Week
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Stories To Read From FNArena
Sunday, 20 March 2011

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Asian Equity Investment Requires Caution

- Asian stocks have been undervalued on US economic strength vis a vis Asian tightening - The potential is there for a strong June quarter - QE2 uncertainty nevertheless throws up risks - Australia is a foreign proxy for Asia

By Greg Peel

Asian equities have been a popular destination for foreign investment flows post-GFC given the disparity between soaring emerging market GDP growth compared to struggling developed market growth. However late last year the tide began to turn as it became apparent the US economy would not double-dip but was indeed recovering quite strongly.

It all comes down to monetary policy of course. The Fed introduced QE2 to re-stimulate growth at the same time China was tightening its policy in order to rein in runaway growth. In the meantime there is still no chance of a US rate rise in the foreseeable future and the jump in oil prices on the MENA unrest has had Asian central banks accelerating tightening efforts in order to head off inflationary pressures.

Thus according to investment headlines, funds have been flowing out of Asian markets and back into US markets, evidenced by outperformance of the S&P 500. The risk premium required to hold Asian equities has expanded, note the analysts at Singapore-based DBS Bank.

Yet actual funds flow data do not support any hysterical headlines, DBS suggests. Flows to end-January were actually larger than a year earlier if not as high as the recent peak, and appear now to have stabilised. Beijing might be aggressively tightening, but that expectation has now been adequately priced in. DBS suggests Asian equities remain supported by the extent of domestic liquidity and on valuation terms.

Indeed, DBS suggests the lower level of foreign funds flow coupled with rising Asian currencies as central banks fight inflation has meant foreign investors have “missed out” on solid returns due to their caution.

DBS suggests three reasons why Asian equities could further provide strong returns in the June quarter. First is the extent of risk premium now being priced into Asian equities which DBS believes is sufficiently stretched, such that a rebound from risk aversion is due. Second is the potential for oil prices to soon retreat as the MENA unrest fear abates, thus alleviating concerns over the high oil price impact on Asian growth. Third is the scheduled June end for QE2.

It is QE2 which is most critical as far as DBS is concerned.

While an end in QE2 suggests a reduction in the supply of US dollars, DBS can still see further weakening of the dollar if the end of QE2 foretells an end to the strength of the US recovery. DBS expects the US economy to grow at a quarterly rate below 3% which is contrary to consensus forecasts above 3%. To get over 3%, retail sales and industrial indicators need to be higher than they are now, DBS suggests.

A weakening of the US recovery and a weakening of the dollar post-QE2 is positive for both Asian equities as an alternative and Asian currencies (foreigners gain on both share price appreciation and currency appreciation). And we can also throw in Congressional pressure on the Obama Administration to reduce the budget deficit as potential for the US recovery to slow.

On the flipside however, if the end in QE2 results in a big jump in US bond yields (ten-year yield back to 4% plus) as Pimco's Bill Gross suggests then this will undermine the risk-weighted yields on Asian equity investment, DBS suggests. Greater returns will need to be offered if US Treasuries return to more attractive yields.

Could QE2 end without much of a reaction at all? DBS suggests it could if MENA unrest is still diverting attention. All global equities would have already pulled back. In theory, the Fed would only end QE2 if it thought the US economy was now recovering under its own steam, such that the private sector can take over the stimulus. But the Fed has already wagged its finger at the US government, hinting that there will not be any QE3 if the fiscal side of the problem is not swiftly addressed (ie budget deficit reduction). While not admitting it, no doubt Bernanke cannot disagree with Bill Gross that ongoing money printing is just a Ponzi scheme which must one day collapse if it is allowed to run on indefinitely.

DBS believes the MENA impact will prove to be only temporary, but acknowledges the risk that it may not. The end of QE2 offers opposing potential outcomes. So while Asian equities are offering value at present in DBS analysts' view, caution is suggested for investment in the June quarter.

Recall that the Australian market acts largely as a foreign proxy for Asian investment.

China's Inflation Problem

- Oil is China's biggest import - Oil price strength pushing inflation higher - Currency revaluation should follow

By Greg Peel

As Libya descended into civil war and Saudis threatened a Day of Rage, the price of Brent crude reached a peak above US$116/bbl. The Saudi protest did not materialise and thus took some of the heat off the oil price, but it is the immediate reaction to the Japanese earthquake, tsunami and nuclear disaster which sparked a fall in the oil price to around US$105/bbl before bouncing back to US$110.

That reaction is not necessarily a simple response based on the expectation of lower Japanese oil demand in the short term. It is a wider exit from risk at a time when nuclear meltdown fears are enough to encourage a shift out of the "risk trade" and back into cash. That gold should also be caught in the sell-off at a time of global fear is testament to the fact recent commodity price spikes are more about speculation than anything else. The MENA unrest has simply not, for example, caused a supply shock as yet. The same amount of oil has been flowing each day with Saudi Arabia in particular making up the shortfall from Libya.

But speculators see the risk of a supply shortage, and hence have piled in. Even before the MENA unrest began, the simple expectation of growing commodity demand out of the likes of China and India had commodity funds loading up on energy, food and metal trades. The irony is that these are often described as an "inflation hedge", yet the inflation is being generated by the speculation itself. Realistically this means "bubble".

For China, it means simple price inflation. Beijing can bitch all it likes about Western speculators (at least one US oil company CEO has suggested West Texas crude would be at US$50 instead of US$100 if you took out the speculation) but the reality is China is importing that inflation via its currency peg to the US dollar. Were Beijing to allow its currency to revalue to where it should realistically be trading, then price inflation would be wiped out in China. Australia, for example, has not suffered the same price-at-the-pump inflation as the US given the release valve of a rising Aussie dollar.

Food price inflation is often focused upon in China. Despite a rapidly growing middle class, there remains among China's more than a billion people a large proportion of low income earners for whom the weekly food bill is their largest proportionate cost. They are thus hit harder by a jump in the price of rice or pork, for example, than would be the case in Western countries. But the real inflation risk is undeniably oil. In 2010, China imported US$2.5bn worth of soy beans, US$4.5bn of copper, US$7.9bn of iron ore but a whopping US$15.7bn of oil, as ANZ's economists note.

China is now the world's second largest user of petroleum products after the US, consuming 8.9m barrels per day, ANZ notes. Like the US, China does have its own oil reserves but also like the US (and Australia), China consumes more than it produces. In 1993 China switched from being a net exporter to a net importer and now it imports 55% of consumption.

China has taken aggressive steps to reduce its oil intensity (ie increase efficiency) but still it consumes 81 tonnes of oil per thousand US dollars of GDP compared to the US on 60t and Japan on 39t. Given the extent to which China's economy has now moved along the maturity path, this figure is a poor score, ANZ suggests. And there is little doubt China's oil demand is on a rising trend.

Beijing has set an inflation target of 4% or lower. The latest monthly data showed a 4.9% reading in February – unchanged from January. Note that People's Bank of China monitors headline inflation (including food and energy costs) while other central banks, such as the Fed and RBA, seek to control only core inflation. US headline inflation remains very low despite the oil price, whereas large per capita oil consumer and high level

importer Australia is looking at headline inflation of only 3.6% at present given the floating exchange rate effect.

In another hangover from its communist days, China is also subject to consumer energy price controls. The government previously kept the price of petrol, for example, at a low level and wore the cost itself of price rises but too much strain was placed on the fiscal budget in the lead up to the 2008 oil price peak of US$147/bbl. This meant a couple of nasty step-jumps in price for consumers, but as oil prices once again sail above the US$100 mark even Beijing's interim solution – a shifting petrol price mechanism triggered once crude trades beyond a given range – is causing fiscal strain. Beijing marks its "world" oil price off an unpublished weighted basket of Brent, Dubai and Cinta (Indonesian) crude prices.

In the hope that the recent MENA-related oil price spike proves to be temporary, Beijing has even been holding off on those petrol price adjustments, meaning consumers have been subsidised at the expense of state-owned oil companies, ANZ notes. Where might the true level of Chinese inflation actually be? In 2008 China was forced to speed up its painfully slow currency appreciation to alleviate oil company losses, and ANZ suggests this could happen again.

In the medium term, suggests ANZ, Beijing could increase its strategic stockpiles of oil, and steps have been made to encourage private sector stockpiling to smooth the impact of price volatility. In the longer term, China needs to reduce its oil intensity and increase its reliance on other energy sources, especially renewables. Beijing's current plan is to increase the proportion of renewable contribution to 15% in 2020 from the current 8%.

In the short term however, it all comes down to just where the oil price is going to settle. More than half of China's oil imports come from only four countries – Saudi Arabia (19%), Angola (16%), Iran (9%) and Oman (7%). It's not exactly a Top Four of political stability at present. By contrast, the US imports more oil from each of Canada, Mexico and Venezuela than it does from Saudi Arabia.

Once again taking the immediate Japan-related volatility out of the oil price for now, ANZ is among those who believe there will not be an oil price pullback soon once things settle down in MENA. ANZ's forecast is for a Brent price of US$110/bbl by end 2011.

MENA may take a long time to settle down of course, and the situation can yet get a lot worse than now if deterioration of incumbent control is seen in the likes of Saudi Arabia, Iran or Iraq. Even if, for example, Gaddafi were to fall tomorrow, some analysts suggest it might take years before foreign oil companies are again prepared to risk their investment (and lives) to provide Libya with much needed assistance on further developing reserves and infrastructure. Then multiply that scenario across the whole MENA oil producing zone.

Returning to the Japan effect, once the initial commodity fund exodus has run its course, attention can then turn to just how much additional oil Japan might need to compensate for lost nuclear power production.

The reality is oil prices are currently very volatile and oil price inflation has become China's biggest economic threat (the property bubble doesn't seem to rate a mention anymore). The risk for Chinese trading partners such as Australia is the double-whammy of a high oil price drag on Chinese economic growth, and further monetary tightening to fight inflation.

Australia would not, however, suffer were Beijing to accelerate the appreciation of the renminbi in isolation. Australia's floating exchange rate squares the impact (via the US dollar) given greater Chinese purchasing power would offset the higher Aussie.

A Valemus Re-Rating For Lend Lease?

- Lend Lease completes Valemus acquisition - RBS Australia lifts forecasts to reflect the deal, retains Buy rating
- Expects a share price re-rating from FY12 earnings delivery

By Chris Shaw

The FNArena database shows brokers are marginally positive on property development, construction and management group Lend Lease ((LLC)), with three Buy ratings and four Hold recommendations among those covering the stock.

RBS Australia is one of the brokers with a Buy rating. The stockbroker has reiterated its recommendation to reflect Lend Lease's recent acquisition of Valemus. The deal has brought Abigroup, Baulderstone and Conneq into the Lend Lease fold, which RBS Australia expects will generate a higher base of regular income going forward. This is significant as Lend Lease as a property developer generally has a high level of earnings volatility.

The Valemus deal also means a higher proportion of group earnings will be generated from construction and project management. RBS Australia estimates earnings from these operations will now approach 50% of group earnings.

The other positive of the deal for RBS Australia was the price paid by Lend Lease, which the broker viewed as attractive. This is likely to become evident in terms of earnings improvement from FY12, so to account for the Valemus acquisition RBS Australia has lifted earnings forecasts.

Earnings per share (EPS) estimates for RBS Australia have increased by 2.4% in FY11 and by better than 15% in both FY12 and FY13. The changes represent expectations of a strong growth outlook for construction activity in Australia, as well as increased investment in infrastructure and population growth, meaning additional property development opportunities.

EPS forecasts now stand at 73.4c this year, 88.6c in FY12 and 106c in FY13, which compares with consensus estimates according to the FNArena database of 68.1c in FY11 and 84.5c in FY12.

This upside potential is one factor behind RBS Australia's Buy rating, as the broker expects delivery of expected earnings in FY12 will likely see a significant re-rating of the Lend Lease share price.

Another factor in support of RBS Australia's Buy rating is the view now is the appropriate time in the cycle to be exposed to property developers. This is based on the assessment asset values worldwide at present are generally stable, while cap rates mean investors can get value without the need for significant leverage. Cap rate is calculated by dividing a property's net operating income by its purchase price.

Finally, RBS Australia notes Lend Lease management continues to improve internal operations, which is supportive for margins. Additional acquisitions remain possible, RBS Australia noting the Conneq business in particular operates in a highly fragmented industry where consolidation is likely. Geographical expansion is also expected as for example Lend Lease remains under-exposed in the Western Australian market.

The contrast between RBS Australia's Buy rating on Lend Lease and Hold ratings elsewhere in the market is a valuation issue, as RBS's above consensus earnings estimates imply additional value not being factored in by other brokers.

BA Merrill Lynch is an example of this, as following a review of the Australian REIT sector last week the broker downgraded to a Neutral rating on Lend Lease on relative valuation grounds.

The changes to earnings forecasts for RBS Australia mean an increase in price target to $11.12 from $10.70. The consensus price target according to the FNArena database stands at $10.03, with RBS the high marker and BA-ML the lowest with a target of $9.40.

Shares in Lend Lease today are weaker and as at 10.45am the stock was down 10c at $8.67. The market in general is struggling with yet another day of heavy losses. Over the past year Lend Lease has traded in a range of $6.70 to $9.28, with the current share price implying upside to the consensus target according to FNArena of almost 16%.

Kingsrose Offers Low Costs And Upside Potential

- Kingsrose Mining a low cost gold producer - Way Linggo project has good exploration potential - DJ Carmichael rates Kingsrose a Buy

By Chris Shaw

Kingsrose Mining Limited ((KRM)) is an emerging gold mining company, producing from the Way Linggo project in Sumatra, Indonesia. Kingsrose has an 85% stake in this project, which has a current resource of around 165,000 ounces of gold.

Perth based stockbroker DJ Carmichael rates Kingsrose as a Buy, while reporting it is attracted to the potential for increased production as Way Linggo reaches full output of around 45,000 ounces of gold annually and as exploration adds to resources and extends mine life.

Gold production at Way Linggo is expected to be around 10,000 ounces in the March quarter, while DJ Carmichael notes a new SAG (semi-autonomous grinding ball) mill should be fitted by June. This will lift throughput to capacity of around 140,000 tonnes per year.

As production picks up so too should earnings, DJ Carmichael noting Kingsrose is a low cost, high margin producer given high grades at Way Linggo. Silver by-product credits also help keep costs low, with operating costs estimated at less than US$100 per ounce.

An increase in mine throughput offers a potential way to boost earnings, DJ Carmichael noting throughput could be lifted to 600 tonnes per day from 400 tonnes at present by only small changes to the existing mill. How soon this could occur is uncertain as there are some current constraints on underground mining.

The exploration outlook at Way Linggo is very positive in the view of DJ Carmichael, as early sampling along strike of the underground veins has delivered significant results. These include 104 metres at 20.6g/t gold and grades of between 10-20g/t gold and 150-250g/t silver on average over the full mining width.

Exploration will be a focus for Kingsrose in coming months, DJ Carmichael noting the company currently has six surface diamond drill rigs and one underground diamond drill rig in use. The Way Linggo North Vein is unlikely to be an isolated vein, as DJ Carmichael expects a field of vein systems in the region.

Elsewhere, Kingsrose currently has an 85% interest in the Sarinc Tailings Project and DJ Carmichael sees this as a potential source of additional value going forward.

An advantage for Kingsrose is a solid financial position, DJ Carmichael noting a pre-paid silver forward sale arranged with Credit Suisse raised $13 million. This has allowed the company to repay all of its outstanding debts.

In estimating a valuation for Kingsrose, DJ Carmichael has assumed a long-term gold price of US$964 per ounce, an average gold grade of 15 grams per tone and a long-term production rate of 64,000 ounces annually.

This generates a valuation of $1.62 per share. The main risk to this valuation is if high grade gold veins are not continuous and don't extend further underground. Further drilling should address this issue in DJ Carmichael's view.

Kingsrose is capitalised at around $350 million, so is too small to receive significant coverage. As evidence of

this, none of the brokers in the FNArena database provide research on the company.

Over the past year the stock has traded in a range of $0.65 to $1.55.

Could The Quake Actually Benefit QBE?

By Greg Peel

Is the world about to end? Fans of the Book of Revelation may be somewhat inclined to believe so, but seismologists recently interviewed by the media have played down the implications of the seemingly endless stream of seismological events the world has suffered over the past couple of years, noting that such activity usually occurs in clusters. Eventually the earth will settle down again, they say.

For Australian insurance companies, the end just never seems to come. If the pre-Christmas floods in Queensland weren't enough then came Brisbane, followed by Cyclone Yasi, and while insurers at that point were still comfortably within annual catastrophe provisions the warning bells were sounding that there wasn't a lot left in the kitty. Earnings forecasts would not be largely impacted, analysts noted, as long as the catastrophes stopped.

Then came Christchurch, and provisions were again stretched. Then came the big one. (Let's hope it still proves to be "the big one".)

Yesterday QBE Insurance ((QBE)) announced it was estimating US$125m of insurance losses stemming from the Japanese earthquake. QBE has reinsurance exposure through its Lloyds stake as well as some marine and energy insurance cover. JP Morgan was surprised at just how quickly QBE was able to arrive at this figure given past delays, and as such is assuming it to be a worst case scenario.

Analysts note the figure is only around 0.9% of QBE's net earned premiums (NEP). QBE operates on a calendar financial year, so unlike peers operating on June financial years QBE still has plenty left in the kitty of annual catastrophe provisions. After all that has occurred in 2011, the company's claims now total US$550m against the full-year provision of US$1.65bn incorporating aggregate reinsurance protection. About a third of the provision has thus been accounted for already in the first quarter of the year.

Again we say, if it all now stops...

The bottom line is that analysts have not deemed it necessary to make any meaningful adjustments to earnings forecasts based on QBE's assessment. JP Morgan queries whether QBE can reach even the bottom end of its 15-18% profit growth guidance, but it, too, left forecasts unchanged this morning.

But the Japanese quake throws open a wider question for discussion.

The global insurance business is a competitive game, and as such margins need to be carefully managed. One cannot just put up premium prices willy-nilly given (a) the level of competition and (b) the destruction of insurance demand high premiums will spark. We recall that many Brisbanites had decided not to buy flood insurance on their houses given the high cost. The cost of flood insurance is understandably high for houses built in a flood plain.

An industry body has estimated the cost of the Japanese quake to reinsurers could be as high as US$35bn, which moves to US$50bn or so if you then add in the actual tsunami. After a shocking couple of years, when is enough enough? The question is as to whether global reinsurers will now simply have to raise their catastrophe premiums and damn the demand destruction given the extent of mounting claims. Were this to happen, QBE would be a beneficiary of higher prices.

"The key question for the stock," notes JP Morgan, "is whether the losses for the global industry could lead to a turn in the insurance cycle. In this there could be a strong silver lining for QBE".

Macquarie's take is, "whilst this tragic event will almost undoubtedly give rise to a massive economic loss, it is still too early to determine whether the insured loss will be of sufficient scale to turn the global reinsurance pricing cycle".

Deutsche Bank thinks not. The bottom line is that building a house on the Ring of Fire is not dissimilar to building a house in a flood plain. Insurers either don't want to know you, or price their premiums so high as to make insurance untenable. Hence the number of householder and small business claims in Japan will not be nearly as extensive as one might expect. The real cost will be on infrastructure claims, and for that the Japanese government pays the premiums.

Macquarie notes that following the 1995 Kobe earthquake, losses totalled some US$100bn for infrastructure and property and another $50bn for economic disruption, yet the insured loss totalled only US$3bn.

Following Kobe, the Japanese government instituted the Japanese Earthquake Reinsurance fund which covers residential policies. BA-Merrill Lynch notes there is low insurance penetration outside Tokyo. It is the Japanese government which will cop the brunt of the cost, and not the global insurance industry. And as Merrills notes:

"With insurance losses estimated at 1-3% of the global reinsurer capital base and large amounts of surplus capital even today, the jury is out as to whether this loss will be enough to tip broader global commercial insurance pricing more positive".

RBS makes note of competition in suggesting, "abundant global insurance capacity may limit more broad based price increases".

On that summation, it would seem analysts are leaning away from the notion of industry-wide price increases and thus benefits for QBE. Without, that is, fully dismissing the possibility.

In the meantime, for QBE the wait continues for the day global interest rates start to rise again, to which the company's fortunes are highly levered.

A Wave Of Broker Upgrades

- 40 broker ratings upgrades since Friday - Resources and energy feature but upgrades are widespread - Analysts are looking through to the other side of the disaster

By Greg Peel

On Monday, FNArena produced 20 Broker Call entries (total stock reports worthy of note from the daily reports of the eight major brokers in the FNArena database) and there was one recommendation upgrade.

On Tuesday there were 49 entries, featuring six upgrades and three downgrades. On Wednesday there were only 28 entries but eight of them were upgrades and there were no downgrades.

This morning there are 69 entries. Of those, 25 feature recommendation upgrades. There are no downgrades. This is very unusual.

But we are suddenly in unusual times. In terms of the Japanese earthquake and tsunami we have the experience of the 1995 Kobe earthquake to draw from. In terms of nuclear disaster, we have to go back to Chernobyl in 1986. In 1986, Chernobyl was in what was then still the Soviet Union, which was not a part of the free financial markets. Japan, on the other hand, is the world's third largest economy and fully mature. If Japan is impacted, the world is impacted – right down to whether or not the new i-Pad will have to be delayed due to lack of Japanese manufactured parts.

The Japanese nuclear threat is the last in a line of problems which have beset stock markets since the February peak. MENA unrest has sent the oil price soaring, thus threatening the global economic recovery from the GFC. Debt issues have again arisen in the eurozone following more credit spread blow-outs and ratings agency downgrades. The Japanese earthquake/tsunami has threatened a short-term disruption to earnings outlooks and commodity prices but Kobe and common sense tells us that will ultimately turn around once the rebuilding phase commences. But nuclear meltdown? Get me out!

The information has been flowing from Japan hour by hour, and from other probably unreliable sources. The information is often conflicting as a fluid situation ebbs and flows. The reality is no one really knows the answer to the question “what if?” Everyone knows, however, that if the nuclear threat is contained then the stock market correction will reverse very rapidly.

Clearly stock analysts are looking towards that scenario, rather than entertaining any apocalyptic notions. As can be seen by weak opens followed by rally-backs over the past week in stock markets around the globe, there are plenty of investors out there looking for bargains as well, basing their theses on a “buy when everybody else is panicking” theme. While obviously there are some stocks in the Australian market which will suffer from lost Japanese trade (yesterday Billabong ((BBG)) announced a profit downgrade for example), elsewhere analysts have seen little reason to readdress their FY11-12 earnings forecasts which have only just been updated in the wake of the February results season.

So if stock prices fall a long way from target prices that analysts don't feel driven to reduce, then clearly recommendation upgrades must follow. And that's exactly what's happened.

Yesterday the equity strategists at BA-Merrill Lynch issued a short but sweet note simply entitled “Stocks that have fallen too far”. The report selected for attention groups of stocks that (1) were stand-outs in unjustified price falls, (2) that had fallen the most, (3) that now looked cheap on a PE basis and (4) that were safe havens. The strategists are clearly suggesting that weakness created on the back of everything that's happened since February does not have anything other than emotional basis. That emotion, of course, is blind panic.

Utility DUET ((DUE)) appears in all four categories. Qantas ((QAN)) appears in 1-3. National Bank ((NAB)) appears in 1-3. Tatts ((TTS)) appears in 1, 2 and 4. Amongst all other stocks there's everything from engineering to publishing, transport to beer.

JP Morgan has not changed its view on Macquarie Group ((MQG)). It still believes the investment bank's earnings prospects are limited in the near term. But on sheer price drop, the analysts this morning upgraded MQG to Neutral.

We can go right back to the Queensland floods to acknowledge that markets always panic unnecessarily and sell insurance companies whenever natural disaster strikes, simply assuming a jump in claims. This panic ignores both insurers' catastrophe provisions and levels of reinsurance. But having experienced floods, then Yasi, then Christchurch and now Japan, Australian insurance stocks have been hammered.

This morning Credit Suisse noted that Insurance Australia Group ((IAG)) and Suncorp-Metway ((SUN)) actually have so much excess capital they are thinking of giving some back to shareholders. Their catastrophe provisions might now be dangerously low, and reinsurance costs set to rise, but share price weakness has this well factored in. And higher prices can be passed on. QBE Insurance ((QBE)) is struggling with margin pressures and may yet not make FY11 guidance, but QBE had fortuitously locked in three years of reinsurance before the wave hit.

Credit Suisse has upgraded IAG and Suncorp to Buy this morning and QBE to Neutral.

Given the level of commodity price volatility at present, one might consider now not the best time to be making a wholesale reassessment of commodity price forecasts. But that's exactly what the RBS global commodity analysts have done this week having last updated, and upgraded, in October. Despite some sell-offs, commodity prices are now higher than the RBS forecasts set in October.

So up we go again. And this has prompted the RBA Australia analysts to plug the new forecasts into their models and thus increase earnings forecasts and target prices across the resources and energy sectors. The end result is no less than twelve recommendation upgrades in the space from RBS this morning, from junior miners through to major producers and even indirect beneficiaries such as West Australian Newspapers ((WAN)).

And UBS is also in on the act. UBS, too, raised its oil price forecasts this morning, resulting in energy company upgrades. The analysts also noted that resources stocks that were only a month ago high-flying have suddenly been beaten down to less than net present value in some cases. “A remarkable turnaround,” says UBS, and one the analysts see as offering some pretty sweet entry points for investors. UBS made four recommendation upgrades this morning.

And I haven't even covered the whole list. In short, analysts do not see an ongoing impact from the Japanese disaster, and indeed are looking ahead to where Australian companies can benefit, no matter how uncomfortable that concept might make us all feel.

One need only note this morning's local stock market action to see a repeat of the “fall first then rally back” pattern – a pattern that has so far caught out early value seekers but may yet prove very profitable. As we stand, the nuclear situation seems to be improving in Japan. A power line will soon be hooked up to restart emergency systems and water is being poured onto the reactors from land and air.

We must, of course, acknowledge that the news has swung back and forward from bad to promising several times since Friday.

No Doom And Gloom From Oil

- Magnitude, speed and duration of higher oil prices matter - Growth impact of recent oil price gains expected to be mild - Morgan Stanley forecasting US growth of 4.0% in 2011

By Chris Shaw

With oil prices surging recently, Morgan Stanley notes investors are again questioning just how sustainable is the US economic expansion. The concerns appear justified, as Morgan Stanley suggests a rough rule of thumb is a sustained US$10 per barrel increase in the oil price would cut growth by about 0.3% this year.

In the view of Morgan Stanley, the potential threat from any energy shock is likely to remain mild unless there are additional supply cuts and oil prices move significantly higher. At present, Morgan Stanley is forecasting US growth of 4% in 2011 and the broker sees a number of factors in support of retaining this view.

Looking at energy shocks in general, Morgan Stanley notes the magnitude, speed and duration of any shock all make a difference. Price increases due to stronger demand generally have little impact on growth as they reflect strength in the economy.

In contrast, price hikes resulting from a shock to supply are a different story, as such shocks both depress growth and boost inflation. In the current environment, if prices decline somewhat in the next few months Morgan Stanley sees little impact from current high prices, but if prices were to remain at current levels there is scope for 0.4-0.6% to be cut from US GDP growth this year.

This is because a supply-driven change in energy prices acts like a tax hike in that discretionary income is drained from consumers. This means a transfer of wealth to oil producers, so the effect on global growth will depend on how energy producers spend this wealth.

As all energy price hikes mean income is transferred from consumers to producers this means duration is also of importance notes Morgan Stanley. The energy price shock post Hurricane Katrina was temporary and so there was only a short-term impact. The 1970s oil shock was more sustained, meaning more serious and long-lasting implications.

What makes the current situation different to the 1970s according to Morgan Stanley is developed economies are less vulnerable, as energy efficiency has improved significantly. As well, energy as a share of US household budgets has fallen from 7% in the late 1970s to just over 5% now.

This reduced vulnerability is important as Morgan Stanley notes it is allowing central banks to maintain policies that are more supportive of economic growth. Also helping here is lower inflation, as while picking up core inflation in the US at present is still below 2.0%.

In terms of the present environment, Morgan Stanley notes demand has driven most of the increase in energy prices. Global oil demand in 2011 is forecast to grow by 1.2 million barrels per day to a record high of 88.6 million barrels per day, while non-OPEC supply is forecast to fall by around 380,000 barrels per day.

A more resilient economy is another positive, as apart from weather disruptions expansion appears to be gaining in momentum and resilience as de-leveraging continues and as household balance sheets strengthen. Economic data through February also suggests a rebound in economic activity, supporting the view momentum in the economy is improving.

This trend should continue as Morgan Stanley expects economic policy in the US will remain supportive of growth, as no shorter-term change in currently accommodative policy settings are likely.

Morgan Stanley does concede the risk for oil prices is skewed higher at present, as spare capacity remains tight and any disruptions to supply are likely to push prices up significantly. Another minor threat to growth is Federal fiscal austerity, given the potential for disruptions to Treasury auctions and expectations of a protracted fight over the budget.

On the plus side, Morgan Stanley estimates if the full amount of cuts to appropriations proposed by the Republican Party were agreed to, which is not likely, there would still be only a minimal impact on growth this year.

Overall, Morgan Stanley sees no reason at present to adjust its 4.0% GDP growth forecast for the US this year, even given a higher oil price environment.

Uranium: A New Dynamic

By Greg Peel

Regular readers of this weekly report will appreciate that it summarises activity in the spot uranium market from the week before as noted by industry consultant TradeTech, and notes the indicative price for the week set by TradeTech. While this week's report will briefly summarise last week's activity, let us be clear all reported transactions occurred in blissful ignorance of what was about to happen.

Last week's Uranium Report noted that after a few weeks of falls in the uranium spot price, the announcement from the US Department of Energy that it would commence an incremental selling program of 4.2mlbs of stockpiled uranium over three years suggested that a cap would be placed on the market as a result despite the orderly and tender-based nature of the program. Speculative holders of uranium have become a little nervous of late, but genuine buyers have still been keen to pick up supplies at levels below earlier peaks.

That was underlined last week when the DOE's parcel met with “exceptionally strong” interest from buyers, as TradeTech notes. All up seven transactions totalling 1.2mlbs were concluded and TradeTech's weekly spot price indicator rose US$1.00 to US$67.75/lb.

Then the earthquake hit. TradeTech notes that as of Friday, when little was yet known, both buyers and sellers simply jumped to the sidelines.

We now know of the extent of damage to nuclear reactors in Japan and the possibility of meltdown. We also know of the bigger picture threat to the global nuclear power industry as a viable alternative energy source as represented by double-digit percentage sell-offs of listed uranium producing stocks across the globe. Clearly those stock sell-downs are also anticipating a big drop in the spot uranium price.

Last night fellow uranium industry consultant UxC suggested weakness will indeed hit the spot uranium market as speculative holders join in the panic. Speculative players, such as hedge funds, were blown away in 2007 when the price peaked at US$136-138/lb and then collapsed, were scared away for the market for some time, but recently have been moving back in as the uranium price has run from the 40s to the 70s. Positions are nowhere near as significant as 2007, so UxC does not expect a price collapse back to the US$30 lows. But panic and a temporary withdrawal from genuine buyers could see more recent lows above US$40/lb tested, the consultant suggests.

The impact will thus be sorely felt by producers and builders of reactors in the short term, but the reality is that only some 20% of Japan's nuclear capacity has shut down, reactors across the rest of the globe are still fully operational, and China's nuclear ambitions remain the swing factor in longer term uranium demand. Operating utilities will still need to purchase uranium, and if they were keen under US$70 then they should be more keen under US$50.

But what of the future? UxC notes the Japanese disaster has encouraged Germany and Switzerland, at the least, to reassess the security of their own reactors and to contemplate “possibly reducing their reliance on them”.

There is thus likely to be short term turmoil in the uranium market on the “fallout” from the Japanese disaster. As for the longer term ramifications, it's too early to know.

Stay The Course For Copper, Barclays Says

- Barclays remains bullish on copper - Copper demand concerns from Chinese monetary policy tightening overdone - Seasonal patterns favour a strong 2Q for Chinese refined copper imports

By Chris Shaw

Chinese copper imports fell in February and Barclays Capital notes this has increased market concerns the current phase of monetary tightening will limit consumption of the metal in the world's most important copper consuming economy.

Barclays takes the view such a bearish approach to copper is a mistake. While current monetary policy poses some headwinds to consumption, China was already likely to experience a showdown in metals demand growth in 2011.

Even allowing for this slowdown, Barclays expects China's copper import requirements will remain substantial. As well, while physical market indicators are not showing any signs of improvement, there is scope in the view of Barclays for Chinese imports to continue to increase.

As Barclays points out, China has been securing increasing volumes of raw materials on a contractual basis rather than pay spot prices. This has made Chinese imports less sensitive to price movements and swings in price spreads.

Chinese copper semis output has a clear seasonal pattern and Barclays notes this in turn drives a seasonal pattern in refined copper demand and imports. The trend calls for a steep drop in activity in January and February, followed by a sharp recovery in the March to June period.

Barclays expects this trend will continue in 2011, even allowing for the potential for an increase in bonded warehouse stocks to limit any pick-up in imports. Reports suggest bonded warehouse stocks have increased to as much as 700,000 tonnes, a level Barclays sees as overstated as this would imply Chinese copper demand has contracted by more than 10%.

According to Barclays, any increase in bonded warehouse stocks most likely reflects a change in where supply inventory is being held. Such an increase implies inventory is now being held at ports rather than by the customer.

For 2011 in total Barclays is forecasting only a small increase in total Chinese refined copper imports, but seasonality suggests there will still be a strong pick up in imports in the second quarter.

Additional macroeconomic headwinds suggest increased volatility in copper prices in coming months. But with fundamentals for copper specifically set to improve significantly in coming months, Barclays continues to recommend a long position in copper. Any price dips for the metal should be viewed as a buying opportunity, say the analysts.

Technical limitations

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Material Matters: Japan's Disaster And Commodity Markets

- Experts are trying to assess Japan's earthquake and commodity market implications - LNG, Coal likely winners - Long-term contracts to support uranium - Oil price forecasts also lifted

By Chris Shaw

The full impact of the damage and losses suffered in Japan in the wake of the earthquake and tsunami that struck on Friday afternoon still cannot be accurately assessed, but with markets remaining open brokers have attempted to formulate some preliminary views on the implications for commodity markets from the tragedy.

Taking a broad view, Citi sees the combination of the Japanese earthquake and tensions in MENA are likely to generate an increase in risk aversion. This suggests a correction in commodity prices short-term. Longer-term this should be more than reversed.

According to Citi, short-term conventional thermal fuels such as oil, gas and coal should find some support as the shutdowns at its nuclear plants causes Japan to adjust its energy mix. The biggest impact is likely in thermal coal, Citi estimating Japan's demand could increase by 10% or seven million tonnes this year. Such an increase would add to existing upward pressures on prices.

Goldman Sachs agrees, pointing out about 10% of Japan's coal-fired power capacity is understood to be suspended at present, while stockpiles at a number of power stations have either been washed away or contaminated.

Deutsche Bank takes the view the immediate impact on bulk commodity prices will be a weakening in line with the weakening in the Japanese economy. As activity recovers and the rebuilding process gets underway, the broker expects a meaningful pick-up in demand for coking coal.

In terms of Australian coal plays, Citi estimates Coal and Allied ((CNA)) has the largest exposure to Japan at 49% of its market, while Whitehaven Coal ((WHC)) has 31% exposure and Macarthur Coal ((MCC)) 25%.

Estimates by Deutsche Bank suggest only minimal valuation impact for Macarthur and Whitehaven from any shorter-term fall in prices, so there is scope for volatility in markets to create an opportunity if share prices over-react.

Both stocks are rated as Hold by Deutsche Bank, while the FNArena database shows Sentiment Indicator readings of 0.3 for Coal and Allied, 0.2 for Whitehaven and minus 0.1 for Macarthur.

Goldman Sachs also expects LNG demand will increase, though the magnitude of any increase will be limited by storage issues. Upward pressure on gas prices is expected to flow through to similar pressure on coal prices.

Short-term there may be some negative impact on the base metals in the view of Citi, this reflecting a temporary reduction in demand. But longer-term the need to rebuild should be a positive, with lead likely to receive the greatest boost in demand. The rebuilding process should also boost the steel, iron ore and coking coal markets, notes Citi.

In steel, Goldman Sachs estimates around 23% of Japan's steelmaking capacity has been affected by the disaster, while Deutsche Bank estimates as much as 40% of capacity is currently shut-in. This interruption to production opens up scope for some iron ore and coking coal contracted to Japanese mills to be diverted to the spot market.

Goldman Sachs expects this will put further pressure on spot iron ore prices. These have been trending lower in recent weeks in response to weaker Chinese demand.

On its numbers, Goldman Sachs estimates about 25% of Japan's installed nuclear capacity is currently offline. While longer-term China's response to the crisis is important given the intention to increase its nuclear power generation capacity, short-term Goldman Sachs expects spot prices will fall sharply.

Citi suggests uranium demand should only be slightly hit given most uranium producers have long-term price contracts in place. The broker agrees with Goldman Sachs that longer-term implications could be more serious if there is any significant public backlash against uranium as a source of power.

At present, JP Morgan notes International Energy Agency (IEA) forecasts are for Japan's nuclear power industry to supply 23% of primary energy demand by 2030, up from 13% in 2007. This compares to LNG's share increasing to 19% from 16%.

The earthquake means this expectation for nuclear fuel may prove overly ambitious, especially given likely community opposition stemming from the issues at nuclear plants in the wake of the earthquake and tsunami.

This suggests there is scope for LNG to experience an increased proportion of Japan's primary energy mix. If this is the case, JP Morgan sees a meaningful impact on global LNG demand given Japan is the world's largest LNG importer.

Macquarie agrees, estimating the need to replace the nuclear reactors that have been shut down will see additional call on other sources such as gas, fuel oil and diesel. Incremental LNG demand could equate to around 3.5% of global demand on Macquarie's numbers.

Short-term, JP Morgan expects greater Japanese demand for imported LNG and coal. This should benefit LNG producers with flexible capacity, which implies Woodside ((WPL)) among the Australian plays.

Longer-term an increase in Japanese gas demand should favour Woodside, Oil Search ((OSH)) and Santos ((STO)), which JP Morgan rates as Underweight, Neutral and Overweight respectively. Sentiment Indicator readings for the three companies stand at 0.1 for Woodside, 0.4 for Oil Search and 0.9 for Santos (the maximum is 1.0).

Macquarie also sees the most bullish impact of any long-term increase in LNG demand as applying to Woodside, which the broker rates as Neutral. Origin Energy ((ORG)), on which Macquarie is currently restricted, is also a likely beneficiary as the current situation could offer a good time to negotiate pricing terms on new LNG contracts. This should be a positive for Origin's APLNG project.

Origin Energy has a Sentiment Indicator reading of 0.6 according to the FNArena database.

Most exposed in the uranium market among the Australian plays is Paladin ((PDN)) as Citi estimates the company only has around 60-65% of volume contracted. In contrast, Energy Resources of Australia ((ERA)) is essentially fully contracted for the medium-term. Sentiment Indicator readings stand at 0.0 for Paladin and minus 0.4 for ERA.

Elsewhere in the energy market, Macquarie has lifted oil price forecasts to reflect ongoing uncertainty with respect to supply across MENA countries. Supply disruptions are tightening the global supply/demand balance, Macquarie estimating spare capacity now stands at about three million barrels a day. This has come about a year earlier than the broker had expected just two months ago.

Lower spare capacity increases the risk OPEC is less willing to moderate prices aggressively in the second half of 2011, especially given underlying demand growth of around 2.5% is expected this year.

Given the changed market dynamics, Macquarie has lifted its average annual oil price forecasts to US$116.50

per barrel this year from US$97.10 previously and in 2012 to US$119.50 per barrel from US$115.50 previously. There is no change to Macquarie's long-term price forecast of US$88 per barrel.

The changes to oil price forecasts flow through to higher earnings for Australian oil plays, with the large cap exposures enjoying the largest benefit. Macquarie has lifted large cap earnings forecasts by an average of 31% this year and by 5% in 2012.

Higher earnings mean a boost to corporate balance sheets, while also supporting valuations in the sector. The changes have not generated increases in share price targets.

In the sector, Macquarie rates Santos, Oil Search, Australian Worldwide Exploration ((AWE)), Beach Petroleum ((BPT)), Horizon Oil ((HZN)), Roc Oil ((ROC)), Molopo Australia ((MPO)), Tap Oil ((TAP)) and BHP Billiton ((BHP)) as Outperform.

Only Woodside and Nexus Energy ((NXS)) are rated as Neutral by Macquarie.

PGMs Hardest Hit By Japan's Earthquake

- Earthquake to lower Japanese auto production - This implies lower demand for PGMs - Barclays sees further short-term price pressures - Market balance for PGMs should continue to tighten long-term

By Chris Shaw

Among the precious metals, Barclays Capital suggests the impact of the Japanese earthquake is greatest for platinum group metals (PGMs). This reflects Japan's importance to the global platinum and palladium markets, accounting for about 15% and 16% of respective demand.

As Barclays notes, car manufacturers in Japan have announced production suspensions since the earthquake struck. Toyota will reduce output by around 40,000 vehicles by closing operations from March 14-16, while Nissan has halted production until at least March 18 and Honda until March 20.

As an estimate of the impact on the PGM markets, Barclays suggests this lost auto production could equate to a near-term drop in PGM demand from auto-catalyst consumption of around 15,000 ounces of both platinum and palladium.

But as Barclays points out, the loss won't only be evident in auto demand, as Japan is also a large consumer of platinum jewellery. Demand in this market is also expected to suffer in the shorter-term, which is significant given Japanese platinum jewellery demand accounts for about 12.5% of that market's global total.

Platinum physically-backed ETPs (Exchange Traded Products) are most closely linked to physical demand according to Barclays. This suggests any reduction in exposure in this market by investors could exacerbate any price falls stemming from reduced auto industry demand for the metal.

This is particularly the case given platinum ETP holdings at present are at record highs. In contrast, palladium holdings are around 70,000 ounces short of peak levels.

Both platinum and palladium prices have come under pressure in the past couple of days as negative demand factors are priced into the respective markets. This pressure should remain near-term, but longer-term Barclays expects the market balance for both metals will continue to tighten.

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Material Matters: Short-Term Issues For Metals Prices

- Threats to global growth weighing on metal prices - Positive US economic data supportive - Current Chinese monetary policy not a threat to commodities demand

By Chris Shaw

Global investors are currently dealing with the twin shocks of political uprisings among nations in the MENA region and Japan's largest ever earthquake, which combined have increased downside risks to global growth. As Barclays notes, this is currently weighing on metals prices.

In the view of Barclays, until there is greater clarity with respect to these events and the likely policy response to any related inflationary pressures, prices of growth sensitive assets such as base metals and PGMs (Platinum Group Metals) should struggle. At the same time, gold should outperform given the perception the metal offers a safe haven.

Once the safe haven buying of gold runs it course and investor confidence returns, the big question according to Barclays is will physical demand be enough to set a floor under prices. There is some confidence it will, as Barclays remains of the view underlying demand remains robust.

Citi takes the view the political uncertainty in the MENA region as well as the ongoing EU sovereign debt crisis are issues likely to linger, which raises the question of why commodity markets have been so resilient.

Part of the answer in Citi's view is ongoing positive economic data from the US, which is confirming a cyclical improvement in that economy. But higher oil prices are a threat in this regard, as continued oil price strength could lead to a reversal of rising growth expectations in developed markets.

Any increase in global growth concerns and waning risk appetite could, in Citi's view, lead to near-term weakness in base metals prices. Medium-term, Citi expects strong physical demand in emerging markets and buoyant investor demand should be enough to deliver some price upside.

Post the devastation in Japan, Barclays sees the immediate effect for base metals as the closure of refined copper and zinc production and weaker consumption. Medium-term however, demand should receive a boost from reconstruction work.

Lead demand in particular could possibly rise very quickly given likely strong demand for batteries and generators, while Barclays also expects copper demand to receive a boost from power utilities replacing damaged transformers and power lines.

Chinese metal demand indicators are not particularly clear, Barclays noting weak physical market indicators are fueling fears monetary policy tightening is weighing on metals consumption. Rather than turn too bearish, Barclays points out even if a slowdown in demand is assumed Chinese metal import requirements would remain large and should improve in the second quarter.

Given the current market uncertainty, Barclays suggests aluminium offers one of the best risk/reward equations among the base metals at present, so it remains a favoured defensive trade. While copper has underperformed in recent weeks fundamentals look set to continue to improve, so Barclays remains positive and suggests buying the metal on any price dips.

Citi has a somewhat different view, suggesting the outlook for aluminium depends whether or not the price

should essentially follow global energy prices as has been the case in recent weeks. For Citi, the answer is yes if prices are close to the marginal cost of production for a large portion of the industry.

At present Citi estimates the aluminium price is significantly above the cost of production for all but a small number of producers, which offers some risk for the price of the metal in the broker's view. Additional risk comes from the potential for a moderating of demand, which dropped sharply in January after rising by around 15% in 2010.

Zinc is expected to be the underperformer of the base metals suite, Barclays noting the combination of a growing market surplus and rising stocks of the metal should continue to weigh on prices over the medium-term.

For the base metals generally, Barclays suggests leading indicators for base metals demand continue to point to sustained momentum in demand growth continuing into the second quarter of 2011. A re-acceleration of Asian activity levels is evident in recent data, confirming the region as the major driver of global demand at present.

Among the precious metals Barclays expects silver and gold should find near-term support given current market uncertainties, while platinum group metals (PGMs) will struggle more in the short-term. Longer-term however, the PGMs look set to benefit from a tightening in market conditions.

Barclays retains a positive long-term view on gold, suggesting many of the long-term investment drivers remain intact in a period of low interest rates. For silver, Barclays argues as long as investment demand, and in particular retail interest, remains strong prices should retain their gains. If this interest wanes, there is scope for a fast correction in prices.

Turning to China, Standard Bank has looked at the effect of a slowing in credit extension in China in terms of any potential impact on commodity markets. The conclusion is increased monetary conservatism in China doesn't pose a long-term threat to commodity demand.

This is because fiscal policy related to infrastructure expansion remains supportive of commodity demand generally. As well, Standard bank suggests given China's current inflation outlook future monetary policy actions should already have been discounted into commodity prices.

If the inflation outlook was to deteriorate further, Standard Bank notes a more aggressive policy approach could be warranted. This would see zinc, copper, lead and nickel as the metals likely to be worst affected.

Such a scenario currently appears unlikely according to Standard Bank, though the group does suggest credit expansion in China this year is unlikely to offer the same level of support for commodities as it did in 2010.

Material Matters: Enery Substitution, Oz Steel, Oil Upgrades, Copper, Silver and Gold

- Japan's nuclear issues to see large scale energy substitution - Oz steel plays - Oil price forecasts lifted - Copper prices and demand - Silver more vulnerable to near-term reversal

By Chris Shaw

According to BA Merrill Lynch, the earthquake in Japan is likely to have a relatively limited impact on total Japanese energy demand. What is likely to result is large scale energy substitution, with LNG and oil use in electricity likely to grow in the near-term.

As BA-ML points out, the quake and resulting tsunami has shut down 9.7GW of nuclear power, with much of this capacity not likely to come back in the next 12 months at least. This should see a pick up in LNG imports to as much as 7.1mmtpa, which equates to around 1bcf/d.

As well, demand for low sulphur (sweet) fuels for power generation should increase by at least 140,000 barrels per day at least temporarily. BA-ML also suggests Japanese thermal coal demand could increase by a modest one to two million tonnes in 2011.

Major accidents such as the Three Mile Island disaster in 1979 can significantly alter long-term energy policy and, while early, BA-ML sees scope for the current issues at the Fukushima nuclear plant in Japan to have a similar impact.

While China has indicated it will continue with plans to increase its nuclear energy capacity, Germany has announced a moratorium on the extension of 17 old nuclear plants. While reaching any long-term conclusion is difficult, BA-ML suggests one possibility is upward pressure on UK natural gas, thermal coal and European carbon emissions prices.

In terms of the outlook for Japanese GDP, BA-ML notes a recent World Bank study shows earthquakes don't have a significant effect on GDP growth, especially in developed economies. While Japanese GDP cold temporarily rebound on reconstruction, the broker's analysis suggests the economic effect is likely to fade after two years.

The earthquake may have a greater impact on bulk material markets, as BA-ML notes Japan is a major steel producer accounting for about 8% of global production. Shorter-term, severe port damage and ongoing power shortages may result in steel production losses, but excess capacity in Japan as well as China and Korea is likely to provide an offset.

Near-term imports of thermal coal may slip as Japan has lost about 7.5GW of thermal coal power generation and 15mtpa of thermal coal demand. With limited ability to lift thermal coal power production at other facilities, BA-ML suggests LNG may be better placed to fill this gap.

Post the earthquake BA-ML has maintained a price forecast of US$125 per tonne, while the broker's long-term thermal coal price forecast is retained at US$100 per tonne. For met coal BA-ML is forecasting prices to ease to US$300 per tonne following the recent record settlement of US$330 per tonne.

Iron ore prices are forecast to ease to US$140 per tonne over the June quarter from current spot prices of around US$167 per tonne. As BA-ML notes, China and India remain the major drivers of prices in bulk commodity markets.

In terms of the impact on Australian steel plays from changes to steel and iron ore price expectations, Deutsche Bank suggests BlueScope Steel ((BSL)) remains profitable at current prices, costs and currency levels.

Assuming increases in hot rolled coil and iron ore prices in the second half of this year, Deutsche expects a significant turnaround in earnings for BlueScope. Second half of 2011 net profit after tax is expected to be $65 million, compared to a loss of $55 million in the first half.

Bluescope is Deutsche's pick in the sector, being rated as Buy, while both OneSteel ((OST)) and Sims Group ((SGM)) are rated as Holds. Sentiment Indicator readings for the three stocks according to the FNArena database stand at 0.7 for BlueScope and OneSteel and minus 0.1 for Sims.

Elsewhere in commodities, BA-ML has lifted oil price forecasts for Brent crude to US$122 per barrel for the June quarter, This is up from a previous forecast of US$86 per barrel and reflect the recent Libyan oil supply disruptions. For 2011 overall the broker is forecasting an average Brent price of US$108 per barrel, up from US$86 previously.

UBS has also adjusted oil price assumptions, lifting it 2011 Brent forecast to US$103.75 per barrel and its long-term forecast to US$95 per barrel. These compare to previous forecasts of US$85 per barrel in both cases and reflect the view both stronger demand and increased sensitivity around geopolitical risks to supply. Both factors suggest higher prices are appropriate.

The changes to oil price expectations have an impact on earnings forecasts among the Australian oil plays in UBS's coverage universe, with estimates being increased for both large cap and mid cap producers.

Among the large cap plays, UBS notes Oil Search ((OSH)) gains the strongest earnings benefit, while Woodside ((WPL)) and Santos ((STO)) gain most from a valuation and price target perspective. In the smaller caps the broker sees strong oil price leverage for both Tap Oil ((TAP)) and Beach Energy ((BPT)).

Following the sector review UBS has upgraded Australian Worldwide Energy ((AWE)), Beach and Roc Oil ((ROC)) to Buy ratings from Neutral previously. Horizon Oil ((HZN)), Oil Search, Santos, Tap and Woodside remain as Buys, while the broker continues to rate Caltex ((CTX)) as Neutral. With the exception of Caltex price targets have also been increased.

The FNArena database shows Sentiment Indicator readings for the stocks of 0.9 for Santos, 0.8 for Horizon, 0.5 for Oil Search, 0.4 for Australian Worldwide, 0.3 for Roc, 0.2 for Beach and 0.0 for both Tap and Caltex.

Turning to metals, for some time Goldman Sachs has had a preference for copper among base metals given expectations of a tight market for the foreseeable future. This has supported Buy ratings on both BHP Billiton ((BHP)) and Rio Tinto ((RIO)), copper making up 18% of the broker's value for the former and 12% for the latter.

But assuming a tight market, does this mean prices rise to ration demand because there is not enough supply, or is there a supply response? Goldman Sachs is at present forecasting a price that effectively destroys demand until, as new projects come on-line, the market moves into an oversupply position. This will cause a subsequent fall in prices.

Goldman Sachs is forecasting a long-term copper price of US$2.28 per pound in 2016 dollars and using this price expects BHP Billiton will likely to adopt a 'steady as she goes' strategy. This suggests maintenance of production, incremental growth though increased concentrators and some phased growth. Longer-dated, more capital intensive and technically challenged projects such as Olympic Dam are likely to be continually pushed back under such a scenario.

In Rio Tinto's case, Goldman Sachs expects a bit more pushing of the curve as the company continues to look for growth outside of its iron ore operations. But the fact both companies also offer exposure to strong steelmaking raw material prices as well leads Goldman Sachs to suggest both stocks should outperform more pure copper plays.

Most in the market agree, with BHP Billiton scoring a 0.8 Sentiment Indicator reading in the FNArena database and Rio Tinto a 1.0 reading.

On precious metals, Citi has looked at the relationship between gold and silver prices, particularly in light of silver having outperformed gold significantly since the start of the economic upturn. Partly this is because silver is less liquid than gold, meaning the weight of money effect has been stronger when compared to gold.

In Citi's view this reflects both a growing investor appetite for silver given the metal is much cheaper than gold, as well as silver benefiting from rapidly expanding use in applications such as electronics, solar panels, batteries and plasma screens.

Silver's key supply and demand statistics looks strong, Citi noting silver's industrial applications now consume 60% of mine supply, up from 50% before the credit crisis. While supply should increase this year, so too will industrial and investment demand in the view of Citi.

Based on its estimates, Citi suggests silver's strong fundamentals are now being priced in by the market. As evidence of this the broker notes the gold/silver ratio has fallen to its lowest level in many years.

This change in relative value has, in Citi's view, left silver more vulnerable to a near-term reversal.

Uranium Update

By Greg Peel

In this week's regular uranium report (Uranium: A New Dynamic) I noted that pre-quake trade had the uranium spot price rising for the first week in many, by US$1.00 to US$67.75/lb on industry consultant TradeTech's weekly indication. It's all academic now of course, given the situation in Japan has thrown the global uranium industry into turmoil.

Fellow consultant UxC published its weekly spot price indicator on the Monday, and it has fallen 10% to US$60.00/lb. Given only a handful of transactions occur each week in the market, it is not considered helpful to mark prices any more regular than weekly. But the expectation is that by week's close tonight that price will have fallen further.

Japan's now disabled reactors (14) represent 25% of the country's nuclear capacity, and 3% of global uranium demand. In isolation, this figure should not be overly harmful to medium-term uranium prices, and nuclear aspirations in China, India, South Korea and Japan represent 75% of expected global growth over the next decade, Deutsche Bank notes. But the disaster, which is still playing out, has had a big psychological impact.

The Fukushima plant may be safely shut down, and nuclear lobbyists can point to the age of the plant, the fact it was set for decommissioning anyway, and its (curious?) location on the Ring of Fire as reasons why this isolated disaster should not be reason to abandon all nuclear power generation across the globe. Perhaps there needs to be a pause to reassess safety, but new plants are far more technologically advanced and thus safer than old ones. And they don't have to be built on major fault lines.

But what of the political fallout? Will governments feel safe to press on with nuclear ambitions if the Fukushima disaster turns the electorate solidly against the idea? One is reminded that the Three Mile Island (1979) and Chernobyl (1986) disasters set the global nuclear industry back twenty years.

Germany and Switzerland have already contemplated a reassessment of reliance on nuclear power, and the elephant in the nuclear room – China – has currently put a moratorium on new reactor approvals at least until Fukushima plays out. Citi analysts were forecasting 333GW of global nuclear capacity by 2020 but now suggest 16% of this figure is at risk through existing plant closures, cancellation of projects and non-renewal of licences for old plants.

Deutsche now suggests a 9mlb uranium surplus in 2011 and believes the price can fall towards US$50/lb, but doesn't see US$40 being tested. At these levels China should come in to stockpile, the analysts suggest. Clearly Deutsche is working on the assumption a Japanese disaster will not completely kill off Chinese nuclear plans.

And that belief is borne out in the broker's upgrade of Paladin Energy ((PDN)) this week to Hold from Sell, based on the share price plunge. Deutsche already had a Buy on ERA ((ERA)).

The fortunes of uranium stocks have fallen, risen and fallen with every piece of new news from Japan this week. It is still too early to know where this all may end.

Japan And The Energy Market Impact

- Short term economic contraction should give way to medium term economic growth in Japan - The Kobe quake in 1995 provides lessons - Demand for crude, LNG and coal should increase to offset lost nuclear power - The longer term impact on nuclear energy as a whole is of concern

By Greg Peel

As the impact of the Japanese earthquake and subsequent tsunami became apparent, the response from global financial markets was rapid yet not based on any level of certainty. Initial logic centred around a drop in Japanese economic growth and thus a sell-off ensued in commodity prices. The fall in the oil price reflected the shutting down of Japanese refineries and hence a fall in demand for crude. The Japanese Nikkei stock index fell and will continue to fall today, while the yen rose on expectation of the repatriation of foreign investments to fund rebuilding necessity at home.

It is the Japanese stock market which will likely bear most of the brunt of the earthquake's financial impact, analysts agree. While the images have been graphic, it is nevertheless not simple to estimate the extent of damage at this stage, nor the time needed to clear up and commence rebuilding. Uncertainty will linger for some time, but history does provide us with some guidance.

The earthquake which hit Japan in 1995 was less powerful than this one, caused what will likely prove to be fewer lost lives (6500) and what will likely prove to be less widespread damage. However the 1995 quake occurred underneath the city of Kobe which is Japan's major export distribution point. Hence Danske Bank, for one, is already suggesting the economic impact of Friday's quake will prove less than that of the Kobe quake.

In the days following the Kobe quake, the Nikkei index fell 7% but was quick to recover. Industrial production dipped on the month of the quake but rose again in the following two months as rebuilding commenced. There was little ultimate impact on either the yen or Japanese bond markets. All up the Kobe quake wiped 2.2% off Japan's 1995 GDP.

Danske does not believe Friday's quake will derail Japan's tenuous economic recovery. “If anything,” say the analysts, “it will be a short-term boost to growth”.

We are reminded that in the view of the Reserve Bank of Australia, the devastation in Queensland and elsewhere earlier this year (and still ongoing in some parts) will provide only a temporary impact on Australia's GDP. This March quarter may produce a negative growth result but ultimately the impact will be offset by the growth resulting from the rebuilding phase.

The same expectation is held for New Zealand. While the timing of Christchurch's recovery remains uncertain, the same offsets on GDP are assumed. The Reserve Bank of New Zealand has made an emergency cut in its cash rate to accommodate immediate costs and household relief.

While the Bank of Japan is scheduled to make a regular policy announcement tomorrow, Danske Bank does not believe any more than some emergency fiscal hand-outs will be announced. The BoJ's cash rate is already only 0.1% so there's little room to move, but Danske does not expect any major monetary policy changes anyway.

There is nevertheless another element to Friday's quake than just straightforward GDP impact, and that relates to the shutting down of nuclear energy capacity. There is also a major meltdown risk.

History also provides us with some guidance on the nuclear front. When a smaller earthquake hit the Niigata region of Japan in 2007 it shut down the world's largest nuclear power plant. JP Morgan notes that the result

was an increase in global natural gas, crude oil and oil products prices. While circumstances were different then to now, JPM believes it should be noted that the Nymex natural gas price hit US$13/mmbtu as a result (current price around US$4/mmbtu).

And therein lies the rub. The initial response to the Japanese quake in Friday's trade was to sell oil futures, but markets closed before the extent of the damage to nuclear energy supply became apparent. Japan is the world's largest producer of nuclear energy with nuclear power accounting for 35% of electricity demand. It is estimated that the plant shutdowns in the wake of the quake represent 21% of Japan's nuclear capacity. Given the apparent extent of damage it is expected that capacity will be down for quite some time. It takes years to build or rebuild a nuclear plant.

The offset will come from LNG and coal-burning power generation, JP Morgan suggests, as well as crude oil burning. There will also be an increase in light sweet crude and diesel demand. Hence the drop in the price of oil seen on Friday night may well now reverse.

For the oil price, any sudden increase in demand comes at a difficult time. Saudi Arabia in particular, along with Kuwait and Nigeria, have been using up their own limited spare production capacity to cover for lost production out of Libya. And all MENA nations are witnessing local unrest. Further spare capacity is not a given.

The Obama Administration has flagged the possible release of strategic reserves to offset the rising price of gasoline resulting from the rising price of crude. However, analysts and oil companies have railed against any such release on the basis that global oil supply is yet to actually be disrupted. High oil prices simply represent rampant financial market speculation, they argue, and not any supply shock along the lines of those experienced in the 1970-80s.

On the other hand, nevertheless, there is plenty of gas about. So much so that Australian CSM LNG aspirants are having trouble finding the long term customers they need at the right price to render projects economically viable. The US imports very little LNG, so despite the 2007 experience there is not expected to be any big jump in the US natural gas (Henry Hub) price. But the impact could well be felt in Europe and Asia.

Japan is going to need LNG right now, so while this may result on further immediate sales to Japan from Australia, the impact on planned LNG projects is not as clear. Coal exports should also, in theory, increase to Japan. With the weather still hampering Australia's coal production and transport, one can only assume coal prices will rise as well as local gas export prices.

And what of uranium exporters? Well, today's stock price movements make the response there abundantly clear. The loss of Japan's nuclear capacity means less import demand for uranium until such time as those reactors are ready to be rebuilt or replaced, albeit it does not take a lot of uranium to keep a reactor going once it's on line. The wider impact is that of potential nuclear disaster – disaster which, like Three Mile Island in the 1970s and Chernobyl in the 1980s may well scare the world away once again from the dangers of nuclear power.

Japan's reactors are the most sophisticated in the world and their earthquake-related warning and back-up systems state of the art. Yet it appears at least one, if not more, Japanese reactors could melt down due to damage to those very back-up systems. As I write Paladin ((PDN)) shares are down 11% and Energy Resources of Australia ((ERA)) shares down 9% while the shares of gas producers such as Woodside ((WPL)) and Santos ((STO)) are only down 1% in a generally weak session.

At the same time the Nikkei – only just opened – is down 2%. The Australian market is clearly suffering an "all this and Japan too" response following on from the MENA and euro debt-driven weakness of last week. If the global oil price does now spike it means increased headline inflation for the likes of China, for example, which would exacerbate the need for further monetary tightening. Will this be Beijing's response to Japan's woes? We can only wait and see.

At Last, Good News From Europe

- The eurozone has surprised by suddenly announcing new agreements - The bail-out fund is now bigger and concessions have been made to Greece - It's an improvement, albeit still not enough to cover Italy - But it may yet prove a turning point

By Greg Peel

Last week the world was distracted by MENA uprisings, including planned Saudi protests and the ongoing civil war in Libya. But Europe was suddenly back in the frame again when Moody's made another one of its behind-the-curve ratings downgrades, this time for Spain. The world was reminded that euro-debt yields have pushed out to new records.

Then came the earthquake and subsequent nuclear threat which has understandably taken the limelight. Behind the radiation cloud, European Union leaders have sparked considerable surprise. It's now over a year since Greece hit the headlines and many months since it became apparent the EU bail-out fund and individual budget cuts were not going to be enough. Talk ever since has been of a more permanent, structural solution addressing both immediate issues and possible future issues. In short, the eurozone as a cooperative and the euro as a common currency have been under threat of fragmenting.

Progress has nevertheless been painfully slow. More recently, eurozone ministers have been meeting every week to nut out some sort of plan but arguments and dissent have hampered the process. Were it not for other distractions, the euro may well have slipped further against the US dollar. On Friday night however, as everyone else in the world was glued to their TV screens, substantial progress was suddenly made. Economists had given up any hope of an announcement before the planned March 23-24 EU summit. Germany and France had both indicated as much.

As Danske Bank reports, four important steps were made.

Firstly, the European Financial Stability Fund, which is the fancy name for the bail-out fund, has been increased from E260bn to E440bn. Throw in the existing European Financial Stability Mechanism worth E60bn and the kitty now stands at E500bn. This amount had been previously flagged but there was an issue over not receiving a necessary AAA rating. While it is not exactly clear how, that issue has now been overcome, notes Danske.

Danske suggests that E500bn is enough to cover Greece, Ireland, and Portugal and should also be enough to cover Spain barring any further real estate crash. It is nevertheless not enough to cover Italy if it came to that. And Italy is currently dealing with its own endogenous issues, being the growing resentment of a serial womaniser and party animal for prime minister and the fact Italy imports most of its oil via a cushy little deal with Libya.

Secondly, the EFSF will be allowed to, under specific circumstances, buy eurozone government bonds in the primary market (meaning a form of QE mechanism). This means the EFSF can buy directly from the governments on issue whereas the European Central Bank can only buy bonds in the secondary market. The EFSF can thus buy Greek and Irish bonds right now, except that those governments have not issued any lately.

Thirdly, as a more immediate gesture, the rate of interest being charged by the fund for the E80bn Greek rescue package has been dropped by 1.0% in exchange for a government promise to sell E50bn worth of state-owned assets. The maturity date of the loan has been extended to 7.5 years from 4.5 years. This means an extra E800m Greece doesn't have to pay annually, but as Danske suggests this really just brings the country one step back from the abyss – not to safety.

Ireland was offered the same 1.0% drop if only were it to raise its deliberately low corporate tax rate to levels in line with other European nations, thus generating more income. But the new Irish government has declined, just as the previous one had. Ireland sees its low tax rate as its only potential saviour if it can encourage foreign businesses into the country to help the economy grow out of its crisis.

Fourthly, a "pact for the euro" has been agreed upon and should shortly be finalised. The existing Stability and Growth Pact encouraged eurozone members to keep budget levels within agreed guidelines but did not legislate such. The new pact means members will need to incorporate the EU's fiscal rules into individual legislation and then stick to those rules. Given several nations have already long ago strayed – in some cases some distance – members will have to come up with their own agendas to eventually meet the goals.

Danske notes, nevertheless, that the new pact does not include any mechanism for sanctions, so realistically this new step is still only based on little more than good intentions. The success of the pact basically relies on peer pressure, Danske suggests, which given attitudes to date is a bit of a joke. Let's face it, the EU has seen nothing but one-finger salutes between members all of its existence. The EU rules do cover a raft of fiscal issues including employment, wages, productivity, pensions and financial stability.

Danske had not expected any agreement ahead of the upcoming summit, and the content of what has been agreed upon to date is better than the analysts were hoping for. There are still details missing, but it is assumed the summit will clear those up.

The analysts suggest the new measures are particularly positive for Portugal, which they believe is about to face another credit rating downgrade from Moody's, and positive for Greece and Spain. Ireland has chosen to opt out and Italy is effectively on its own as well, being too big an economy for the members to contemplate. The winners should now see reductions in their credit spreads, Danske believes, and the way has been made more clear for the ECB to raise its cash rate next month as expected.

More importantly, Danske suggests this might just, possibly, represent a turning point in the euro crisis. That still depends on no further negative developments in the larger economies of Spain and Italy.

And of course, there's plenty else to worry about in the world right now.

Rudi's View: Looking Forward

- February revealed an extreme gap in earnings growth between "winners" and "losers" - This gap is expected to narrow, if not close over the next 18 months - This prospect is not priced in share prices for most industrial stocks

By Rudi Filapek-Vandyck, Editor FNArena

You wouldn't have noticed from the price action we have seen since mid-February, but the recent corporate reporting season in Australia had strengthened overall market confidence in that earnings growth should continue for those sectors performing well (miners, energy and pick and shovel service providers) while others were staring at or near the low point in their earnings cycle. Under different macro-economic circumstances this would have created the ideal platform to extend the share market rally that started in August last year, but this time around it simply isn't to be.

In Australia, major indices have now lost more than 9% since their peak in February. Despite many experts calling "value on offer" it is clear investor sentiment has been dented quite significantly over the past few weeks. The underlying message from the February reporting season, however, hasn't changed because of tighter liquidity in China, doubts about what will happen post QE2 in the US and a series of natural disasters. That message still is: there's value in the Australian share market if forecasts for FY11 and FY12 prove more or less accurate.

Confidence in these forecasts seems pretty high. Not only have analysts emphasised the point in their regular updates post February, market strategists at various stockbrokerages have done the same while retaining their projections for the Australian share market post the "correction" from the past four weeks. As an example, both Goldman Sachs and UBS maintain earlier estimates that put the ASX200 at around 5500 by year-end, while noting this includes further potentially small downward adjustments to FY12 forecasts between now and then. On Wednesday the ASX200 closed at 4558.

At face value, the February reporting period was one of the worst in a long time. One stand-out observation was that Australian companies seemed unable to outperform analyst forecasts, contrary to the preceding reporting season in the US, for example. A second observation was that earnings forecasts continued their downward trend, in place since May last year. Other negatives include an extreme gap in earnings growth between resources and industrials, low profit margins and cautious consumers, and a general reluctance to give specific guidance, let alone optimistic guidance.

There were some clear positives too. One of these involved further increases in dividends, consolidating Australia's position as the dividend capital of the world. Another positive was that, while earnings projections outside natural resources remained negative, the size of overall downgrades had become much smaller than in previous months and certainly than during the previous two reporting seasons. Above all, the most important positive characteristic from the February reporting season was that forecasts for FY12 had been left largely untouched. For a good reason it seems, as analysts would claim in many cases their confidence had been boosted in significant fashion, suggesting if there was a risk, it was likely to the upside.

All this translated into higher valuations and higher price targets for individual stocks. No wonder the balance between recommendation upgrades and downgrades had shifted in favour of the former.

However, there was more to all this than initially meets the eye. Behind the headlines on financial television and in newspapers, market observers had noted the valuation gap between the outperformers (miners, energy and pick and shovel service providers) and most of the rest of the market had blown out to such extremes, that the latter seemed to represent the better value - on the condition that the February reporting season would

boost overall confidence in future earnings for these companies.

It is here that the February reporting season has played a key role. Because, just as every engineer and mining service provider had been re-rated since late 2010, investors had by now jumped on every laggard among industrials in the run up to the actual reporting season. As one would have expected, not all companies (or even sectors) lived up to expectations. Within this framework, the February reporting season has set a few new trends, and broken a few others.

First up are the mining and exploration companies. Their results were good, but merely as expected. Big drivers were ongoing strength for commodity prices and a near relentless bullish investor sentiment. The main problem with the sector was that the easy gains had been made. Small cap mining stocks in particular no longer looked cheap. Market strategists at the likes of UBS and Credit Suisse decided to go "Underweight" the sector and they have not regretted that decision since. Both stockbrokers stuck to their decision this week, even after the Japan disaster-inspired sell-down.

Second are the oil and gas companies which have a long history of failing to live up to market expectations. Santos ((STO)) did surprise, but few others matched its example. To make matters worse, few share prices across the sector have genuinely kept up with oil prices in the past two months. My favourite sector observation is that long term investors who bought Santos, Woodside ((WPL)), Oil Search ((OSH)) and many others in the sector five years ago, and held on to their shares since, are still waiting for a positive return today. The February reporting season was not particularly inspiring for the sector. If anything, it raised more questions about what exactly is going to be achieved by the likes of Woodside, Origin ((ORG)) et all in the months ahead.

Having said that, the sector is definitely on investors' radar with stockbrokers and others raising their oil price forecasts for this year and next and this has triggered higher valuations, targets and recommendations. The shut down of nuclear power plants in Japan has only further fueled speculation that LNG will remain in high demand from here onwards.

Third up are the pick and shovel service providers. This group has grown to a wide and varied bunch of companies in the Australian share market, comprising the likes of Leighton ((LEI)) and Transfield Services ((TSE)), but also WorleyParsons ((WOR)), Monadelphous ((MND)), Fleetwood ((FWD)), Ausdrill ((ASL)), Decmil ((DCG)), Sedgman ((SDM)), UGL ((UGL)), Neptune Marine ((NMS)), Norfolk ((NFK)) and Imdex ((IMD)); and that's still only a few of them. This sector had been re-rated since late 2010 and most share prices had rallied above broker price targets in anticipation of future earnings growth on the back of higher capex in 2011 and 2012.

February showed, however, that overall earnings growth across the sector is still modest, so the re-rating remains one based on "anticipation". Secondly, not all companies in this sector managed to live up to expectations, which led to severe price falls for the likes of Sedgman. Thirdly, those who proved they had the goods to warrant the re-rating (Monadelphous, WorleyParsons, Fleetwood, etc) found out that broker targets were being raised to where the share price already was. Nowhere to go but down? This certainly proved the case once oil and Japan put a big dent in investor optimism. Falls in share prices for companies such as Fleetwood and WorleyParsons have been much larger than for most other stocks during the past four weeks.

Two interesting developments for the sector came to the surface in February. One, there is a move towards placing more risks with the client (companies like Leighton, UGL and Downer EDI ((DOW)) have been burnt recently) and two, labour shortages have become a real problem and will lead to missed opportunities. Access to labour is thus becoming a key differentiator inside the sector.

Next up are the banks which mostly managed to beat analysts expectations by a small margin, but it was enough to excite journalists, commentators and investors. Alas, once share prices reached for consensus price targets, this positive news story came to an abrupt end. Most share prices for banks have outperformed the broader market to the downside since mid-February. Banks are mostly exposed to that particular part of the Australian economy which is still going through a rough patch and thus investors don't see any upside (right now). This has opened up the obvious valuation gap for longer term investors who can buy into the sector at seldom seen dividend yields (approaching 7% on FY12 estimates). The fact that most banking analysts in the country hold a high conviction regarding their estimates only adds further to the overall appeal.

Note the February reporting season once again widened the gap between the regionals (have-nots) and the majors (haves) in the sector.

Among industrials, February failed to bring the anticipated turnaround for building materials stocks, as well as for gaming and gambling and for media. Expectations for retail stocks were already low on the back of many a profit warning prior to the reporting season and the overall view remains that more pain is likely to precede a turnaround later for most companies in these sectors. What makes stocks in these sectors interesting is that if current market expectations for better results in FY12 prove correct, then today's graveyard valuations for the likes of Fairfax ((FXJ)) and Tatts ((TTS)) should open up excellent value-opportunities once the turnaround materialises. No wonder thus, the media sector is abuzz with one deal after the other - valuations are cheap.

The problem is that more pain first seems almost a given and then what if the awaited turnaround is pushed out further away? Complicating matters is that while analysts' conviction in their estimates is high, it certainly appears much lower for these sectors. Note for example Fletcher Building ((FBU)) had to issue a profit warning recently because the anticipated pick up in building activity post the Christchurch quake turned out weaker and later than expected.

Healthcare stocks equally failed to ignite share prices in February with earnings forecasts mostly falling post results and with questions being raised about valuations for the likes of CSL ((CSL)) and Cochlear ((COH)) which seem more based on past legacies than on what realistically lies ahead. Pathology stocks remain subdued because of uncertainty about what the Australian government will come up with, while distributors to pharmacies are going through a tough time as well. Most excitement in this sector came from the smaller end of town with biotech companies such as Mesoblast ((MSB)) recently regaining investor interest in a manner that throws up flash-backs from eight, nine years ago, when biotechs were too hot to handle.

The stand-out sector in February, however, were the Real Estate Investment Trusts (REITs), otherwise known as LPTs (Listed Property Trusts). The sector has gone through its own cleansing exercise post the financial engineering bubble turned into bust in 2007. Most experts will tell you prices are still at considerable discount to Net Tangible Assets (NTA). The problem is: once burnt, most investors have not paid any attention to the sector over the past three years. Fact remains though, if there was one sector for which overall confidence has risen, and significantly so, throughout February, it is the long forgotten about REITs.

Three observations further strengthen this conclusion. REITs have been outperforming the Australian share market in all three months of 2011 so far. CFS Retail Property Trust ((CFX)) has been featuring as a Buy-with-conviction at several stockbrokers. And last but not least, property analysts have been busy issuing sector reports featuring that same underlying theme: the worst is now behind the sector, how long before valuations will close the gap with NTAs?

All in all, the general mindset among analysts is that 2011 is likely to mark the peak, as far as earnings growth goes, for the outperformers of February -- the miners. Higher oil forecasts should unleash a new dynamic for energy companies, while pick and shovel service providers will be biting each other's hands to get their slice of the big capex wave that is about to hit Australia (and the rest of the world). The extreme gap that has opened up between those companies and most industrials, however, is expected to narrow from the second half of this year onwards.

Even if not everyone is equally convinced about how strong exactly profit growth will be for today's laggards, virtually no-one is doubting industrial companies will see much better performances later this year and into 2012.

It is on this basis that several stockbrokers have recently come forward to point out stocks that have been, in their view, sold down too far. These stocks include Qantas ((QAN)), National Australia Bank ((NAB)), News Corp ((NWS)), ResMed ((RMD)), OneSteel ((OST)), APN News and Media ((APN)) and Pacific Brands ((PBG)). Many of these stocks can be found towards the top of the R-Factor on the FNArena website (which further strengthens the thesis).

Market strategists at BA-ML even published a whole report on Wednesday, titled "Stocks that have fallen too

far". Names that stand out according to the research include Duet ((DUE)), Qantas, NAB, Tatts, Toll Holdings ((TOL)), Seek ((SEK)) and Bendigo and Adelaide Bank ((BEN)).

Maybe what investors should keep in mind post the February reporting season is that overall growth in earnings per share for industrials has been non-existent for the six months to December. This is expected to become low single digits for the six months to June, with more improvement anticipated for H2. In 2012 EPS growth for the sector should print double digits.

For most industrials stocks, this is not priced in the share price. Quite to the contrary.

P.S. I - All paying members at FNArena are being reminded they can set an email alert for my Rudi's View stories. Go to Portfolio and Alerts in the Cockpit and tick the box in front of 'Rudi's View'. You will receive an email alert every time a new Rudi's View story has been published on the website.

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Mad As Hell And Icahn Take It Any More

By Tim Price, Director of Investment PFP Wealth Management

"Independence is for the very few; it is a privilege of the strong." - Friedrich Nietzsche.

There has been much chatter among the financial chatterati about Carl Icahn's recent decision to hand back capital to investors in his funds. Since he's apparently keeping some US$5 billion of his own money invested, this doesn't appear to amount to a closure as such, rather a polite de-emphasis of third party client capital. Here is what he wrote to his limited partners:

"While it may sound "corny" to some, the losses that were incurred by investors in our funds in 2008 bothered me a great deal more, in many respects, than my own losses. Perhaps this is because over the years I have become inured to dealing with large "paper" losses for myself. During 2008 and part of 2009, unlike many other funds, we did not impose "gates" on our investors that would have prevented them from withdrawing capital from our funds if they chose to do so. Therefore investors seeking liquidity did withdraw a fair amount of cash from our funds. Additionally, rather than liquidating positions that we believed in, we infused our own new capital into our funds which provided cash for withdrawing investors. As a result, fee paying assets now constitute only 25% (US$1.76 billion) of total assets in the funds of approximately US$7 billion.

"While we are not forecasting renewed market dislocation, this possibility cannot be dismissed. Given the rapid market run-up over the past two years and our ongoing concerns about the economic outlook, and recent political tensions in the Middle East, I do not wish to be responsible to limited partners through another possible market crisis. After careful consideration of all relevant factors, we have determined to return all fee paying capital to investors."

The knee-jerk response by the financial chatterati was that Icahn had grown "weary" of managing other people's money, and was getting out while the going was good, ahead of a possible "market dislocation" that he was careful to suggest, rather than predict. The chatterato on the Clapham Omnibus, the FT's Lex columnist, pointed out that hedge fund managers Stanley Druckenmiller and Paolo Pellegrini last year either "chucked it all in" or returned external capital:

"Cynics say that hedge funds are simply being found out at last.. the decisions to quit raise a bigger concern: that the industry remains a fragile one based on superstars."

We draw an entirely different conclusion, consistent with the fact that we do not represent a financial newspaper heavily dependent on advertising revenue from traditional fund management firms: Mr Icahn's decision to return money to external investors is a principled decision to conserve his investors' capital. If anyone is being "found out" here, it is those traditional asset management groups that continue to tout for business irrespective of any necessary obvious ability to add value for their investors that those investors are not capable of delivering for themselves. There are, in other words, fundamentally only two types of institutional investors: asset managers, and asset gatherers. Mr Icahn can plainly be seen to be in the first school. We prefer not to point fingers as to who might be caught nervously "cramming" in the second, but as a clue you can probably find plenty of their advertisements in publications such as The Financial Times.

We are certainly hounded sufficiently by them in unsolicited approaches either in email or telephonic form. It is an intriguing insight into the over-sophistication of the London capital markets that fund managers are now busily selling to each other: the market has started to eat itself. In the words of Mark Twain, fund managers are now furiously taking in each other's washing. Could it be that, three years into the banking crisis, fund managers are now the only people with any money left ?

We find behaviour such as Mr Icahn's refreshing, albeit exceedingly rare. One beauty of hedge funds that Lex's probably imaginary (or self-representing) cynics do not recognise is that the typical hedge fund manager has plenty of skin in the game, in the form, ordinarily, of a substantial part of his or her net worth as part of the fund's overall capital. Their interests are largely aligned with those of their investors. The same cannot be said for the typical open-ended, long-only, traditional fund, in which the typical manager is a hired hand, with little or no skin in the game. The fact that the typical traditional manager is invariably pursuing an index-relative (read: unsophisticated, if not plain stupid) strategy merely adds insult to injury.

The decision of individuals like Messrs Icahn, Druckenmiller and Pellegrini to de-risk their clients. assets may not be indicative of a wider trend, given the extraordinarily low barriers to entry and constant churn in the asset management business. If it is, it is likely only to reflect the decision-making of principled investors with a greater focus on capital preservation and their clients' well-being than on asset gathering and fee generation. It is to be applauded, rather than disparaged as part of a generalised attack on a sub-set of the asset management business marked "alternative".

Interestingly, within the same edition, Lex also cites "Star" bond fund manager Bill Gross, of Pimco. We have no animus against Mr Gross whatever, but we do wonder whether he or his company has ever turned down new assets citing size of assets constraints or fears about prospective returns. If they haven't, they may wish to. (We note their recent sales of US Treasuries.) Because contra-indicator par excellence James Glassman has now advised anyone mentally deranged enough to buy his latest book, "Safety Net: the strategy for de-risking your investments in a time of turbulence" to load up the truck on US Treasury bonds.

Those who appreciate stunningly poor investment advice will need no introduction to James Glassman. He is the co-author of a book titled "Dow 36,000" which was published in 1999, just months ahead of the market peak. Your correspondent remembers this book with a certain grisly satisfaction, since his erstwhile employer, Merrill Lynch Private Banking in London, distributed free copies to the entire salesworkforce shortly before the stock markets blew up. Having succeeded once at inadvertently calling a huge market top by advising everyone to pile in to the stock market, it could well be that Mr Glassman has, incredibly, managed to pull off the same trick in relation to the US government bond market.

We have no intention of wasting any time in reading this almost certainly clownish piece of magical thinking, but within it Mr Glassman purportedly recommends a 50/50 allocation between stocks and bonds. There would appear, sadly, to be no role for absolute return investments or real assets in Glassmanland - a realm, perhaps, populated entirely by writers about investments all guesting on channels like CNBC dispensing unsolicited investment insights to the mentally defective, none of whom are likely listening to a word that their fellow panellists say, all of whom refuse to admit when they.ve got it catastrophically wrong in the past. Evidently the financial media in 2011 is much like a particularly easy-going Heaven: all sins are forgiven, and penitence isn.t even required for entry.

In the grotesque event that Mr Glassman is right about buying US Treasuries, the good news is that at least there's no shortage of the damn things. You should have no trouble buying them to your heart's content. And to those of us who insist on being defensively positioned as a matter of course given the strained financial environment, news like Mr Icahn's is a bit like hearing an ice cream van tootling past: all quite nice, but it doesn't really change anything.

Tim Price Director of Investment PFP Wealth Management 14th March 2011.

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High Frequency Trading - Some Home Truths

(This story was originally published on March 10, 2011. It has now been made available to non-paying members at FNArena and to readers elsewhere.)

The following is the text of a speech prepared by Greg Peel and delivered in November 2009 to a financial markets seminar in Singapore. The text is no less relevant today and given the attention being directed towards high frequency trading in the US and also more recently in Australia. FNArena deemed this an appropriate time to publish the speech for the benefit of readers.

High Frequency Trading The Global Financial Crisis of 2008 is the most recent financial market "bust" in the long line of booms and busts that dot history, including the Crash of '29, the Crash of '87 and the Tech-Wreck of 2000. After every such crisis, fingers are pointed, accusations are made, politicians vow revenge, and the media has a field day. Such a response is simply part of human nature – the same human nature that determines the following trading tenet: If I make money it is because of my skill. If I lose money it must be someone else's fault. Which brings me to the true topic of today's presentation: High Frequency Trading – Every Crisis Needs its Scapegoats Let me start with a brief historical tale. In the late eighties, the Australian Stock Exchange was in a transitional phase which was to see the old open out-cry and chalk board system gradually replaced by an automated trading system. The Australian stock trading model never included "specialist" market makers as had always been the case on the New York Stock Exchange. However, the accompanying exchange-traded option market relied almost entirely on specialist market makers. The ETO market was also open-outcry in the late eighties, and whenever a specialist quoted a price spread on an option, he would do so based on the prevailing price spread on the underlying stock as displayed on a screen. If the specialist was hit on a price, he would then run across the floor to the chalk board, find his designated operator, and attempt to cover his delta hedge. If the stock in question was one of those already automated, he would instead run into his designated booth, pick up the phone, ring his computer operator, and attempt to quickly snatch that bid or offer upon which his option price was originally based. Frustration would result if the phone at either end was already busy. If several options market-makers were simultaneously hit at the same price, a scramble ensued. The market-maker who was quickest to the phone would get the best stock price on his hedge. The laggards would have to settle for something less. Macquarie Bank –with whom I'm sure you're all familiar – operated the largest team of option specialists. While having the biggest team was an advantage, it was also a disadvantage. Like all specialists, Macquarie's team was only allowed one phone line out of the exchange. This often resulted in Macquarie specialists also racing each other to transact delta hedge trades. (Remember that this was long before the advent of the mobile phone.) Macquarie solved the problem, however, by giving each of its specialists, and the computer operator, a walkie-talkie. Macquarie overcame reception problems by running a cable from a transmitter at the exchange to a receiver at its trading desk. As luck would have it, the Australian Stock Exchange and Macquarie Bank shared the same building. From that point, the Macquarie specialists could immediately place stock orders from where they were standing. From that point, Macquarie specialists were the first to every delta hedge trade. Macquarie's competitors, understandably, immediately cried foul, and petitioned the exchange to ban the walkie-talkies. The Exchange took a quick look at its rule book and noted every rule pertaining to fair and equal communication access specifically referred to telephones. There were simply no rules against walkie-talkies. The walkie-talkies were thus deemed permissible. For a brief period, Macquarie ruled the options market. But eventually, every specialist had his own walkie-talkie. The playing field was once again even. I relate this anecdote today because the determining elements within it are "speed", "technology" and "advantage". Let me now jump forward to the present day, and highlight this recent quote: "Powerful computers enable high-frequency traders to transmit millions of orders at lightning speed and, their detractors contend, reap billions at everyone else's expense." (New York Times, July 2009) Since the "sub-prime credit crisis" of 2007 became the "Global Financial Crisis" of 2008, many fingers have been pointed, accusations made, and scapegoats sought. The usual suspects have been trundled out, including greed, fraud, derivatives, leverage, hedge funds and short-selling. But when the angry mob is frustrated that no progress is being made in lynching one particular culprit, it will quickly move on to another. As always, ignorance is the dominant force. That is particularly the case when the culprit is deemed to be a computer. Computer-driven high-frequency trading has become the

most recent target of critics, the media, politicians and regulators. HFT now appears on all the fresh "Wanted" posters. One might be forgiven for thinking HFT is a new concept that was created just in time to bring down Lehman Brothers. But HFT has been with us for many years in one shape or form. Indeed, HFT may have given philosopher Plato another reason to suggest that "necessity is the mother of invention", scientist Charles Darwin further proof of "natural selection", and economist Joseph Schumpeter further evidence that "money will always pass from weak hands to strong". HFT is not just some passing fad. "In recent years, HFTs have been the single greatest influence on many aspects of market structure globally, including exchange pricing, new order types, competition among market centres and the technology that handles everything from matching trades to spitting out market data to customers." (Rosenblatt Securities, September 2009) And to maintain the historical theme, perhaps King Canute might suggest at this point that "you can't hold back the tide". HFT is the subject of various criticisms, all of which lead back to the simple concept of "unfair advantage". To assess whether accusations of "unfair advantage" are in themselves fair, one must first appreciate the evolution of HFT. Let's go back in time again, back to when stocks were traded by open out-cry at designated exchanges, and orders could only be placed with stockbrokers by telephone. Various exchanges across the globe adopted differing trading models. On the New York Stock Exchange, specialist market-makers were licensed to ensure a level of liquidity and a constant bid/ask spread. Specialists were compensated for the risk they assumed by being granted the "first look" at all orders. On Australian exchanges, only options markets boasted market-makers. Stocks traded only when broker-operators matched orders with their peers. At varying times, some stocks were liquid, and some were not. Whether or not an exchange adopted a market-maker model, the successful trading of any market – stocks, futures, options, forex, interest rates etc – required a level of discretion, intelligence, experience, talent and overall "street-smarts" in order to be consistently profitable. And just as if it were a poker game, good traders never immediately "showed their hand". If an operator needed to fill a big buy-order, for example, which he knew would move the price, he might sell a few contracts first to confuse his rivals. Sell a few before buying many. Perhaps he might buy only a few contracts first, hoping he might unearth a big seller who could fill his order quickly. Buy a few to see who's selling in volume. Perhaps he might have been instructed to test the water first, and if there appears to be no real sellers, cancel the buying. Fill or kill. Or perhaps he might decide the best way to achieve a good price is to work the order over the course of the session and be happy with the ultimate volume-weighted average price. Work a VWAP. These are just a few examples of what might be called "tactics" or "strategies" used by traders since around about…um…the dawn of time. Funnily enough, no one in the market on the day – not the rival operators, nor the clients, nor the exchange officials, nor the regulators, nor the media, nor politicians – complained about such practices. Indeed, an operator who could achieve the best price on an order - by any stealthy, but not illegal, means - was much admired. He might be considered a "gun trader". And the best operators attracted the most business for their firms. Such operator strategies were even more important when, as was often the case in the stock market, the contract being traded was somewhat illiquid. In the US, illiquidity in stocks was resolved by the specialist market-maker system, although dealing with a market-maker often meant crossing a wide bid/ask spread. Given the history of computers, it is surprising to appreciate that the first computer-based, electronic stock market was established as early as 1971, when the US National Association of Securities Dealers created a computer bulletin board where buyers and sellers could publicly post their bids and offers. Importantly, this initially over-the-counter market served to reduce the spreads on listed stocks. This pleased the buy-side, who could buy or sell at a better price, but not the sell-side, which relied on spreads to make profits. But the buy-side won, and from this early market was born the National Association of Securities Dealers Automated Quotient, or NASDAQ, stock exchange. 1971 Nasdaq created On the New York Stock Exchange meanwhile, the broker-dealers continued to keep their orders a secret from the market, thus exploiting the advantage of exclusive information in return for offering a spread. But in 1997, the rules were changed, and the broker-dealers were forced to disclose their limit orders. The immediate effect was that bid/ask spreads became tighter. 1997 Disclosed orders tighten NYSE spreads The new rules, along with the exponential growth of computer power by this time, gave rise in 1998 to Electronic Communications Networks, which were off-market facilitators of trade matching, and which evolved with the blessing of the US Securities Exchange Commission. Importantly, in order to attract business the ECN's re-engineered the old model that every trade attracts a fee and a commission, instead offering rebates to anyone placing an order and funding the rebates by charging more for anyone hitting an order. The concept of liquidity rebates was thus born. 1998 ECNs offer rebates for liquidity The development of greater computer power at this time also offered a simple means of dealing with those fiddly smaller orders. Nasdaq created the Small Order Execution System, allowing orders of 500 shares or less to be routed directly to market-makers for automatic execution. 1998 Automated execution for small parcels Which brings us to arguably the most fundamental development in the evolution of high-frequency trading. When small order execution was automated, wily traders with fast computers realized they could pick off market-maker prices in small parcels faster than the systems used by

market makers would adjust their prices. The faster the computer, the more incremental profits were available. The ultimate response was that Nasdaq shut down its Small Order Execution System in 2001. All this meant was disgruntled traders shifted their business to the Electronic Communications Networks, which by now were building even faster order-matching systems. 2001 Fast computer traders hook up with fast off-market exchanges Arguably the second most fundamental development in the evolution of HFT occurred one year later. From its early beginnings, stock trading in the US had always been executed on increments of one eighth of a dollar, meaning the tightest possible spread was a full 12.5 cents. In the late nineties, this tradition was under immense pressure from liquidity providers who would happily offer prices inside the spread if allowed. And so in 2002, decimalization was introduced. Suddenly the tightest possible spread became a mere one penny. 2002 Decimalization closes the spread At this point the US was suffering in the aftermath of the tech-wreck and 9/11. Many hotshot traders had blown themselves away chasing the tech bubble. But computer-trading of stocks on America's plethora of competing on-market exchanges and off-market automated matching services continued to grow, as did the speed of the computers themselves. Now that market-makers had lost the risk/reward safety of their spreads, speed – not risk tolerance – became the successful traders most important tool. Using speed and small parcels, traders could break down their risk into tiny increments and thus build consistent profits over the course of a session, without needing to take much of a punt on actual market direction to do so. But there remained one more hurdle. America's biggest stock exchange – the NYSE – remained stoically open out-cry. The final domino fell in 2007 when the SEC moved to eliminate price mismatches across the various exchanges and trading platforms by introducing rules to ensure buy-side orders must receive the best available price. On the introduction of this rule, the NYSE was forced to join the electronic age. 2007 The NYSE goes simultaneously electronic By now, computers were fast enough to place, execute, and cancel orders within milliseconds – far faster than the human brain could ever respond. With the biggest exchange now ripe for the picking, high-frequency trading exploded. But if computers could act faster than humans, then computers needed to be armed with the trading tactics and strategies which humans had developed in order to profit from trading. Over the course of this same time line, another evolution was occurring. It was the evolution of algorithmic programs, or "algos", which instructed the computers how and when to place and cancel orders. These algos have been heavily criticized by those on the buy-side for using supposedly "predatory" tactics and strategies which disadvantage and indeed compromise honest orders. And what might some of these tactics be? Sell a few before buying many. Buy a few to see who's selling in volume. Fill or kill. Work a VWAP.

And there you have it. In the stock and other financial markets of 2009, high-frequency trading using super-fast computers and clever software programs are estimated to account for up to 70% of any day's turnover in US stocks. The geeks have inherited the earth. Let's now revisit our earlier quote. "Powerful computers enable high-frequency traders to transmit millions of orders at lightning speed and, their detractors contend, reap billions at everyone else's expense." (New York Times, July 2009) It is true that HFT now dominates turnover – a feature of 2008-09 that not only relates to the growth of HFT trading, but to the plunge in natural interest over the course of the GFC. HFT has meant that millions of orders are now generated at millisecond speed – and apparently now at even microsecond speed – the bulk of which are then just as quickly cancelled. The remaining turnover generated has maintained overall volumes but significantly reduced the average size of each trade. HFT reduces risk by trading only incrementally, which is why HFT has continued to thrive through the riskiest period most of us has ever experienced. The more liquidity HFT traders provide, the greater the rebate they receive. To those attempting to lay blame as to why they lost so much money over the past two years, HFT is an easy target. Those ignorant of the evolution of HFT can only assume that evil computers are instructed by evil geeks to trade on evil algorithms designed to rape and pillage the unsuspecting, honest investor. This, of course, is rubbish. As our little trip through history shows, nothing much has actually changed at all. Stocks and other financial instruments are traded the same way they always have been – just a lot faster. Yes – the computer has replaced the human for execution purposes. Geeks have indeed found a purpose in life, and a profitable one, but realistically computers are no better than the humans who program them in the first place, and resulting software is no better than the humans who have been trading by stealth since the dawn of time. While HFT may be a way for traders to diffuse risk, at the end of the day the risk always remains. Just because computer programs are fast does not mean every trade must be a winner. At the end of the day, all stock market investment will generate winners and losers, just as it has throughout time. Even liquidity rebates are not sufficient compensation for being forced to cross a spread. The ignorant assume that the remaining 30% of stock market turnover not attributable to HFT must, by definition, be the losers. Computers are hunting in packs, they assume, picking off the slow movers in the herd. This, they suggest, is not fair. But what has realistically ever changed? Traders have been looking to exploit price mismatches for profit since the beginning of time. Moreover, winners and losers in the stock market cannot ever be

determined at the end of one day's trade. While a day-trader may have profited on a quick turnaround, the investor with a longer time horizon is unconcerned that his one, two, or maybe five-year investment meant paying up a couple of extra pennies. Winners and losers are only determined over time, and time will always roll on. Furthermore, the fact that HFT turnover volume exceeds 50% suggests a mathematical fact – there must equivalently be winners and losers among the HFT traders. Thus the concept of "reaping billions at everyone else's expense" cannot, by definition, be true. It is true, nevertheless, that HFT traders have been reaping the spoils of their technological innovation over several years. But just as the Macquarie options traders of the late eighties enjoyed only a brief window of dominance when they alone introduced walkie-talkies, so too will the first-mover advantage of HFT be lost once the practice becomes generic, if it hasn't already. There are those that contend that HFT has no place in the market. But one must ask the question: if US stock volumes are no greater today than in recent times, and HFT is accounting for up to 70% of the volume, what would liquidity be like in 2009 if not for HFT? HFT provides massive liquidity Should computers be allowed to dominate liquidity, thus clouding what we might call the "natural" market? Well consider that for decades, 90% of all daily foreign exchange positions are closed out at the end of a session. In other words, only 10% of turnover represents the "natural" market. Consider further that for decades an average of only 3% of all deliverable commodity futures contracts ever result in actual delivery. This means 97% of all futures trades do not represent natural buyers and sellers. And finally, note that on any given day, turnover volume in the Comex gold futures contract can exceed the entire volume of physical gold ever to be extracted from the earth in the course of history. Yet we don't hear too many complaints about these markets. Indeed, we don't ever hear much complaint about anything going on in the stock market – be it derivatives, short-selling, algos, HFT or computers in general when the market is going up. Such complaint is only reserved for when the market is going down – - for when those who have lost money are looking for scapegoats. HFT is not, however, without its problems, and nor is it totally impervious to abuse. But then throughout time every new development in financial markets has brought with it previously unforeseen problems, and opened up loopholes which can be exploited before the regulators catch up. Regulation is only ever imposed in hindsight, and most often by knee-jerk reaction following crises. In many cases, regulations are later relaxed, and the cycle resumes. HFT is only another step in the evolutionary process. There are no doubt those among you sitting here today who despise the concept of super-fast computers taking over from humans in the business that we know as financial market investment. You might even pine for the day when trading and profiting meant living and dying simply by the seat of your own pants. And no doubt those same people also own a computer, an internet connection, a smart phone, and maybe even an iPod. Can we ever force technological innovation to move backwards? Not often. HFT is here to stay – get used to it. Thank you for your time.

Note: Greg Peel was employed as a proprietary trader in equity and other derivatives markets from 1986 for Macquarie Bank, leaving as Division Director - Equity Derivatives in 1994 to join a hedge fund.

Minara Resources: No Need To Be There

LAYMANS: "... If we are correct substantially lower levels should be tagged over the weeks and possibly even months ahead." There's no doubting that the decline over the last few weeks has been a very strong, powerful move which gives us every confidence that the ultimate target down toward the $0.60 area is going to be met over the weeks/months ahead. Inevitably there will be bounces along the way so it could well be that some bargain hunting is going to appear over the next week or two. Either way, it's highly unlikely that any strength is going to be sustainable with further weakness likely being the way forward over the medium term.

With a push up from around $0.52 back in May of last year to the recent high at $0.995 you'd be forgiven for thinking a decent trend has been seen. Unfortunately, we have to remember this was almost a $5.00 stock back in 2007 so looking at the bigger picture only a small amount of those losses have been clawed back. If our analysis is correct it's unlikely that further inroads into that substantial decline is going to be seen any time soon. The bottom line is that the company remains weak with this characteristic likely to continue into the foreseeable future.

TECHNICAL: We suggested wave-B was in position during the last review with the first two legs of the subsequent anticipated decline also in place. To keep the bearish case alive it was imperative that a forceful push lower was seen, remembering that wave-iii is usually the most powerful of all the impulse waves. We couldn't have asked for too much more in that regard. There is no doubting that the current leg is extended with the 1.618x projection of wave-i already exceeded. As a rule of thumb when this happens price will continue down to the next possible target which in this instance is the 2.618 projection at $0.695.

Should the road map put forward be taken there would then be scope for a small consolidation into wave-iv before the final probe lower kicks into gear. With price pretty much meandering sideways for almost two years, trying to make a high probability count is next to impossible although having said that our labeling remains intact.

We continue to look for a combination pattern with the first stage of the correction completing as a zigzag. With wave-B penetrating the high of wave-(X) we're looking for the second stage to complete as a running flat. This means it isn't a necessity for MRE to head down to the low of wave-A to complete the larger correction. However, we'd expect $0.65 to be tagged as a minimum before any sustainable trend higher commences. For now we'll concentrate on the shorter term patterns and see if a 5-leg move is going to come to fruition from the high of wave-B. The evidence at hand suggests it will.

TRADING STRATEGY: We mentioned the Type-A bearish divergence on the weekly chart last month which added weight to the bearish case. Our oscillator has now moved into the oversold position though in itself it's not a reason to anticipate higher prices ahead. It's quite feasible for the recent weakness to continue with the oscillator bouncing around current levels over the next few weeks. Indeed, if our wave count appears to be correct that's exactly what is likely to transpire.

At this stage there is no reason to be involved with Minara with longer term investors interested in the company being better to stand aside until the current retracement runs its course. More nimble traders could look for a shorting opportunity once wave-iv has worked to a conclusion though that time should be a couple of weeks away as a minimum.

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Oil Price Action A Bullish Signal

- Oil prices returning to previous breakout levels - Momentum approaching oversold levels - Technical analysts at Barclays turning more positive

By Chris Shaw

Oil prices are returning to breakout levels of US$94/95 for West Texas Intermediate and US$103.35/$105.60 for Brent Crude. This price action is seeing the technical analysts at Barclays Capital turn more bullish.

As the analysts note, momentum is quickly approaching oversold levels, a complete reversal of the overbought signals being displayed a week ago.

In the view of the technical analysts Brent crude appears to be forming a flag-like pattern. This suggests if the uptrend of the past 10 months is to continue, fresh demand should be located around these levels.

A break above former range lows around US$112.40 would suggest a re-test of US$116.50 according to the analysts, though the preference is for gains above US$118.50 as this would confirm an extension through previous highs of US$119.79.

Medium-term the technical analysts at Barclays remain bullish for a move towards US$122 per barrel for Brent crude.

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Everything You Need To Know About The Banks

This story was first published two days ago in the form of an email sent to paying members.

By Rudi Filapek-Vandyck, Editor FNArena

The long term average Price-Earnings (P/E) ratio for the major banks in Australia sits at 12.5. However, any study that looks into the finer details will show bank share prices seldom trade on PEs of 12.5, with the notable exception of Commonwealth Bank ((CBA)).

History shows banks either trade on PEs between 13-15 or between 9-12. In the first instance we are talking "bull market conditions", in the second we are experiencing the opposite.

The past decade has produced several violent swings between these two scenarios. When share prices reached for PEs of 15 in late 2007, this marked the top of investor exuberance. In the subsequent sell-offs share prices tanked to PEs of 9 with share markets and bank share prices bottoming in March 2009.

At a time when many an investment expert with a positive view tries to convince the world that equity markets have embarked on a new bull market journey, maybe the banks in Australia can provide the answer whether such a view is merited? Ever since the rally off March 2008 lows ended with an abrupt correction in April and May 2010, major banks in Australia have seen their PEs swing between 9 and 12, back and forth, back and forth.

Taken from a broader perspective, it is difficult to escape the conclusion that banks in Australia are caught in a relatively narrow trading range, one that appears to be defined by the "depressed earnings outlook" range of PE ratios; between 9 and 12. Only CommBank, as the leader in the sector, every once in a while enjoys a PE ratio of 12.5.

In February, just before equity markets corrected from post 2007 highs, share prices for major banks in Australia had rallied once again towards PEs of 12 (13 for CommBank) after which a swift retreat has followed.

Right now, PEs have fallen back to 11.8 for Commbank, 10.8 for Westpac ((WBC)), 10.4 for ANZ Bank and 10.1 for National Australia Bank ((NAB)). This has opened up gaps between share prices and consensus price targets in double digits for all four majors, indicating bank share prices have once again landed into "cheap" territory. It is probably fair to assume this applies to the share market overall.

The Australian banks as a value indicator for the broader Australian share market? I have often observed throughout the years this appears to be the case at points of extreme circumstances. Right now, the banks are indicating value on offer appears high if forecasts for FY11 and FY12 can remain largely intact. One initial thought would therefore be: this sets up the market for a strong bounce once the macro-economic environment allows for some relief.

Investors should note overall confidence in analysts estimates for FY11 and FY12 has increased significantly during the reporting season in February.

Banking analysts at JP Morgan published a sector report in August last year, in which they predicted shares for the major banks would remain inside a narrow trading range for the foreseeable future. This prediction was repeated in a recent update. As indicated above, I tend to agree with this view.

I believe the macro-environment that defines the broader framework for Australian banks is poised to keep PEs

in between 9 and 12 for at least another twelve months. Whether this is good news, or bad, it all depends on what investors want from their participation in the share market, and on what their horizon is.

For starters: current PEs indicate share prices can potentially weaken further still, but one would have to adopt an ultra-depressed view on the sector and on the Australian economy to assume that PEs below 10 will be anywhere near sustainable or even justified on a mid to longer term horizon.

Another way of looking at the sector is through dividend support. Right now the cheapest of the pack is NAB with a prospective dividend yield of 6.8%. Historically, dividend yields for the present year seldom exceed 7%.

For traders, there seems to be an obvious strategy: buy when PEs are close to the bottom of the range and sell when PEs are back near the top of the range.

Of course, the same applies for investors with a longer term horizon. The cheaper the point of entry, the greater the future leverage will be. This is in particular the case for investors who understand the power of compounding dividend returns.

As at Monday afternoon, March 14, 2011, forward looking estimated (FY11) dividend yields for the Four Majors in Australia are as follows (all consensus forecasts):

- National Australia Bank 6.8% - Westpac 6.6% - ANZ Bank 6.3% - Commbank 6.3%

And for FY12:

- National Australia Bank 7.4% - Westpac 7.0% - ANZ Bank 6.8% - CommBank 6.8%

An astute observer would have noticed the relatively big jumps in dividend yields even when growth in earnings per share is projected to remain in single digits for years to come. I have calculated what will happen to dividend yields in five years from today in case the Big Four in Australia will increase their dividends by 7% each year (I have taken FY12 projections as a given and added three more years of 7% increases each):

- National Australia Bank 9% - Westpac 8.6% - ANZ Bank 8.3% - Commbank 8.3%

Nothing of the above should be taken as a given, but these calculations clearly show where the value of buying into banking shares lies today for longer term oriented investors. Especially if one considers the long term average investment return (share price appreciation plus dividends) in Australia is somewhere in between 9 and 10%.

Finally, readers who keep up with my regular market analyses, know I pay close attention to the gap between bank share prices and consensus price targets in Australia. Last month I warned bank share prices were at or above consensus price targets and they have corrected in significant fashion since (as have equity markets in general - true to historical patterns).

What has caught my attention since is that technical analysts put strong technical resistance in the vicinity of those same consensus price targets. In my view, this once again confirms the view that bank share prices are poised to remain inside their trading ranges for some time to come. As an example, take a look at the latest update by The Chartist on Westpac, published last week.

Concludes The Chartist: only and if Westpac shares finally manage to convincingly break through the strong resistance zone in between $24-24.50 it can be concluded the trading range in place since May last year has finally lost its grip on Westpac's share price. Until then, however, range trading and a neutral view overall seem but appropriate.

At present, the FNArena consensus price target for Westpac sits at $25.04 with most stockbrokers having set their price targets in between $25 and $26.

A similar picture emerges for the other three leading banks. For example, The Chartist reports the "resistance zone" for ANZ bank shares lies in between $25-$26 when the consensus price target currently sits at $26.25.

This story was originally written and published in the form of an email to paying subscribers on Monday, 14 March, 2011.

Subscibers should note a subscription to FNArena comes with a bonus e-book written by myself, "Five Observations (That Matter)". Bank shares and consensus price targets feature prominently in this e-book. If you haven't yet downloaded your copy as yet, send us an email at info@fnarena.com

P.S. For more information on The Chartist, see www.thechartist.com.au

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