices in this way makes little difference in the near-term given poor market sentiment, movements attributable to currency markets and the US dollar in particular relative to weakness in a specific commodity will be important once the market settles down.

Looking specifically at iron ore, Citi takes the view the market is showing the first signs of weakness. This reflects Chinese steel output falling 1% in month-on-month terms in August, which has resulted in iron ore port inventories rising to a record level of 94.3M tonnes or 34 days of cover. This level is the highest since the GFC.

While the outlook for the market remains constructive, Citi suggests the current environment means there is limited upside to iron ore prices for the final quarter of this year. But a still tight seaborne market and macro indicators suggesting a soft landing for the Chinese economy should keep iron ore demand from collapsing.

As a result, Citi has not adjusted its short-term iron ore price target of US$165 per tonne. The broker's 6-12 month target is also unchanged at US$150 per tonne.

Credit Suisse has looked at the iron ore market slightly differently, attempting to assess an appropriate pecking order for the Western Australian pure iron ore plays in the current environment.

From being the most preferred prior to the market downturn Credit Suisse now suggests Fortescue is the highest risk play, as iron ore price weakness could impact on the company's planned aggressive expansion plans. Credit Suisse estimates Fortescue would need to scale back its spending plans at iron ore prices between US$130-$140 per tonne.

On the other hand, while Atlas Iron ((AGO)) is also a growth stock the company does not have similar financing concerns as planned expansion will require low levels of capex. This will allow Atlas to remain net cash rich.

The change in conditions means Mount Gibson ((MGX)) now looks relatively defensive, even with a relatively short mine life, the absence of a growth strategy and corporate governance issues. As Credit Suisse notes, these factors are offset by high cash levels and improved valuation from recent share price weakness. Credit Suisse sees little attraction in Gindalbie ((GBG)) at present, as the company is entering the higher risk ramp-up stage.

This means in order of preference at present, Credit Suisse regards Mount Gibson as probably the safest, followed by Atlas, with Fortescue the highest risk play at present given the potential for a funding shortfall.

Credit Suisse has made no changes to recommendations on the stocks, ascribing Outperform ratings to all four companies. By way of comparison, Sentiment Indicator readings according to the FNArena database stand at 1.0 for Gindalbie, 0.9 for Fortescue, 0.8 for Mount Gibson and 0.7 for Atlas Iron.

Turning to coal, RBS Australia notes feedback from market participants suggests physical trade, pricing and the outlook are still resilient, especially for thermal coal. In contrast RBS suggests a more cautious approach is justified, as it appears only supply constraints in Queensland are maintaining tension in quarterly pricing.

Given an expectation prices will cycle for longer than had first been expected and to account for the view cost escalation will continue in the Australian and Chinese coal sectors, RBS has lifted coal price forecasts.

Long-term price estimates now stand at US$180 per tonne for hard coking coal and US$100 per tonne for export thermal coal. These compare to previous respective forecasts of US$145 per tonne and US$80 per tonne.

In annual average price terms forecasts for hard coking coal have increased by 36% to 68% through 2014, RBS now expecting prices of US$305 per tonne in 2012, US$275 per tonne in 2013 and US$285 per tonne in 2014.

For thermal coal the increases to forecasts have been 18% to 21% over the same period, leaving forecasts at US$115 per tonne, US$105 per tonne and US$100 per tonne respectively.

Factoring in the changes sees RBS adjust earnings and price targets across the sector, with targets increasing for Macarthur Coal ((MCC)) and Aston Resources ((AZT)) and falling for Whitehaven and Gloucester Coal ((GCL)). There is no change to the target for New Hope Corporation ((NHC)).

Recommendations are unchanged, RBS rating all the above stocks as Buy with the exception of Macarthur, which is rated as Hold. Of the Buys, New Hope is regarded by RBS as the most compelling defensive exposure in the sector.

Citi has similarly reviewed the coal sector, continuing to take an optimistic view on Asian demand given Chinese imports should remain high and Japanese demand should improve as the impact of the earthquake in March fades.

While US coal exports are currently weakening Citi suggests this is no surprise, as the US is the swing producer and had lifted exports earlier in the year to fill a void in the market left by the flood induced fall in Australian exports.

Indicators continue to point to strong import demand for met coal in Citi's view, but the current macro environment is likely to weigh on near-term spot prices. The sector's long-term supply issues should help

contract prices hold up, so Citi sees limited downside from current levels for quarterly contract prices through 2012.

In dollar terms, Citi expects 4Q11 met coal contract prices to settle at US$280 per tonne, while the broker's 12-month price target is US$270 per tonne.

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Material Matters: What Are The Risks For Commodities Demand?

- Chinese property a risk for commodity demand - Orders of preference in commodity markets - Differing views on base metals - Alumina prices expected to remain firm

By Chris Shaw

Chinese property stocks have fallen 33% this month, performance that highlights the concern of JP Morgan the sector has become over-extended. This implies some meaningful downside risk for demand for commodities, argues the stockbroker.

JP Morgan's research shows private sector housing sales are falling behind target levels, cash conversion is falling and gearing is rising. The likely response is developers will cut production, which could translate to an 8% fall in steel demand if starts drop to the current level of sales. JP Morgan notes in 2010, 35% of Chinese steel consumption was housing related.

Other drivers of demand appear unlikely to fill up any slack resulting from lower residential construction levels in JP Morgan's view. The infrastructure sector faces balance sheet issues, capex for the railway sector appears to have peaked and credit restrictions are also hitting commercial real estate activity levels.

While stocks exposed to Chinese metal demand have pulled back during the recent correction, the falls have not been by much more than markets generally. In JP Morgan's view, if Chinese demand softens it is hard to see how mining shares could outperform. As a result, JP Morgan continues to recommend an Underweight position on the Australian resources sector.

Further on its analysis of the potential impact of lower global economic growth on commodity markets, Goldman Sachs has run some numbers on a scenario assuming global GDP growth forecasts are downgraded to below 3.5% in 2012.

Under such a scenario Goldman Sachs sees gold stocks as beneficiaries, as gold would be expected to outperform in the event of a sustained period of economic weakness. In contrast, base metal stocks would see earnings and valuation downgrades to varying degrees, the differences depending on the currency in which earnings were reported and what levels of by-product credits were produced.

The impact on mineral sands stocks would be varied, with Iluka ((ILU)) a beneficiary from the weaker Australian dollar assumptions of such an economic scenario. In general, Goldman Sachs would expect mineral sands equities would outperform those of the base metals in a lower growth scenario.

In terms of how this impacts on the commodities' order of preference, gold and mineral sands would continue to be Goldman Sachs's top picks. From a longer-term perspective those commodities where there is structural tightness, which includes rare earth metals, copper, zinc and the platinum group metals, would be next in line, while nickel and aluminium should continue to be avoided in the view of Goldman Sachs.

RBS Australia has updated commodity and foreign exchange forecasts, trimming base metal estimates by 2-8% in the near-term while lifting precious metal estimates by 7-29%. Long-term forecasts have increased by 13-20%, these changes reflecting the view ongoing unit cost inflation and growing capital costs for new projects will need higher long-term incentive pricing.

The changes impact most on the mid-cap base metal stocks covered by RBS. Targets have been reduced, with the target for PanAust ((PNA)) falling to $4.32 from $4.82, for Discovery Metals ((DML)) to $1.30 from $1.43, for Mirabela Nickel ((MBN)) to $2.03 from $2.21 and for Intrepid Mines ((IAU)) to $1.62 from $2.70.

Ratings are unchanged, RBS ascribing Buys to PanAust, Mirabela and Intrepid and a Hold rating to Discovery. PanAust is offering value at current levels in RBS's view as the current market cap implies a flat copper price into perpetuity of US$2.40 per pound and means no value is being priced in for development or exploration upside.

Operationally Mirabela appears to be achieving a turnaround, a trend RBS suggests could help avoid potential balance sheet stresses. Intrepid's joint venture structure at the Tujuh Bukit project remains an issue but the risk/reward metrics are considered compelling at current levels, while commissioning at Boseto is some cause for concern at Discovery.

Given current market conditions, Macquarie takes the view the order of preference among the base metals should be aluminium and zinc ahead (!) of copper. This partly reflects price performance over the past few years, as while base metal prices in general are up by less than 90% since the GFC, copper prices have risen by more than 150% higher over the same period.

Copper's gains are not such a surprise given the metal offers the most compelling investment proposition from a fundamental perspective according to RBS, as the market is in deficit and is likely to remain so through next year. Helping this is copper supply continues to fall short of expectations.

But at the same time RBS suggests the copper price presents the most significant fundamental downside risk, as prices remain far above the industry's marginal cost. This means prices could fall further without impacting the supply-demand balance of the market.

In contrast, prices for both aluminium and zinc are already below the marginal cost of production. At the same time, the two markets are showing some positive signs such as solid demand, a moderation in production and positive physical market price signals.

As well, RBS notes while aluminium and zinc stocks are high they are not easily accessed given ongoing carry trades are keeping metal in storage and de facto limits on withdrawals from LME warehouses. This is keeping physical markets closer to balanced.

In RBS's view, if aluminium and zinc prices continue to sink there are likely to be cuts to production, so tightening market balances. This should provide support for a price recovery, making both metals look increasingly attractive from a fundamental perspective.

US based Hallgarten and Company has also looked at zinc as well as lead, noting recent weakness has both metals trading below recent highs. This suggests some unappreciated potential for zinc in particular, as prices remain reasonably well supported as at levels under US70c per pound most producers are losing money.

Prices are unlikely to stay at such levels according to Hallgarten, as zinc production is falling as few new mines are appearing on the horizon. At the same time, Chinese import demand for the metal is expected to continue to increase as domestic output remains inadequate.

When diminishing supply from ongoing mine closures is added to the equation, Hallgarten expects the zinc price will soon trade above US$1.00 per pound level on a consistent basis. From a 12-month perspective the forecast is US$1.10 per pound or higher, while from a 2-3 year perspective Hallgarten expects prices of better than US$1.50 per pound.

While lead prices have been more resilient than zinc in recent years, Hallgarten sees scope for lead's price lead over zinc to erode over time. This reflects the fact an expansion in zinc demand could come from a number of sources but there are less price motivators for lead.

ANZ Banking Group's commodities research team has turned its attention to alumina, taking the view prices should remain firm in coming years even though there will be limited demand growth from outside of China.

China itself is largely self-sufficient in alumina and should remain so even as smelter expansion drives demand increases. They key factors for ANZ are ongoing bottlenecks in bauxite and high Chinese marginal costs, which together should support alumina prices well above long-term averages. The spot price is

currently around US$400 per tonne, which compares to a long-term average price of around US$307 per tonne.

The pricing mechanism for alumina has seen a shift away from benchmark prices, even as consumers have been slow to accept the change to index-based pricing. In the view of ANZ, alumina and aluminium will maintain their price relationship going forward, even as traditional pricing methods are abandoned. As the pricing environment changes, ANZ expects both consumers and producers will be able to develop new hedging alternatives in the alumina market.

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Material Matters: Copper's Supply Issues, Oil Price Expectations, Oz E&C Sector

- Supply side issues persist in copper - Oil prices expected to range trade - Updates on Australian developers and contractors

By Chris Shaw

The current focus in the copper market is on downside demand risks in China, the US and Europe but Macquarie suggests it is important to remember ongoing poor supply performance has also been an important contributor to market tightness.

On Macquarie's numbers, global mine production growth has averaged only around 1.5% per year since the copper price began to boom in 2005. The current year is not expected to be any exception, as mine production is likely to show little growth in 2011 thanks to nearly 600,000 tonnes of supply losses.

Much of the lost supply can be attributed to a strike at the Escondida mine, but Macquarie notes Chinese production was down 8.7% a year in August and total Chilean production has fallen 5% in year-on-year terms for the first eight months of the year.

Challenges to supply increases such as declining grades and project delays are expected to continue, so there is no change to the forecast of a small deficit between global supply and demand in 2012. The size of the deficit will depend on both supply performance and the extent of any Chinese re-stocking.

In oil, JP Morgan sees a number of factors potentially impacting on the path of the oil price into 2012. On the supply side these include the return of supplies from Libya, with scope for output from that country to reach 1.3 million barrels per day by the end of next year.

As this is coming at the same time as rising supply from Iraq and non-OPEC producers, JP Morgan sees scope for supply to increase by about 1.9 million barrels per day relative to current levels.

At the same time, weaker global economic growth expectations lead JP Morgan to suggest oil demand growth next year may come in at around one million barrels per day, meaning the market would need to re-balance by an amount of around 0.9 million barrels per day from current levels.

This suggests to JP Morgan prices for Brent crude should remain in a range of US$100-$120 per barrel, even as the market re-balances. As an example of this re-balancing, JP Morgan notes there are proposed refinery closures of 700,000 barrels per day in the US and 200,000 barrels per day in Europe expected in the coming year, offset by an addition of 810,000 barrels per day of capacity in Asia.

This re-balancing process is likely to increase the pull on Atlantic Basin crudes from Asian refineries by around one million barrels per day. JP Morgan expects this will increase the pressure on a potential narrowing of the sweet/sour crude spread.

At present JP Morgan suggests short-term risks for the oil price are skewed to the upside, this due to North Sea production issues and the fact it will be several months before significant additional supply from Libya hits the market. But moving into the second half of 2012 JP Morgan suggests the Brent/Dubai spread could compress, to the extent that Dubai prices might trade at a premium occasionally.

Similar to JP Morgan's view, Barclays Capital also sees little in base case assumptions to imply any large changes to oil price estimates are required at present. This base case assumes an 80-85% chance economic policy failure is avoided.

In 2011 Barclays notes oil prices have been capped on the upside by supply fears and macroeconomic issues, while downside protection has come from strong fundamentals in the physical market, narrowing spare capacity and disappointments in non-OPEC supply growth.

This means assuming only an economic slowdown, the oil market should stay relatively tight. The 15-20% chance of a different outcome remains the major concern, Barclays noting this is resulting in the market currently behaving in an irrational manner by reacting to headlines falling in the 80-85% scenario as strongly as those relating to the 15-20% scenario.

In terms of market fundamentals, Barclays notes the degree of excess demand in 3Q11 has been so large even the release of significant government stockpiles has not been enough to balance the market. With space capacity also low, market volatility has increased.

Given the more likely outcome of an economic slowdown, Barclays expects Brent crude prices should comfortably average more than US$100 per barrel this year. West Texas Intermediate is expected to remain at lower levels given an expected 3Q11 average of about US$90 per barrel.

Returning to the Australian market, Deutsche Bank has attempted to assess current and expected conditions with respect to labour supply in the Australian resources sector. Deutsche suggests a labour shortage is likely if planned resources capex plans proceed.

Assuming these shortages eventuate, Deutsche suggests project delays and low industry growth rates are likely. Most likely to be affected are smaller projects and the oil and gas sector, as both have disadvantages in terms of attracting labour.

This potential for labour shortages has the potential to impact on resources sector industry growth rates and Deutsche has lowered its forecasts to reflect this view. While industry forecasts are for growth of 12-24% annually over the next few years, Deutsche now expects growth of 5-10%.

Added to this have been changes to Deutsche's foreign exchange forecasts, the end result being adjustments to earnings forecasts for the major developers and contractors listed on the Australian market.

The changes to forecasts flow through to modest adjustments to price targets, though Deutsche's ratings on the stocks are unchanged. Buy ratings are ascribed to Leighton Holdings ((LEI)), WorleyParsons ((WOR)) and Boart Longyear ((BLY)), while the broker rates UGL ((UGL)), Downer EDI ((DOW)) and Transfield Services ((TSE)) as Hold.

By way of comparison, the FNArena database shows Sentiment Indicator readings for the stocks of 0.9 for Boart Longyear, 0.7 for UGL, 0.5 for Transfield, 0.4 for both Downer EDI and WorleyParsons and 0.1 for Leighton Holdings.

Goldman Sachs has also looked more closely at the engineering and construction sector, maintaining a positive view given record levels of planned resources capex spending. At present, planned capex projects total $210 billion, while less advanced projects suggest additional capex of around $170 billion.

Dominating the expected work is the LNG sector, accounting for around 70% of definite projects over the next few years. The sheer magnitude of this pipeline suggests a solid scope for work levels for Australian engineering and construction companies.

This elevated level of work should allow companies in the sector to achieve improved project pricing, which should also boost margins. At the same time, Goldman Sachs expects an improvement in earnings visibility in the sector.

In terms of how best to play the sector, Goldman Sachs prefers Boart Longyear, UGL and WorleyParsons among the larger cap plays. Among the small to mid-cap plays, the broker's preferences are Sedgeman ((SDM)), Imdex ((IMD)) and Ausenco ((AAX)).

In ratings terms, Goldman Sachs has Buy ratings on UGL and Boart Longyear among the larger cap plays and Hold ratings on Leighton, WorleyParsons, Transfield and Downer EDI. At the smaller end of the market

Goldman Sachs rates Ausenco, Bradken ((BKN)), Imdex, Norfolk ((NFK)) and Sedgeman as Buy, while rating Monadelphous ((MND)) and WDS ((WDS)) as Hold.

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Top Ten Weekly Recommendation, Target Price, Earnings Fore

By Chris Shaw

It has been a relatively quiet week for ratings changes for Australian equities, the eight brokers in the FNAre
over the past seven days. This leaves total Buy ratings unchanged at 58.7%.

Among those stocks seeing upgrades during the period were Sigma Pharmaceutical ((SIP)) following a better
given better than anticipated full year earnings.

Other upgrades were centred on resource stocks such as Oz Minerals ((OZL)), Kingsgate Consolidated ((KCN))
((PDN)) following revisions to commodity price assumptions. Sandfire Resources ((SFR)) also saw an improvem
Buy rating.

On the downgrade side of the ledger both Premier Investments ((PMV)) and Myer Holdings ((MYR)) scored dowr
results and expectations of ongoing difficult trading conditions.

Initiations with Hold ratings for both Intrepid Mines (IAU)) and Discovery Metals ((DML)) have brought down
resulted in cuts in ratings for Iress ((IRE)) and Oakton ((OKN)). Mirvac ((MGR)) has also been downgraded on va

The reviews that generated rating changes for Sigma, OceanaGold, Kingsgate, Sandfire, Mincor, Western Are
targets for Newcrest rose on the back of increases to gold price forecasts and for Panoramic Resources ((PAN
coal price forecasts have seen increases to both estimates and price targets for New Hope ((NHC)).

For the same reasons as ratings were cut, targets have come down for Intrepid, Myer, Oakton, Premier
Independence, Paladin and Oz Minerals among resources stocks.

The cut in target for Paladin comes despite an increase in earnings forecasts, while a new contract win ha
increases to earnings estimates generally reflect revisions to commodity forecasts and so impact the likes of N

Earnings forecasts were lowered for Gindalbie ((GBG)) post the company's full year profit result, while slightly
saw a trimming of earnings forecasts as well.

Other cuts were largely the result of either weaker profit results for the likes of Myer and Premier Investmen
Estimates for Kathmandu ((KMD)) were trimmed given increased capex assumptions and challenging retail con
ratings.

Total Recommendations Recommendation Changes

Broker Recommendation
Suisse,Deutsche<*br*>Bank,JP<*br*>Morgan,Macquarie,RBS<*br*>Australia,UBS&b0=125,122,131,101,88,147,197
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Recommendation Positive Change Covered by > 2 Brokers Order Symbol Previous Rating New Rating Change R
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17.0% 33.0% 16.0% 6 10 PDN 43.0% 57.0% 14.0% 7 Negative Change Covered by > 2 Brokers Order Symbol Previc
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DML 33.0% 25.0% - 8.0% 4 Target Price Positive Change Covered by > 2 Brokers Order Symbol Previous Target N
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1.275 - 19.05% 4 5 MYR 27.014 24.650 - 8.75% 8 6 TEN 8.475 8.150 - 3.83% 8 7 PMV 40.810 39.277 - 3.76% 6 8 k
ALL 11.000 10.750 - 2.27% 8 Technical limitations

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Weekly Broker Wrap: Recession Is Coming

By Rudi Filapek-Vandyck

The eurozone is heading for recession, possibly as early as the final quarter of this calendar year, which starts next week. This is not my view, but one that is increasingly popping up in stockbroker research around the globe. And yes, sad to say but I have to admit: I concur. So the Big Question then becomes: will this affect the rest of the world and how badly?

Here opinions remain divided. Some experts at prominent household names including BNP Paribas, Societe Generale, Morgan Stanley and Royal Bank of Scotland have already warned their clientele to position investment portfolios for global recession next year, but this is as yet not a global consensus view. What does seem a prediction carried by an overwhelming majority is that the next few months will remain challenging for risk assets in general. Some strategists have all but given up on prospects for a sustainable rally between now and mid next year. US strategists at Morgan Stanley issued an eye catching report this week carrying the title "Hope is not a strategy". The strategists suggest investors should sell shares in any rallies because things are likely to get uglier before they get better.

Whether this is bad news depends on investors' portfolios, intentions and horizons. Market strategists at GaveKal, for example, believe crude oil "looks set for a sizeable reckoning", and yes, commodities across the world, including grains, industrial metals and precious metals have now started to follow equities into a relentless downward cycle. But GaveKal's Charles Gave also believes "the coming months are going to be one of the best times in investment history to accumulate good-quality equities".

Which is probably why the following quip seems so appropriate: how does one recognise an investment genius? He who has cash available at the end of a bear market!

A recession in Europe will have direct short term consequences, starting with a new loosening cycle for central banks in the region. Already, predictions are being made about pending interest rate cuts in Norway, Sweden, by the European Central Bank (ECB) and potentially across Emerging Markets in Asia as well. The jury is still out whether central banks in China and in Australia will join in too, but the obvious observation stands: there's a new trend in global interest rate forecasts and it is quickly gaining pace amongst the world's financial experts.

All this has made for some serious reshuffling in FX experts' forecasts and preferences. In Danske Bank's view, the underlying message for FX speculators has now become clear: sell the EUR against USD, GBP and NOK and sell AUD/USD and NZD/USD on days where there is relief on the stock market. Gone are forecasts of 1.15 or even higher for the Aussie against the greenback. Instead FX predictions are now mentioning "below parity for a while" and "targeting 90c".

The changed dynamic in FX markets has caught some experts by surprise. Macquarie, which as yet is only forecasting slower growth, not a recession anywhere, this week revised its AUD/USD forecasts upwards with negative implications for mid-tier and small oil companies in Australian in particular. In Macquarie's defense, the analysts do concede the immediate outlook for the Aussie does look wobbly on a three to six months horizon, but Macquarie maintains the view that stronger for longer will remain the theme for AUD in years to come (carried by ongoing strength for commodities prices in general).

Macquarie strategists also issued research based on historical data suggesting equity markets are -believe it or not- at present in a sweet spot with history showing the period from October to April tends to generate noticeably better results than the rest of the year. The Big Question remains, of course, with investors taking an ever so negative view on developments in Europe and on the outlook for the global economy next year, whether history will stay on course this time around as well?

Meanwhile, it would appear the stockbrokers' favourite pastime has turned into trying to determine how much downside is left for equities and for commodities, and how much negative news has already been priced in? On Goldman Sachs' assessment, industrial companies in Australia, including the banks, are now priced for no growth into perpetuity, which suggests value galore (see also GaveKal above). Strategists at Citi and at Deutsche Bank would like to agree, but as long as economic and earnings forecasts across the globe remain in a downtrend, there simply seems little valuation support, let alone a positive catalyst, is their argument.

Citi's call is that earnings forecasts will have to stabilise first before share prices can do so too. Deutsche Bank believes earnings forecasts for industrial companies in Australia will settle in the 5-10% growth range for FY12. As current consensus forecasts assume 14% growth, this implies more adjustments need to be done by stockbroking analysts. Data provided by Deutsche Bank also suggests earnings estimates in Australia are currently battling with more downward pressure than elsewhere, with one sole exception: Europe. I'd like to put forward this probably explains as to why the Australian share market is significantly underperforming most overseas markets.

In a report on Australian small caps stocks, analysts at Credit Suisse predict that, as platonic shifts are taking place in and around Australia, formerly out-of-favour sectors could start outperforming. While acknowledging finessing the timing of this occurring is challenging, CS analysts suggest investors should put the following small caps on their radar: Virgin Blue ((VBA)), Adelaide Brighton ((ABC)), GWA Group ((GWA)), APN News & Media ((APN)), Wotif.com ((WTF)), Cabcharge ((CAB)), Programmed Maintenance ((PRG)), Flightcentre ((FLT)) and OrotonGroup ((ORL)).

In what might well turn out another case of bad timing, analysts at Citi initiated coverage on some junior copper companies this week. Citi remains positive on copper's longer term outlook, but the analysts also believe upside potential for non-producing junior companies doesn't stack up against the risks involved. Citi's advice for investors is to thus stick with actual producers PanAust ((PNA)) and OZ Minerals ((OZL)). The analysts also have a Buy rating for Sandfire ((SFR)) which is the exception amongst non-producers in the stockbroker's view.

Finally, I'd like to introduce the Rotten Tomatoes Award for research that simply isn't worth the paper it was printed on. Quant analysts at JP Morgan have tried to identify "fundamentally defensive" stocks in the Australian share market, but one quick look at the outcome of their hocus pocus with data is sufficient to know this is one piece of research that would have been better left unpublished. Any exercise that directs investors towards names such as Cochlear ((COH)), Fortescue ((FMG)) and Atlas Iron ((AGO)) is seriously flawed. I would like to think I am not the only one to see why.

The share price for Atlas Iron just lost more than a quarter of its value in only a matter of weeks, while the losses for shareholders in Cochlear are even bigger since April this year and it remains yet to be seen whether the share price won't reach for $40 first before clawing its way back to what now looks a near unimaginable $84. Compared with these two examples, the historically volatile Fortescue Metals -down from $6.75 earlier in the year to below $5 and falling- almost looks like a low volatility safe haven, but of course it isn't. One simply cannot change the inner nature of the beast.

Investors looking for safe havens need not look further than actual price action. Supermarket operator Metcash ((MTS)) is still trading around price levels from April, when the share market peaked, plus the stock is offering a fully franked dividend of 6.8%. Stocks like Telstra ((TLS)), Domino's Pizza ((DMP)) and ARB Corp ((ARP)) have held their ground as well. Maybe someone could explain JP Morgan analysts the true definition of "fundamentally defensive"? Unfortunately, we have seen too much flawed fairytale research of late. The Australian dollar is a new safe haven is yet another theory that was quickly exposed as myth, with the currency losing US6c in 48 hours.

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What's Wrong With October?

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

By Rudi Filapek-Vandyck, Editor FNArena Popular delusions. The share market is full of them, as are most other financial markets, by the way. Remember "So goes January, so goes the year"? We haven't heard much about that piece of colloquial "wisdom" lately, despite January providing investors with a positive signal at the start of the year. Could this be related to the fact that most equity markets are lower for the year and we have yet to find out how September and October -the two most feared months on the calendar- are going to impact on global equities? So far we're down for September, and in Australia we're also significantly down for the year thus far (-14%). As the world is commemorating the demise of Lehman Brothers, now three years ago, which triggered one of the most savage sell-offs ever witnessed the following month in October 2008, should investors be worried about what next month might bring? After all, there's plenty of risk material around these days, starting with a potential recession in the US and disintegration of the eurozone? The month October has a fearsome image amongst investors. One quick look at the twentieth century immediately reveals where those fears stem from; October has hosted some of the better known, savage market sell-offs over the past one hundred and four years. It was in October 1907 that the US experienced a run on the banks coupled with panic in the stock market. A consortium led by John Pierpont Morgan at the time brought calm and stability, effectively operating similar to the Federal Reserve today (there was as yet no Federal Reserve back then). In October 1929 the great bull market of the 1920s came to an abrupt end with US equities dropping 23% over two days. 59 years later, in October 1987, Black Monday saw a 22% sell-off on one single day. And then, of course, there was that dreadful month post the Lehman collapse when markets froze and authorities had yet to act decisively. At one point during that month, US equities were down by 27% for the month. In Australia, the ASX200 index had just fallen through the 5000 level in late September. By late October it had barely scrambled back above 4000. A few weeks later it was solidly below 4000. With such a track record, it is no wonder the mentioning of October usually puts fear into an investors' mind, especially when combined with September, the month carrying the dubious label of worst month for the year in terms of average historical returns. Actually, September's historical performance is negative so it is not difficult to fathom where investors' discomfort comes from this time of the year. However, look beyond these historical crashes (while of historic proportions each, there's only four of them, in 104 years) and a different picture emerges for the month October, one that often sees equities bottoming at the end of a tough ride, and rallying instead. Indeed, while October is never mentioned in terms of "bull markets" or "rallies", history shows the month has a solid track record for starting both, which raises the obvious question: why are we so afraid of October because of a few negative events, while the overall balance is merely positive? Historic data show October delivers a positive return about two out of every three years. History also shows weak September performances are often followed by equities reaching a bottom in October, followed by rallies higher. As such, October is in some circles known as the "Bear Breaker"; the month has a track record for finding a bottom and setting equities up for solid rallies higher. For example, after Black Monday in 1987 investors would have done well buying into a significantly weaker share market. Similar conclusions can be drawn from October experiences in 1990 and 2001. What about in more recent times? To refresh everyone's memory, including mine, I have lined up the various September-October experiences between 2002 and 2010: 2002: Sep = sell off, Oct = bottom, shares end month higher, Nov + Dec = sideways 2003: Sep = sell off, Oct = bottom + rally, Nov = sell-off, Dec = rally 2004: Sep = gains, Oct = further gains, Nov + Dec = further gains 2005: Sep = rally, Oct = sell-off, Nov = rally, Dec = rally 2006: Sep = volatile, Oct = rally, Nov = pause, Dec = rally 2007: Sep = rally, Oct = volatile but higher, Nov = sell-off, Dec = sell-off 2008: Sep = pause, Oct = sell-off, Nov = more weakness, Dec = pause 2009: Sep = rally, Oct = sell-off-rally-sell-off, by month's end weaker, Nov = volatile but higher, Dec = rally 2010: Sep = volatile but higher, Oct = volatile but higher, Nov = sell-off, Dec = rally A few obvious observations can be drawn: 1. Six positive performances have been offset by three negative performances which is in line with longer term average data: two out of every three years tend to be positive. It has to be acknowledged though, the past four years saw two negative performances and two volatile performances, so maybe the times of simply witnessing a rally taking off in October are no longer upon us? 2. September appears to be acting as an opposite indicator; a weak September tends to be followed up by a positive October and vice versa. 3. It

would appear, on the basis of the experiences of the past nine years, that investors might have to worry more about what might happen in November instead of October? Below is the 2002 chart which comes closest to October's "typical" offset of a weak September month. The second and third charts are from 2009 and 2010 when the traditional pattern is nowhere near to be found. (I will post the other seven charts in a separate news story on the website tomorrow): As far as seasonalities go, I personally prefer April which, year-in-year-out, tends to mark a decisive change in the underlying trend for various assets. Both this year and in 2010 April put a stop to uptrends for crude oil, base metals and for global equities. No wonder as to why analysts are nowadays talking about how accurate "Sell in May and go away" has proved two years in a row. (This story was written on Monday 19th September, 2011. It was published in the form of an email to paying subscribers on that day).

China: More Than Meets The Eye

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

By Rudi Filapek-Vandyck, Editor FNArena

Earlier this year commodities analysts observed China's monthly manufacturing index was noticeably at a lower level than usual. This, some analysts suggested, proved the government in Beijing had a firm control on overall financing and economic activities inside the Middle Kingdom and government policies had now all but flattened the usual seasonal patterns that had characterised Chinese data and demand in the years prior to 2011.

I found this a strange reasoning in May this year and I still find it strange today.

When I looked at the same charts my initial thoughts were China's gradual tightening is slowing down the economy, not the government is flattening out seasonal patterns. My view has been vindicated since with this month's HSBC Flash PMI for China indicating the manufacturing sector remains in mild contraction for the third consecutive month.

This does not mean the Chinese economy is headed for a hard landing. Personally, I believe financial media are too much focused on potential extremities -hard landing or not- while stockbrokers and market commentators allow themselves to be sucked in. The real message that is emanating from Chinese data is the same message that still applies today: China is transforming towards a gradually lower gear of growth. Whether investors like it or not, this will have consequences elsewhere.

Firstly, let's have a look at China's main growth engine in years past as this will instantly show why too much talk about a pending hard landing for China is just that; too much talk. With economies in Europe, the US and elsewhere faltering post the Lehman collapse, the Chinese authorities used local banks and the current account surplus to solidify economic growth by ramping up infrastructure projects worth trillions of dollars. Not all funds were wisely spent as witnessed by the YouTube revelations about Chinese ghost cities, but the policy did protect China from joining Europe and the US into the financial abyss and in fact, it has helped Greater China and the rest of the world in successfully dealing with the US deflationary fall-out.

The policy is not a perpetual medicine, however. It is in the same breath the reason why many an economist feels at least a little uncomfortable with China's economy becoming the hope for many others elsewhere, including in Australia. China is not unique. Not so long ago Japan and Korea went through a similar phase, and before that it was Germany. One hundred years ago the US went through a similar growth phase. What makes China unique today is the uncomfortably high reliance of the economy on ongoing strong investment spending. This is why the likes of hedge fund investor Jim Chanos have been talking about the next crash waiting to happen.

In 2010 China was, against the odds, still growing at double-digit speed. Look at the details behind the reported GDP data and one sees an ever declining contribution of Chinese households and growing importance of infrastructure spending to sustain economic growth. Last year the investment-to-GDP ratio for the country reached 48.5%. This, economists point out, marked a new milestone for no other country in the history of mankind has ever shown a similar ratio. Japan and Korea, during their own fast growth phases, had ratios of 40%. China's is practically half of its (high) GDP growth.

Already a few negative consequences have come to the surface. Local government debt in China doubled between 2008-10 to reach RMB10.7tn, lifting total government debt to circa 45% of GDP (there's eternal discussion about these estimates and data with some economists putting the numbers at much higher levels, but let's stick with these for now). Also predictably, Chinese banks are starting to see a rise in doubtful and non-performing loans (another heavily discussed topic). Equally important, and equally non-surprising, the return on all these investments is in gradual decline.

The latter effectively makes the current policy of economic stimulus unsustainable. Earlier this month, China specialists at Citi concluded: "It becomes increasingly clear that aggregate demand created by low-yielding investment would increase government debt and banks' NPLs, and cannot support sustainable growth".

We all know the solution. Chinese growth has to switch from infrastructure spending to local demand from households and businesses. This is already happening, at slow pace, as the Chinese authorities know full well their current policy cannot be relied upon in perpetuity. Assuming the transformation goes smoothly, which is no sinecure with downward pressures on China's exports to Europe and to the US, economists the world around are virtually united in their prediction this will ultimately result in a Chinese economy growing at 5-6% per annum, instead of the 10-14% we have seen in years past.

China also has the additional problem that favourable dynamics from demographics have started to reverse. Labour costs are firmly on the rise. One way to deal with this challenge is through increased productivity and Chinese manufacturers are already embracing robotics and modern technologies, as well as through the development of a local services industry. The latter will become an important tool in developing internal demand, but economists also believe more services will equal lower trend growth as it is much easier to improve productivity in manufacturing than it is in services.

There is more than just a fair chance that what we are experiencing right now is the early stage of what will be a significant transformation for tomorrow's economic super power. The problem is, we cannot know for certain because the world's attention is firmly focused on Europe either imploding, or spiraling into recession, or both. Meanwhile, the jury is still out whether the US will remain in low growth mode, or whether the world's largest economy will experience its own recession (pulled down by Europe?) in 2012. And China? Well, as I stated in the opening sentences of today's story, China's growth is slowing down at a time when the existing policy of massive infrastructure investments are becoming less and less attractive, with inflation at elevated levels and labour costs on the rise.

For commodities, the main threat does not come from the inevitable transformation of China's internal growth dynamics, but from liquidity tightening measures by Chinese authorities and the People's Bank of China. As pointed out by many a China observer, these tightening measures are impacting particularly hard on small and medium sized companies in the country, and many have been forced to seek alternative routes to access cash as Chinese banks, on directive from Beijing, reined in their lending. Many of these alternative funding routes have a direct link to commodities, supporting my personal view that apparent commodities demand from China is partly fueled by "financial" demand. It remains anyone's guess as to how large exactly this financial demand is in the bigger scheme of things.

Anecdotal evidence suggests that at the very least there is potential for unforeseen mayhem were commodity prices to continue to weaken. The reason is the widespread practice amongst Chinese SMEs to acquire physical commodities and then arrange "inventory financing" through Chinese banks, which effectively gives them access to fresh cash. It doesn't take a genius to figure out that these types of financing deals come unstuck when the value of the underlying collateral -say a tonne of copper- decreases in value. Already, some analysts have started to become quite uncomfortable about this. After all, copper is down close to 30% from its peak earlier this year and it would appear the red metal was the crowd's favourite when setting up these deals.

For good measure: nobody knows exactly how big of a threat this "inventory financing" is or how important it can become, neither can we find out how far commodity prices have to fall to trigger a negative spiral from China. The only insights we have today are anecdotal, speculation or pure guesswork. But don't be surprised if we start reading more about this in weeks or months ahead.

(This story was originally written on Monday, 26th September 2011. It was mailed out on the day to paying subscribers of FNArena).

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http://www.tradingandinvestingexpo.com.au/special-offers/rudi-filapek-vandyck-offer/

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