Week 21

Stories To Read From FNArena

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Xero Poised For Substantial Reinvestment

Accounting software provider Xero passed several milestones in its FY19 results and brokers assess the substantial opportunities that lie ahead.

-Little clarity on specifics with no actual guidance provided -Growth momentum slowed, but the US remains the largest opportunity -Main issue for investors could be the cost of growth

By Eva Brocklehurst

Subscriber growth accelerated offshore and accounting software provider Xero ((XRO)) experienced its first full year of positive free cash flow and a maiden half-year of profitability.

Cash flow in FY19 of NZ$6.5m represented 1.2% of revenue and the company has guided to a similar proportion in FY20. Ord Minnett calculates this to mean that total R&D (research & development) expenditure in FY20 is likely to increase 45%, to NZ$247m.

As a result, the broker's forecasts for operating earnings (EBITDA) decline by -31% for FY20 and -23% for FY21. Despite the large step up in investment expenditure, Ord Minnett points out there was little clarity on the specifics. No actual guidance was provided.

Platform revenue was up 128%, which comprises revenue from adjacent products, and a lot of the company's commentary involved investment around the scalability of its platform. There were positive impacts from the introduction of Single Touch Payroll in Australia as well as the UK's Making Tax Digital. Brokers accept the timing of this regulation helped UK subscriber growth, although at 48.4% it was definitely a highlight.

Meanwhile, the core business is tracking well and North America remains the largest opportunity. However, Macquarie points out this is likely to be a slow path for growth because of a fragmented market. Xero is focusing on the partner channel and cultivating relationships.

Credit Suisse found North American results "pedestrian". US growth was less than 10% half on half and is typically more than 20%, although the company was pleased with the build up of capacity in the partner channel. Morgan Stanley liked the result, as underlying operating earnings were slightly stronger than expected, and flags the company's growing success offshore.

Ord Minnett takes a different view, downgrading to Lighten from Buy. Annualised monthly recurring revenue was little soft relative to expectations and there are concerns the strength in the UK could be a one-off. While acknowledging cloud accounting adoption rates in the UK are still relatively low the broker suspects the tailwind from the April 1 revenue customs deadline for compliance legislation affected the result.

Reinvestment

Reinvestment is now to the forefront and Credit Suisse believes this will constrain free cash flow in FY20. The main concern is how quickly the company can leverage its investment and the issue for investors, the broker also asserts, is the cost of growth. Credit Suisse expects a focus on product development and subscriber acquisition in similar measure to past years.

While incorporating a bullish UK scenario and extending Australian subscriber growth, the broker offsets this with increases to product and subscriber acquisition expenditure. As a result there are downgrades to FY20 and FY21 estimates of -12% and -9% respectively, but meaningful upgrades from FY23.

While expecting Xero to continue to invest, Citi forecasts operating expenditure growth to slow to 24% in FY20 from 28% in FY19 and free cash flow as a percentage of revenue to rise to 3.2%.

Valuation

The lack of material near-term free cash flow is a drag on valuation and, to justify the current share price, UBS believes Xero needs to lift its share in the UK/US to 30/7% over the long-term and hold share in Australasia.

Drivers of FY20 growth are expected to be revenue per unit growth in Australasia, subscriber momentum in the UK, and subscriber growth taking priority over yield in the rest of the world. Citi expects UK revenue to grow at a 3-year

compound rate of 35%, driven by subscriber growth of 29%. The UK already represents the second largest region in terms of revenue and the broker envisages upside risk to forecasts.

UBS acknowledges Xero has transitioned from a loss-making start-up to a self-funding business with structural growth opportunities and the outlook is less risky, yet downgrades to Sell from Neutral. While comfortable with the growth prospects and supportive of the strategy, the broker believes valuation has overshot the level at which there is a fair risk/reward trade-off for investors.

While positive about the strategy and execution, Macquarie believes it is too early to hail the company as a winner, and the valuation is difficult. The broker sticks with a Neutral rating, given the strong run up in the share price. Operating excellence can continue to translate to earnings, and the next leg of growth is likely to come from adjacent products such as payroll and inventory, in the broker's view.

FNArena's database shows one Buy (Morgan Stanley), two Hold and three Sell ratings. The consensus target is $52.75, signalling -13.5% downside to the last share price. This compares with $45 ahead of the results. Targets range from $41 (Credit Suisse) to $61.50 (Citi).

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Will Fortescue Metals Spread More Cash?

Unusually, Fortescue Metals decided to pay a dividend outside of the standard reporting season and most brokers expect there will be plenty more.

-A demonstration of just how much cash the company is generating -Credit Suisse suggests iron ore prices are likely to peak in the September quarter -But is the stock trading ahead of fair value

By Eva Brocklehurst

A surprise early dividend payment from Fortescue Metals ((FMG)) has put the focus on the bumper profits expected from the sector when iron ore companies report in August. Amid upgrades a-plenty to the iron ore price outlook, Fortescue Metals declared a $0.60 dividend, payable June 14, outside the standard February and August announcements that typically come with results.

Brokers suggest the dividend is a pulling forward of part, or all of, the dividend that otherwise would have been announced in August. Deutsche Bank asserts timing made this payment unique, rather than the quantum.

A large dividend in FY19 was always expected from an iron ore company. The broker does not envisage any other candidates in the mining/oil coverage will make an early dividend payment and the move also reflects Fortescue Metals' nimble culture.

For larger peers Rio Tinto ((RIO)) and BHP Group ((BHP)) Deutsche Bank considers there is more potential for downward pressure on the iron ore price to weigh on these stocks, rather than increased dividend potential.

Citi points out the company may have acted early because of concerns around possible changes to Australian dividend imputation ahead of the election but, most certainly, it was about increased confidence in 2019 cash flow. Credit Suisse agrees, at the very least, this is further demonstration of just how much cash the company is generating.

Macquarie believes an extra $0.20 dividend is possible at the FY19 results should iron ore prices remain at current levels. Including the $0.19 interim dividend and $0.11 special dividend announced in February the company has so far paid out $0.90, equating to a fully franked yield of 11% for FY19.

The company has stated it will return to a March/April interim dividend and September/October final dividend going forward, which signals to the broker that this is actually an early payment. A pay-out ratio of 50-80% of net profit has been reiterated. Macquarie expects a further $0.20 special dividend with the FY19 result, assuming a pay-out ratio of 80%.

Ord Minnett expects such returns to be a feature of FY20. Iron ore markets are tight and the company's achieved price estimate is at recent highs of US$82/t. The broker does not expect a further dividend payment at the August results, although accepts the company did not rule one out. Ord Minnett expects an FY20 dividend of $1.09 a share, implying a 14% returned to shareholders.

Iron Ore Peak?

Iron ore prices have rallied significantly this year in response to a supply shock caused by the Brucutu dam failure in Brazil. Credit Suisse expects iron ore prices to peak at US$110/t in the September quarter, when China's port inventory is likely to be at its tightest. The broker expects an iron ore deficit over 2019.

By lifting forecasts by 21% and 33% over 2019 and 2020 respectively, this substantially affects the broker's forecasts for Fortescue earnings. Credit Suisse acknowledges it has gone to almost the highest iron ore price deck from the lowest, which has driven an increase in the target price to $8.20 and pushed its rating back up to Outperform from Neutral.

The broker believes the investment case for Fortescue is compelling for at least six months, given the limited global supply responses to the iron ore market tightness and continued strength in China's crude steel production. Specific to the company are the Eliwana and Iron Bridge developments as well as further capital management.

Outlook

Exceptional strength in the iron ore price has particularly helped lower grade products and meant the company's profitability doubled in the second half of FY19. While a large quantity of Brazilian supply has been suspended and Chinese stimulus is supporting demand, Morgans is concerned.

The stock is understandably trading higher on the news of the extra dividend, but the broker does not change its view that Fortescue Metals is trading beyond fair value on a 12-month basis. History has taught Morgans to be fearful when iron ore is trading at 45% above its long-term sustainable levels, also when the market focuses on spot fundamentals and relies on an upgrade cycle.

UBS suggests recent momentum in the stock can be attributed to the confirmation that Vale's 30mtpa Brucutu mine will not re-start as anticipated. The broker also notes the Fortescue Metals' weighted average discount narrowed to 8% in April/May from around 21% in February.

As a result of the trends, the broker has lifted the June quarter realised iron ore price estimate to US$80.40/dmt. UBS maintains a Sell rating on the stock, nonetheless, believing the current iron ore price is not sustainable.

At spot prices, if maintained for three years, the broker acknowledges, with a 100% pay-out ratio, the company could declare around $2.50 a share in dividends, or deliver an implied yield of 31%, fully franked. UBS suspects that Fortescue Metals intends to pay out 100% of earnings while the iron ore price is elevated.

FNArena's database shows three Buy ratings, three Hold and two Sell. The consensus target is $7.42, signalling -17.1% downside to the last share price. The consensus target has risen from $4.75 at the start of 2019. Targets range from $5.94 (Morgans) to $8.70 (Macquarie). The dividend yield on FY19 forecasts, on present FX values, is 13.0% and 12.1% on FY20 forecasts.

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Incitec Pivot Paves The Way To FY20 Recovery

Incitec Pivot has provided sharply lower earnings guidance for FY19 after a first half plagued by outages and manufacturing problems.

-New global manufacturing strategy expected to deliver ammonia upside by FY22 -Explosives volumes dependent on normalising of mining demand -Some improvement in fertiliser demand envisaged

By Eva Brocklehurst

A swag of events and manufacturing setbacks hampered Incitec Pivot ((IPL)) in the first half, which more than countered higher fertiliser prices and a weaker Australian dollar.

Underlying net profit dropped -72% and underlying earnings (EBIT) were down -15%. The non-recurring events included The Mt Isa rail line outage, disruptions to gas supply and manufacturing problems at a number of plants, overlaid by drought conditions on the east coast of Australia that affected the contribution from fertilisers.

The company has provided formal earnings guidance for FY19 for the first time, expecting earnings (EBIT) of $370-450m, down -25-34% and materially below previous broker forecasts. This guidance is subject to more normal seasonal conditions and no further manufacturing outages. The company also assumes some improvement in fertiliser prices.

The interim results were better than Deutsche Bank expected, yet while company is working through the challenges there are few tangible positives envisaged on the immediate horizon, apart from a rising urea price, recent rainfall, and a lower Australian dollar.

Morgan Stanley finds it difficult to envisage much growth, as the company will face a headwind of around -$22m in FY20 from contract losses and price re-setting. At this point, the broker also anticipates headwinds from fertiliser prices.

Manufacturing Strategy

A new global manufacturing strategy was announced, expected to progressively deliver $40-50m per annum of earnings upside across the ammonia portfolio by FY22. The company is targeting reliability of 95% by the end of FY21, which Macquarie compares with a baseline average of 85%. The broker notes the company's target is to be achieved via a new manufacturing team, greater use of predictive maintenance and a focus on safe and reliable operations.

UBS highlights the importance of the company executing on this strategy and envisages a positive outlook for explosives volumes, as mining demand normalises, although market dynamics and re-pricing will weigh on growth and operating leverage. At this point, UBS expects conditions in Australian farming, hence fertiliser demand, will normalise.

Credit Suisse welcomes the focus on improving profit from plant reliability and low-capital, technology-related investment in the ammonium nitrate business. The company maintains a solid balance sheet and the broker expects de-gearing to continue, as sustaining capital expenditure is well below the cash being generated.

The broker accepts that significant underlying growth in earnings is largely absent, but remains of the view that management can, potentially, distribute more cash to shareholders over the medium term.

Gibson Island

Morgans expects a strong earnings rebound in FY20 as the stronger outlook for Dyno North America and a normalisation of manufacturing come into play. The main overhang is the future of Gibson Island. The company is continuing to have discussions regarding the gas supply and operations at the site will cease in December if affordable gas cannot be secured. The latest estimate for closure costs is $65-75m.

Citi believes the likelihood of achieving lower gas prices is limited. Closure costs are expected to be partly offset by the sale of landholdings, at around $30m, and the company is now looking to use part of the site to import ammonia from an existing storage tank.

Second Half

Morgans points out the company's earnings are seasonally skewed to the second half, which benefits from fertiliser application for winter cereal crops in April/May/June and for cotton in August/September. North American explosives earnings are also skewed to the second half, given the bias to higher-margin quarry & construction markets in the northern summer.

Nevertheless, second half earnings will still be affected by the Queensland rail outage and the closure of the Portland manufacturing facility. There is also the potential for lower diammonium phosphate, urea and ammonia prices. Positives include a slightly lower Australian dollar and a drop in the Henry Hub gas price because of warmer than normal temperatures in the US.

Macquarie assesses the downgrade cycle is close to the bottom and FY19 is likely to be the seasonal/cyclical low point, as internal drivers are improving. The Waggaman plant in Louisiana has been running consistently since April and the Queensland rail line is now functioning.

The broker notes there are -$209m in pre-tax non-recurring items in FY19 and this provides a sense of underlying earnings improvement in FY20. The earnings impact from non-recurring events totalled -$141m in the first half, comprising the Queensland rail outage, third-party gas disruptions, and manufacturing issues at Waggaman & Phosphate Hill. The only updated estimate, Macquarie observes, was an increase in the second half Queensland rail outage impact, to -$55m from -$40m.

Credit Suisse points out second half guidance makes no significant allowance for disruptions. Forecasts for fertiliser and gas prices have a $10m positive impact on the broker's earnings forecasts for FY19 versus the company's price estimates. The market is expected to welcome the re-basing of ammonium nitrate contracts at Moranbah and there is scope for price upside as the east coast ammonium nitrate market tightens over the medium term.

Morgan Stanley acknowledges underlying growth in North American explosives volumes and assumes some improvement in Australian seasonal conditions, yet considers a clear end to the downgrade cycle is a prerequisite for any sustained outperformance, and this will require an inflection point in the fertiliser price and/or greater confidence in manufacturing performance.

FNArena's database shows four Buy ratings and four Hold. The consensus target is $3.65, signalling 13.3% upside to the last share price.

See also, Incitec Pivot Issues Brushed Aside on April 3, 2019.

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Scentre Group Takes The First Step

Scentre Group has made its first asset sale of 2019, a first step towards debt reduction.

-Sale does not do much for Scentre Group's leverage -Underlying conditions soft and balance sheet remains stretched -Further asset sales likely before buyback is considered

By Eva Brocklehurst

Scentre Group ((SCG)) has made its first revamp of the portfolio for 2019, selling a 50% stake in Westfield Burwood (Sydney) to Perron Group for $575m, a 4% premium to book value. The buyer has existing joint ventures at three other Scentre Group assets, two with Mirvac ((MGR)) and four with Vicinity Centres ((VCX)). It is the sole owner of Cockburn Central, Perth.

UBS considers the sale of Westfield Burwood significant, as it is the first regional asset to change hands since the acquisition of Eastgardens in July 2018. The broker calculates the transaction is -0.7% dilutive to free funds from operations over six months, which may imply a 6% initial yield.

Ord Minnett ranks Westfield Burwood six out of Scentre Group's 13 fully-owned assets and the 17th most productive shopping centre in the country. Burwood is a strongly performing suburban centre with potential residential development opportunities. The broker points out Scentre Group has not needed to sell a high-quality asset, nor has it offloaded one of its less productive and more growth-challenged assets.

Given the soft sales, challenging leasing conditions and the excess of retail assets on the market, Ord Minnett expects retail capitalisation rates, the ratio of income to the sale price, to soften by around -50 basis points in 2019.

Leverage

UBS agrees Burwood is not a top quartile asset in terms of dollar sales but it is expensive on a rate-per-square metre basis. Nevertheless, the sale does not do much for Scentre Group's leverage. The broker suspects the market will wait for further evidence of demand from a broader pool of capital, both offshore and local institutional, as Marion, Adelaide and Midland Gate, Perth are also on the market.

The sale was not that unexpected, Ord Minnett asserts, as the company is looking to lower leverage and obtain more flexibility to fund developments, and may be a buyback. The company $700m buyback lapsed in April, having been inactive since June 2018.

Still, the broker suspects Scentre Group will look to execute another partial asset sale before using some of the proceeds to fund a new buyback. UBS agrees the transaction, while reducing gearing by -1%, does not provide capacity to buy back stock. Kotara, Belconnen and Hornsby shopping centres make the most sense as funding sources, but the broker envisages several reasons why they may not be sold in the near term.

Macquarie had previously identified $12bn in assets that the company could divest to reduce leverage. Westfield Burwood was one of these, as it has limited development upside yet is of sufficient quality for capital partners to consider.

While Scentre Group's gearing remains high relative to other listed peers, Macquarie believes this transaction is the first step in the right direction. Downward pressure as other retail transactions come to market is anticipated. Hence, underlying cash flows are weak because conditions are soft and the balance sheet remains stretched.

Credit Suisse believes the stock's discount relative to net tangible assets reflects investor concerns around the balance sheet and the ability to fund the future development pipeline. The broker suspects the transaction will not be a one-off and that the company can fetch similar prices for other partial stakes to provide more room on the balance sheet.

FNArena's database shows one Buy rating (Credit Suisse), two Hold and three Sell. The consensus target is $3.84, signalling -1.4% downside to the last share price. The dividend yield on FY19 and FY20 forecasts is 5.9%.

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Valuation A Chief Concern For TechnologyOne

Large accounting clients continue to migrate to TechnologyOne's cloud offering but brokers remain concerned about the stock's valuation.

-Increased interim dividend, special dividend at final being considered -Sentiment and lower cost of capital are affecting valuations -Free cash flow likely to trail net profit, reflecting migration to SaaS

By Eva Brocklehurst

While accounting changes will have material impact on comparisons in the company's FY19 earnings statement, TechnologyOne ((TNE)) is still expected to increase its product per client as it transitions to software-as-a-service (SaaS). Large clients are expected to continue migrating to the company's cloud offering. TechnologyOne has less than 15% market share in Asia Pacific and 99% customer retention.

Accounting changes made cross-comparisons difficult in the first half results. Morgans notes, as recurring revenue expands, seasonality will dwindle but for now a large skew to the second half remains. The company has guided to pre-tax profit in FY19 of $71.6-76.3m. On-premises and consulting revenue declined -7% and -2% respectively. However, consulting profit of $3.4m reflects a turnaround from a loss in the prior corresponding half.

While free cash flow does not change materially, the accounting standard changes had a significant impact on the balance sheet and shareholder equity took a large hit. Total liabilities went up by $105m, reflecting cash received in advance but not yet booked as revenue in the profit and loss.

Setting aside the messy accounting, which is of little concern, Morgans believes the most appropriate measure to view is the 3.2c interim dividend. This was up 10% year-on-year and 75% franked, with a first half pay-out ratio of 56%. The board is also considering a special dividend at the end of the year.

The company also believes it is turning the corner in the UK business and remains positive about the opportunity, expecting significant upside in the UK in coming years. Macquarie agrees upside exists if the UK segment gains momentum but considers the stock's valuation stretched. The share price is expected to suffer from volatility as it becomes increasingly compared to higher-growth global peers.

Wilsons, not one of the eight stockbrokers monitored daily on the FNArena database, assesses the company has made the journey to cloud from on-premises business smoothly and expects this to continue.

Valuation

The central issue for most brokers is the valuation of the stock. TechnologyOne is trading as though it were a pure play global SaaS operator, Wilsons notes, yet does not fit this category, currently, given the legacy exposure. The broker envisages some near-term weakness but the upside in the medium term negates the need to downgrade and a Hold rating and $6.70 target are maintained.

While changes to forecasts have not improved substantially, the share price has rallied to near $9 from $5 in the last six months and Morgans asserts that sentiment and assumed lower cost of capital are impacting valuations. In conjunction with increasing passive/ETF and momentum funds, this is driving the share price higher. Hence, investors need to watch momentum closely for any material changes.

The main drawback for Ord Minnett was guidance around cash flow, suggesting that free cash flow in FY19 will trail net profit. This does not reflect collections but rather lower upfront cash payments from customers as they migrate to SaaS. While largely related to timing, it still affects forecasts, in the broker's view. As the valuation is now considered stretched, Ord Minnett downgrades to Lighten from Hold.

SaaS

Macquarie agrees the ongoing transition to SaaS is dragging on top-line growth, albeit generating significant long-term value. SaaS grew 45% in annual contracted value which offset weakness elsewhere. The broker expects, given the typical second half skew and the many growth levers TechnologyOne enjoys, the company will hit its typical 10-15% growth in pre-tax profit.

While some investors expect growth will accelerate materially with the transition to SaaS, Morgans does not expect this to happen. The company is expected to grow at at a steady rate around 15% per annum, consistent with CEO

Edward Chung's comment that the business should double in size in the next five years.

FNArena's database shows three Hold and one Sell (Ord Minnett) rating. The consensus target is $6.86, signalling -13.0% downside to the last share price. This compares with $5.61 ahead of the first half results. Targets range from $5.60 (UBS) to $7.80 (Macquarie).

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Cloudy Outlook For Computershare

Computershare will move its registry and mortgage servicing business to a global structure and has outlined expansion opportunities, although brokers suspect growth in FY20 will be difficult.

-Delays in UK mortgage service merger add to uncertain outlook -Interest-rate movements are unlikely to provide support -Equatex synergies reaffirmed

By Eva Brocklehurst

Computershare ((CPU)) has outlined a strategy for growth but brokers suggest a lot remains to be done to achieve its plans. The company will move to a global structure and away from its regional approach to running the business.

Computershare has reiterated guidance for FY19 management earnings growth of around 12.5% but, brokers contend, in the absence of a broader-based pick up in revenue and/or rises in interest rates, growth in FY20 is likely to be difficult.

Macquarie found the articulation of growth opportunities helpful and encouraging although expects it will take several years before these contribute meaningfully to growth. Macro tailwinds have abated, which, in the broker's opinion, limits re-rating potential.

Credit Suisse suggests, as the balance sheet is strong, some capital could be deployed in coming months to accelerate the expansion. Yet, while value is again emerging in the stock the broker remains hesitant to re-rate because of uncertainty over the near-term outlook.

Just as the interest rate environment has turned against the company, its IT integration in the UK has also muddied the water and, while the company is now more optimistic about growth in the registry (issuer) business from adjacencies, this appears to Citi to be a long-dated strategy that will take time to have an impact.

Interest-rate movements are unlikely to provide much of a boost to margin income and, while help could come via an acquisition, the broker points out asset prices are relatively high. Moreover, with a mixed track record in this regard, Citi suggests investors are likely hoping the company proceeds with care.

UBS believes strategic benefits from switching to product-based management from a regional focus are increasingly evident. Issuer services have a clearer and more consistent strategy to expand beyond the core registry and corporate action offerings into higher-growth governance and compliance support services.

Meanwhile, management believes it is approaching scale in US mortgage servicing, targeting 20% pre-tax profit margins and 12-14% return on invested capital in FY20.

UK

The company has completed its platform development for merging the UK Asset Resolution (UKAR) but delays have left stranded costs of US$35m for an extra year. Revenue is being booked in FY19 at above the original rate but will drop sharply in FY20 and FY21 to zero.

Ord Minnett assesses that the profit contribution from fixed fees in FY19, that will no longer apply, is more than previously expected and this will require some meaningful cost savings to offset. The company is seeking an additional US$50m in cost offsets in mortgage servicing over three years in order to retain profits.

Macquarie believes consensus expectations were too optimistic on both margin income and UK mortgage services. As the stock has underperformed the ASX 200 by -9.1% the broker's rating is move back to Neutral from Underperform.

Headwinds in the UK have overshadowed a stronger story in the US, UBS points out. As the execution risks around cost reduction targets are not insignificant, and there is better strategic growth prospects emerging elsewhere, the broker also opts for a Neutral rating.

Equatex

Equatex, meanwhile, is tracking well, with a US$30m target for cost synergies being reaffirmed. The company points to client feedback about its new offering, noting a willingness to purchase more product. As employee share plans will move to a global management model in future, Morgans suggests this should provide benefits in terms of leverage, speed to market and service quality.

FNArena's database shows seven Hold ratings and one Sell (Morgan Stanley, yet to comment on the briefing). The consensus target is $17.10, signalling 2.9% upside to the last share price.

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Domino's Pizza Comfortable With Progress

Domino's Pizza appears comfortable with the progress being made, as it continues to roll out stores in Europe, maintaining earnings guidance for FY19.

-Australasian margins expected to remain under pressure -Aims for 10-15 stores in Denmark within 6 months -August 21 results expected to test forecasts, given recent misses

By Eva Brocklehurst

Domino's Pizza Enterprises ((DMP)) has sounded the 'all's well' siren, reiterating FY19 earnings (EBIT) guidance. Citi, forecasting $225m, prefers to be slightly below guidance, slated by the company at the lower end of the $227-247m range. A lot is factored in to FY20 based on rolling out new stores which, the broker highlights, have recently been below target.

The next catalyst is the results on August 21, which brokers expect will test the company's ability to meet guidance, given four consecutive half-year periods when guidance was missed. However, the fact there was no revelations about trading to cast doubts on forecasts alleviates most of this risk, UBS asserts.

Deutsche Bank finds nothing materially new in the update and continues to envisage downside risk to FY19 guidance, expecting Australasia and Europe to remain soft and this to be only somewhat offset by better results from Japan. Australasian margins are expected to remain under pressure as a large share of the profit pool is taken by the franchisor.

CLSA continues to like the business for its strong innovation and significant long-term growth forecasts. The broker, not one of the eight monitored daily on the FNArena database, assesses the stock is “superb” value, maintaining a Buy rating and $55 target.

Europe

While the absence of an actual trading update for FY19 could be construed as good news, UBS points out June is a key trading period in Europe. Domino's Pizza aims for 10-15 stores in Denmark within six months and, while this is a small market, existing overheads in Europe are expected to provide leverage to drive profitability.

Management expects Europe to accelerate in FY20 and has signalled progress in overcoming historical franchisee reluctance in relation to store expansion in France. Still, Credit Suisse suspects the European expansion debate will likely continue amongst investors until a consistent growth path is achieved.

Citi expects sales trends in Europe to remain sluggish and margin expansion to be modest. The company's performance in France remains difficult, the broker notes, and tactics have reverted to the Mardis Fous (Crazy Tuesday) promotion. Online order aggregators will be used in France, which Citi considers practical and essentially a lower-cost customer acquisition. On this point, however, UBS notes the roll-out of has been delayed.

Meanwhile, Germany is on track and all store conversions from Hallo Pizza have been completed. Credit Suisse was a little surprised that Germany would move to organic store openings, as suggested by management's commentary, given Hallo Pizza has just recently converted to the Domino's Pizza brand. The broker suggests investors could look to FY20 as a test of the company's European strategy.

Australasia

Citi also doubts the Pizza Checker in Australia will have a big impact on customers, although it may improve product credibility. Meanwhile, a number of poor performing franchises in Australasia have moved to corporate stores so the second half of FY19 is shaping up as a transition period. The company is signalling there is no significant profit impact in the second half as a result of the transition.

There has been positive feedback, meanwhile, in Japan regarding new lower-price choices and more marketing expenditure is expected in this regard. The debate in Japan centres on the success of the "barbell strategy", specifically lifting the volume of value sales and adding higher value to the menu. Credit Suisse believes the company needs to do this in order to have an impact on franchise economics in that country.

FNArena's database shows two Buy ratings, three Hold and three Sell. The consensus target is $44.40, signalling 12.4% upside to the last share price. Targets range from $35.00 (Deutsche Bank) to $51.40 (Macquarie, yet to

comment on the update).

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Bright Outlook As Aristocrat Leisure Performs

Brokers are encouraged by the outlook for Aristocrat Leisure after the company's first half results, expecting the digital business will reveal its potential in the second half.

-Retains strong North American share of land-based gaming -Australian margins improve, with a shift in sales mix towards recurring revenue -Digital expected to return to growth in the second half

By Eva Brocklehurst

Aristocrat Leisure ((ALL)) expects continued growth over the rest of FY19, with some skew in earnings into the second half. Brokers are encouraged by the outlook, as the digital business in FY20 should reflect the benefits of the company's design developments.

Aristocrat Leisure is on track for $1bn in profit by FY20 on UBS estimates, as the land-based business continues to expand its revenue share and the outlook for digital improves with the release of major game titles. The broker suggests there is further upside as the market becomes more comfortable about the digital execution. The company has been adding features to Product Madness to arrest sales erosion and has reported positive signs early in the second half.

UBS predicts this will come with double-digit revenue growth and should occur in the second half of FY19. While the market has been rightly focused on the outlook for digital business, the broker highlights a North American ship share of 23% in land-based gaming, and remains of the view that the company is re-entering an upgrade cycle.

North America was the highlight for most brokers, as the company retains a dominant position with strong growth in outright platform sales and installed gaming operations. Deutsche Bank has observed from recent survey and peer results in North America that Aristocrat Leisure is continuing to gain share in class III and class II as well as hold share in the more competitive outright sales segment.

Operating leverage appears to have returned earlier than Macquarie expected. The overall margin in the Americas was 55%, slightly lower than the prior comparable half but a material improvement sequentially. Macquarie expects ship share, excluding adjacencies, and based on buyer feedback, should hold around 24% given the superior game performance.

Morgans notes a significant opportunity in adjacent markets in North America with moves into the Washington CTS and video lottery terminal markets showing good early traction. There are indications this new volume can be sustained to at least FY21.

The Australian performance was also firm, and the company leads the market, with margins improving because a shift in sales mix towards recurring revenue. Still, Credit Suisse is concerned about the company's poor disclosure in Australia, which having experienced lower volumes and slightly higher prices provided no explanation regarding the 7% revenue growth. A weaker second half in Australia is envisaged. The broker has difficulty calculating the effects of the new licensing pricing model.

Digital

Margins contracted in the digital business, as expected, because of an increase in the number of bookings in the lower-margin casual segment. In digital, Credit Suisse found it useful that the company disclosed that no game has revenue large enough to cause an insurmountable drag on earnings should it fail to gain traction.

Digital, which represents around 27% of segment profit, is considered likely to return to growth in the second half. Segment profit fell -7% on a pro forma basis in the first half, driven by increased user acquisition expenditure to support additional game releases.

Macquarie suggests the company's rigorous approach to digital games development, where only games that meet performance hurdles go through to being launched, should drive discipline in user acquisition expenditure. Wilsons expects the digital business will remain a concern for a while as confidence needs to improve despite the company alluding to a better second half.

Ord Minnett expects margins to vary in the digital business between 30% and 35% as the portfolio undergoes changes. However, higher margins are expected in the long-term. The broker assesses the company is methodically de-risking title development for land-based slots and digital platforms.

Growth exists in both areas through FY20 and capital management opportunities should become available. Ord Minnett suggests, coupled with strong execution by management, the risk/reward balance is attractive.

Wilsons, not one of the eight stockbrokers monitored daily on the FNArena database, had conservatively moved to Hold ahead of the results but now believes it was too cautious. Rating is upgraded back to Buy with a target of $32.15.

FNArena's database shows six Buy ratings and one Hold (Morgan Stanley). The consensus target is $32.65, signalling 13.6% upside to the last share price. Targets range from $29 (Morgan Stanley) to $42 (Deutsche Bank).

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Material Matters: Iron Ore, Met Coal & Copper

A glance through the latest expert views and predictions about commodities. Iron ore; metallurgical coal; aluminium; and copper.

-Iron ore supply disruptions continue, prices likely well supported over the next 3-6 months -Macquarie sees limited appetite for capital expenditure on coal by listed Australian miners -Recovery in aluminium prices contingent on supply reforms an easing of trade tensions -Current weakness in copper price considered a reasonable entry point for renewed upside, in Macquarie's view

By Eva Brocklehurst

Iron Ore

Chinese steel production was at a record in April, reaching a 1bn tonnes per annum run rate for the first time. This comes at a time when iron ore shipments are materially affected by supply disruptions from Brazil, and to a lesser extent Australia. JPMorgan expects iron ore prices to remain well supported over the next 3-6 months. The main downside risk is the potential for Chinese domestic supply to re-start.

Shaw and Partners notes supporting themes for the iron ore price, include record steel production in China, declining port stocks and complacency among steel mills. The broker has feedback suggesting steel mills in China have been complacent about procuring iron ore and the trends at ports are worse than many suspect.

There are also temporary capacity curtailments in China likely, as environmental inspectors review mills, sinter plants and coke ovens. Vale has also just announced the potential risk for a rupture at another of its mining waste dams.

Shaw and Partners believes the company's social and regulatory licences are looking increasingly under pressure. Vale has indicated that a step up in production may not be possible until after 2020.

Metallurgical (coking) Coal

Macquarie observes the continued underperformance of Australian supply has supported coking coal prices over the last three years and total exports are still below 2016 levels. The gap has been filled by high-cost supply from the US.

While rail logistics and longwall moves are often the "go-to excuses" for a miss on production, Macquarie notes some hard coking coal mines appear to have deeper issues. The broker is mystified by the underperformance of BHP Group's ((BHP)) Goonyella and Blackwater mines, and notes the prevailing view that limited availability of ROM (run of mine) coal could deliver further negative surprises.

The ramp up of new mines in Australia are mostly adding semi-soft, PCI or lower tiered hard coking coal. Macquarie finds very little growth in the premium sector of the market. The majority of hard coking coal reserves are in the hands of diversified listed miners and they appear to have little appetite for capital expenditure on coal.

Macquarie continues to expect the hard coking coal market will remain tight, pointing out the quality spreads have held up much better than for iron ore, despite the weaker steel margins globally.

Aluminium

Fundamentals are positive for aluminium, as inventory continues to fall amid tightness in world markets, ex China. Demand in China is also improving. However, ANZ Bank analysts suggest any recovery in prices remains contingent on ongoing supply reforms and an easing of trade tensions with China.

The impact of the tariffs on Chinese aluminium imports into the US has been relatively minimal and ANZ Bank envisages little impact from the increase to 25%. Meanwhile, demand in China for aluminium is showing signs of recovery as housing, electricity grid investment and durable goods were all up sharply in recent months. Moreover, while the automotive sector remains weak the recent drop off in growth has eased.

Chinese authorities have been driving a reduction in aluminium smelting capacity to ease the environmental impacts and at the same time producers have been installing new replacement capacity, although the analysts note this trend is coming to an end.

The risk of Chinese output rising, therefore, has not eased completely. Market rumours suggests recent environmental restrictions may also be lifted to support domestic economic growth.

Copper

In the unlikely event of a halt to Chinese exports to the US, Macquarie calculates this would reduce copper consumption by around -1.5% of the global total. However, the downside impact of a failure of talks is likely to ensure a return to stimulus policy in China as a response, and provide support to half the global metal consumption.

The breakdown in US-China talks has come at a fragile time, the broker acknowledges, and the two countries do account for 56% of copper consumption. However, the balance skews towards China's activities, as it incorporates 60% of expected incremental copper demand growth for 2019. Thus, the potential damage to copper demand needs to be primarily assessed in terms of Chinese domestic end-use, plus exports to US end-use.

The theoretical slowdown and expected loss of copper demand has already meant the prices have tracked -6% lower, down to around US$6000/t. Macquarie believes this is a reasonable entry point for renewed upside because cathode supplies are constrained and cathode demand is likely to rise on a 3-6 months horizon. The broker expects, as its base case, that a trade deal will be forged.

If exchanges between the two countries become more aggressive Macquarie expects another sell-off in copper. However, the broker targets a return to the previous range of US$6400-6600/t , and possibly higher, if trade talks are back on the agenda around the same time as news flow around problems in the scrap metal market emerge. The broker points out incoming category 6 scrap restrictions appear set to at least temporarily disrupt the secondary supply chain of copper into China.

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CORRECTION: Trade Impasse Threatens US Lithium, Rare Earth Imports

CORRECTION: The original version of the article below republished by FNArena erroneously stated that Lynas Corp's processing mill in Malaysia had been shut down until the issue of radioactive waste is resolved. The erroneous paragraph has been removed in this update.

Lynas' mill has been under question from Malaysian politicians for many months but the mill is continuing to operate, pending licence renewal in September. The company has this week announced various measures to allay the Malaysian government, including moving the initial process, which produces the waste, to Australia, leaving only final processing in Malaysia.

by Richard (Rick) Mills Ahead of the Herd

As a general rule, the most successful man in life is the man who has the best information.

Trade impasse threatens US lithium, rare earth imports

On Friday May 8 the United States made good on its threat to ratchet up the trade war against China, after the two parties failed, after weeks of negotiations, to reach a deal.

The Trump administration hiked tariffs on $200 billion worth of Chinese imports to 25% from 10%, adding to the $50 billion in goods already being taxed at that level. The tariff hikes went into effect at midnight on Thursday.

The negotiations appeared to be going well up until recently, when Treasury Secretary Steven Mnuchin and Trade Representative Robert Lighthizer accused the Chinese of reneging on earlier commitments.

Nobody outside the trade delegations knows what went on behind closed doors in Washington, but it appears to us that the American team just got played. Dealing with China, or other Asian nations for that matter, is different from negotiating with fellow North Americans, or Europeans. It's important to come across as respectful, and calm. Shrewdness is valued. Bluster and strong-arming are frowned upon.

Chinese negotiators will seldom agree to the first draft of a deal; the more common practice is to go back on what was discussed and amend the agreement, knowing full well that the other side won't accept. But that's ok. Like a chess game, the Chinese delegation was likely awaiting the next US move. Instead the American delegation slammed its fist on the chess board, immediately ending the game.

Now comes the punishment for not agreeing quickly enough to US demands. But anyone who knows Asian culture, understands that "losing face" is a big deal. They can't, and won't, give in to threats, for this shows weakness. Instead China's commerce ministry said it would impose "necessary countermeasures" without giving any details.

President Trump said he's in no rush to reach a deal - although in reality, his deadline is the 2020 presidential campaign - but he also remarked "the process has begun" to slap 25% tariffs on the remaining $325 billion in goods from China – which would raise the total value of Chinese goods being penalized, to $540 billion!

It's worth noting that, with $250 billion of $540 billion worth of total Chinese imports to the US now under tariff, the States has a lot more room to the negotiate than China, which has levied import duties on all but $10 billion of the total $120 billion worth of US exports to the country.

So far this trade dispute has not seriously hurt either nation - although going by GDP numbers, the US is winning (agriculture, tech and automobiles are most affected).

The US Gross Domestic Product is at a healthy 3.2%, inflation is under 2%, the number of jobless is at a record low, and wages are even rising. China on the other hand is still bumping along at 6.4% GDP growth in the first quarter, the same as the last three months of 2018.

The bilateral trade deficit - something Trump has railed against for years - is narrowing, due to US businesses and consumers buying less from China and exporting more. In November 2018, the latest month available, the trade deficit fell US$2.8 billion to $35.4 billion, a fall of 7.3%, South China Morning Post reported.

Trade figures released on January 14 showed China's December exports to the US slowed to $221.24 billion, 4.4% less than December 2017.

"We find strong evidence that the 25 per cent tariff on US$50 billion of imports from China [imposed in July and August last year] is having a significant negative impact on prices and volumes," the Hong Kong-based news outlet quoted the Institute of International Finance, in an analysis of the tariffs' impact.

US negotiators shouldn't feel too emboldened by those figures, however. The China delegation has plenty of ammunition to fire at the US team should negotiations continue to stall. We know that Beijing must retaliate, in order to save face. Light punishments could include selling some US Treasuries, not participating in future US debt sales, devaluing the yuan, in order to make exports cheaper and entice US consumers to buy more Chinese products, or stop buying US soybeans, the US leading export to China.

All this is possible, and will make stock markets roil, but we at Ahead of the Herd are thinking further ahead. We wonder what could happen if the aggro between China and the US escalates, and the two sides start looking at sectors to embargo.

This article looks at two of America's most import-dependent commodities - rare earths and lithium - to get a sense of what could happen if China, due to the trade war, stops supplying US companies with these crucial technology metals.

Two aces in the hole

Most people don't know it, but the US is dependent on foreign countries for over 20 critical metals, including battery metals used in electronic devices like cell phones and electric vehicles.

Without a reliable supply chain, a country must depend on outsiders. This gives foreign suppliers incredible leverage over the United States. There is always the possibility of slowed flows or bans on strategic materials, due to politics or trade disputes, such as the ongoing trade war with China.

If China were to suddenly refuse sale of any of the 20 out of 23 metals the US deems critical to the economy or defense of the nation, the US economy would be in serious trouble.

The Trump administration recognized this when the president issued an executive order in December 2017, instructing his people to devise "a strategy to reduce the Nation's reliance on critical minerals" that are largely imported.

"The United States must not remain reliant on foreign competitors like Russia and China for the critical minerals needed to keep our economy and our country safe," Reuters quoted President Trump saying. The directive was a response to the USGS' first assessment of US critical minerals since 1973. Its report concluded that the US relies on China for sourcing 20 out of the 23 minerals deemed critical for US national security and the economy.

Included on that list are the building blocks of the new electrified economy, including lithium and rare earths. China has a stranglehold on both of these metals, meaning it can use them as a cudgel in trade talks with the United States.

Rare earths

The United States was once the largest producer of permanent magnets, used in dozens of industrial applications including electric vehicle motors and for wind turbines. Permanent magnets are built from the rare earths neodymium, praseodymium and dysprosium.

That was until the mid-1990s, when the US ceded control to China, which now has a monopoly, either mining or processing over 90% of the 17 elements on the Periodic Table, used in everything from smart phones to weaponry.

Without a domestic supply, the US must rely on Chinese rare earths and technology to build "made in America" military and space equipment. (For the fascinating story on how this happened, read Magnequench Has Left the Building and How the US Lost the Plot on Rare Earths)

For example, permanent magnets made from Chinese rare earths are used in the Joint Strike Fighter, the Pentagon's answer to a one-size-fits-all warplane. Rare earth metals, alloys and magnets needed by US defense contractors come either directly or indirectly from mostly China.

The US doesn't want to do that, but China has pretty much cornered the market on rare earths. Sure, there are a handful of other countries that mine and produce them, but the process is so difficult, costly and harmful to the environment, if done wrongly, that few attempt it.

The only US rare earths mine, Mountain Pass in California, was sold a few years ago to a US-led consortium. The rare earth concentrate is shipped to China for processing by the Chinese company in the group.

For years, China has been the world's largest rare earths exporter, shipping over 53,000 tonnes in 2018, 4% more than 2017.

It's all part of China's plan to produce more rare earths for internal consumption than for export, which is in line with the country's ambitions in the global clean energy trade. China is already the world's largest solar power producer and sells the most electric vehicles. By 2020, the Chinese government wants its battery makers to double their capacity (BYD is the largest electric vehicle battery company in the world) and start investing in production facilities overseas.

Here's Scientific American on how China is investing in rare earths in order to monopolize clean energy, at the expense of non-Chinese companies and the US:

Already, more than 80 percent of the world's rare-earth elements are extracted in China. But the Chinese government isn't done—they have higher ambitions for REEs. By 2020, China wants to increase domestic REE production by 15 percent annually while also decreasing the proportion of primary raw materials meant to be exported from 57 percent down to 30 percent. Beijing's intention to control the outward flow of REEs would create bottlenecks limiting the ability of non-Chinese companies to manufacture their products outside of China.

While China has been barreling ahead in its quest to dominate REEs, the United States has only become more dependent on REE imports—rare earths were not mined at all in the U.S. in 2017, with China supplying 78 percent of imports in between 2013 and 2016. These elements are necessary to manufacture not only wind turbines and solar panels, but also cruise missiles and stealth aircrafts.

Molycorp get played

In 2009 the Chinese government imposed export controls on its rare earths, meaning a 40% drop in exports. Beijing said it had to implement quotas to protect the environment, but critics saw them as naked protectionism.

China was about to play Molycorp like an erhu, a Chinese violin.

A year later, an international incident sent rare earth oxide prices into the stratosphere. In September 2010 a Japanese naval vessel interdicted a Chinese fishing boat near the Senkaku Islands, which Japan and China both claim ownership of, and detained the captain. The Chinese decided to ban all rare earth exports to Japan, then an industrial powerhouse and China's largest REE customer. The rare earths market panicked, and within months, all of the rare earth oxides gained in price.

The result was the re-opening of the Mountain Pass Mine, including a $130 million investment by Japanese conglomerate Sumitomo to upgrade the mine. By 2014 it was producing 4,700 tons of rare earths a year.

While the spike in rare earths prices was good for miners like Molycorp and the numerous exploration companies that sprang up in search for them, buyers of products made from rare earths balked and pressured governments to do something about it. The US, European Union and Japan brought a case to the World Trade Organization to try and settle the dispute and get China to lift the restrictions.

In 2015 it did, resulting in a torrent of Chinese rare earth exports into the market and the inevitable collapse in prices. The move caught Molycorp off-guard. The company had just spent over a billion dollars on another upgrade at Mountain Pass but within months, the company fell deeply in debt and went bankrupt.

The mine was put on care and maintenance and eventually sold at auction in the summer of 2017 for a shocking $20.5 million - a fraction of its previous worth. The new owner is MP Mine Operations LLC, an American-led consortium, with Chinese rare earths miner Leshan Shenghe Rare Earth Co. holding a minority interest. Mountain Pass currently ships rare earths concentrate for refining in China, although the owners say they plan to build processing capacity in the US.

At the time, China was using its rare earths monopoly to either choke or flood the market with rare earth oxides, as best benefited them. Now, imagine that Beijing decided to go for the jugular, and embargo rare earth oxides to the United States. All the rare earth end users - buyers of rare earth powders and metals used in high-tech applications such as smart phones, catalysts and LED screens - would be scrambling to find another source.

One key point: while the US is dependent on foreign suppliers of rare earths, it depends 100% on China for rare metals that have been processed into a final, usable form.

Victoria Bruce, the author of 'Sellout: How Washington Gave Away America's Technological Soul' agrees that "China holds a secret weapon that could cripple us instantly. Let's call it, Trade War Option "57 – 71".

Bruce points to America's military vulnerabilities, should China ever exercise its full power over the world's rare earth elements. Here's Victoria Bruce, writing a column in The Hill:

Rare earth metals are so critical and in so many defense components for guided missiles, smart bombs, targeting lasers, sonar, radar, night vision and high temperature resistant metals for military jet engines, that if China cut us off, the U.S. could not replace or build most of our advanced weapon systems.

These materials are also found in smart phones, small electric motors, sensors and catalysts in automobiles, computers, commercial aircraft and most green technology. If China embargoed these materials the U.S. would be forced to shut down all or most of our nation's technology manufacturing assembly lines.

This single category of imports, with a global resource value of about $3 billion, becomes an essential input to about $7 trillion in value-added goods on a global basis. The U.S. controls zero.

How did we get into this precarious position?

The most recent 2016 Government Accounting Office (GAO) report called China's monopoly on rare earths a "bedrock national security issue," and back in 2010, the GAO warned Congress that it could take up to 15 years for the U.S. to re-develop its own rare earth supply chain. Still, Congress failed to act.

In fact, Congress is taking action, though it's too late to prevent any trade retaliation from China. Last year, an amendment to the National Defense Authorization Act (NDAA), that would facilitate streamlined permitting for critical and strategic minerals, passed the floor of the House of Representatives on a bipartisan vote of 229-183.

A press release from the Congressional Western Caucus revealed some interesting tidbits regarding US dependence on rare earth imports, including:

The U.S. Department of Defense uses as much as 750,000 ton of minerals each year. A non-classified defense study recently found that failure to have a reliable supply chain for at least 16 of the 35 critical minerals has already caused significant weapon system production delays for the Department of Defense. According to the USGS, the gear of one U.S. Navy SEAL contains at least 23 mineral commodities, for which the United States relies on its imports. A Chinese embargo on rare earths would be equally devastating to US industry, especially considering that their use in permanent magnets - necessary for electric vehicles and wind turbines, two of the most important technologies to wean Americans off of fossil fuels.

Among the US companies that would be most badly hurt either from export restrictions on rare earths or, outright bans, are Apple, Tesla, General Electric, Western Digital, Seagate and Cree, Inc.

An iPhone has nine of the 17 rare earth elements, such as lanthanum, found in the phone's circuitry. Praseodymium and neodymium are in the ear buds, and rare earth elements are used to make the vivid colors that light up the phone's LED screen.

Tesla's Model X and Model 3 contained induction motors that did not require REEs, but the electric car maker has switched to a magnetic motor that uses neodymium in its Model 3 Long Range. Permanent magnets are also in the Nissan Leaf, Chevy Volt and BMW i3.

Demand for neodymium is so strong that in 2017 it outpaced supply by 10%.

Iconic American company General Electric is also beholden to rare earths, having gotten into the wind turbine market in a big way; GE is one of the world's leading wind turbine suppliers at about 35,000 installed throughout the world. A typical wind turbine contains 350 kilograms of rare earths - primarily neodymium in the permanent magnets.

Finally, the neodymium-iron-boron magnet is an indispensable component for hard disk drives made by Western Digital and Seagate, the two main suppliers of HDDs. Praseodymium and erbium are also used to produce high-strength glass substrates, which optimize HDDs by improving their strength, chemical stability, and adhesion to a magnetic recording layer, Robert Castellano writes in Seeking Alpha. Cerium is employed as a polishing slurry in these glass disks, which are rapidly replacing aluminum disks.

"If a rare earth embargo were to be enacted, it would damage the competitiveness of U.S. companies," Castellano concludes.

Lithium

According to the latest data from the USGS (United States Geological Survey), Australia cranked out 18,700 tonnes of lithium in 2017, with Chile coming close at 14,100 tonnes. Argentina was a distant third at 5,500 tonnes. The global market for lithium carbonate equivalent (LCE), as the mined product is measured, was 284,839 tonnes last year.

Up until a few years ago there wasn't much buyers' competition for lithium, since it was a relatively small market that supplied lithium ion batteries for electronics and power tools, mostly. Since the electric vehicle began to

penetrate the internal combustion engine (ICE) car market, however, lithium has become the commodity to secure.

The International Energy Agency is predicting 24% growth in EVs every year until 2030. A Reuters analysis shows that automakers are planning on spending a combined $300 billion on electrification in the next decade.

Volkswagen has said it will invest $800 million to construct a new electric vehicle – likely an SUV - at its plant in Chattanooga, Tennessee, starting in 2022.

GM is planning to sell its first EV this year, a 2020 Cadillac SUV, built in Spring Hill, Tennessee, in a move designed to challenge Tesla.

Meanwhile more battery factories are being built, driven by the demand for lithium ion batteries which is forecast to grow at a CAGR of over 13% by 2023.

There are 68 lithium-ion battery mega-factories already in the planning or construction stage.

In December Korean company SK Innovation said it will invest US$1.6 billion in the first electric vehicle battery plant in the United States, and is considering plowing an additional $5 billion into the project, planned for Jackson County, Georgia.

All of this explosive growth in battery plants and EVs will means an unprecedented demand for the metals that go into them. This includes lithium cobalt, rare earths, graphite, nickel and copper.

So, the need for lithium is going through the roof, but the United States produces very little of the white metal.

The United States has just one lithium brine operation, the Silver Peak Mine in Nevada, but it's been operating since the 1960s and its grades are said to be declining. Silver Peaks lithium is processed into lithium hydroxide and shipped to Asia.

China doesn't produce much lithium either, about 3,000 tonnes compared to Australia's 18,700 and Chile's 14,100.

But China has made up for its lack of production capacity by becoming the dominant player in processing the stuff, and by inking offtake agreements with overseas lithium miners.

In December, China's Tianqi Lithium paid $4.1 billion to become the second-largest shareholder in SQM, Chile's state lithium miner. The mega-deal effectively gives Tianqi control over half the world's lithium production. The company already owned 51% of the largest hard-rock lithium mine, Greenbushes in Australia.

Chinese entities also control 60% of the world's electric battery production, and the majority of lithium hydroxide, the high-grade lithium product that goes into Tesla's lithium ion EV batteries, for example.

This has put the United States in a vulnerable position with respect to securing the lithium it will need for current and future electric vehicle production.

If China were to embargo all the lithium it mines or processes, destined for the United States, the result would be a serious setback for the country, just as it is taking steps to become a player in the lithium space.

The Diplomat reported in February that "Miners are pushing to sharply boost lithium output in the United States, as automakers in the world's third biggest electric vehicle market are eager to cut their dependence on China for the critical battery ingredient and find more local sources.

"In North Carolina, Nevada and half a dozen other states, miners are working to revive the U.S. lithium industry, once the world's largest until it fell off in the 1990s… Miners are betting U.S. expansion will pay off with orders from battery and vehicle manufacturers who are wary of relying too much on China, which is home to the majority of the world's lithium processing facilities and sucks up most output of top producer Australia."

And Reuters said in April that "U.S. government officials plan to meet with executives from automakers and lithium miners in early May as part of a first-of-its-kind effort to launch a national electric vehicle supply chain strategy, according to three sources familiar with the matter.

While Volkswagen AG, Tesla Inc and other electric-focused automakers and battery manufacturers are expanding in the United States and investing billions in the new technology, they are reliant on mineral imports without a major push to develop more domestic mines and processing facilities.

China already dominates the electric vehicle supply chain. It produces nearly two-thirds of the world's lithium-ion batteries - compared to 5 percent for the United States - and controls most of the world's lithium processing facilities, according to data from Benchmark Minerals Intelligence, which tracks prices for lithium and other commodities and is organizing the Washington, D.C., event.

U.S. imports of lithium have nearly doubled since 2014 due in part to rising demand from Tesla, SK Innovation Co and others building battery plants in the country, according to the U.S. Geological Survey.

Conclusion

The US government under the direction of Donald Trump has either blundered into a dangerous escalation of the trade war with China, by aggressively hiking tariffs on $200 billion worth of imports, or executed a brilliant offensive maneuver. We should know which very soon, when China announces its counter strike.

I say brilliant because, while the Trump administration's brash negotiating style represents everything the Chinese dislike about America, it could get results. So far, as a negotiating tactic, the tariffs appear to be working in the US's favor - just look at how well the economy is doing. We know the last relatively high GDP number reported is due, mostly, to the hundreds of billions of repatriated profits and share buybacks artificially goosing corporate earnings and the stock market. Along with a frenzy of debt-fueled consumer spending.

Meanwhile Chinese growth has flatlined and some believe the country is on the cusp of an ugly debt crisis. In these circumstances, it seems reasonable that the strong US economy could outlast China's weakening one in a trade war.

The latter could embolden Trump to stick to his guns, but this article has been about China upping the ante. The secret weapon that could cripple the United States and force it into making a major concession(s), is an embargo on rare earths, lithium or both, plus other strategic metals the US doesn't have.

We don't know what will happen, but we do have a historical precedent. When China restricted rare earth exports in 2010 rare earth oxide prices went ballistic. Imagine what kind of an effect an embargo could have on prices…

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ESG Focus: Helping Pengana To Sell The ESG Message

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Helping Pengana Selling The ESG Message

By Rudi Filapek-Vandyck, Editor FNArena

Peter Hall, the driving force behind what once was one of Australia's successful and leading ethical investors, Hunter Hall, saw his career abruptly cut short when a too confident bet on local biotech Syrtex turned sour. Since June 2017 Pengana Capital Group is managing the fund renamed Pengana International Equities ((PIA)), which still operates within an ethical framework but solely in international markets.

The new managers in charge have deliberately scaled back the volatility in the fund's performance, and made its dividends to shareholders more reliable and stable, but, nearly two years after taking control, one niggling problem remains unaddressed: a severe lack in liquidity means the ASX-listed shares continue to trade well below the fund's Net Tangible Assets (NTA) valuation, to just about every stakeholder's frustration.

And there doesn't seem to be an easy solution at hand either, with the fund's attempt to increase total shares count via the issuance of options likely to prove futile. It's back to the drawing board thus.

In the meantime, the fund managers are touring Australia in a bid to communicate with shareholders, explain their strategy and ask for understanding as far as the heavy discount is concerned that remains embedded in the share price.

Not completely unexpected, the recent shareholders gathering in Sydney elicited mostly questions about Labor's intended franking policy, its potential impact for retirees living off income from investments and what Pengana can possibly do to cushion any negative consequences.

Questions were also asked as to how the manager's ethically oriented investment process could possibly be to shareholder's best interest, and here, on my observation, the fund managers found it rather difficult to state their case in an overly convincing manner. Which is a shame, because ethical investment is not a guaranteed pathway to subpar investment returns (even though PIA's total returns to date have fallen short of the benchmark and of competitors).

Plenty of international academic research supports the notion that ethical investing over time generates superior returns, irrespective of the observation that stocks with inferior qualities can temporarily rally to the moon and back, as we all know. Instead of trying to argue the point that missing out on a temporary rally in, say, oil and gas stocks does not matter long term, I think the managers of PIA can make a much more attractive, and convincing case by referring to what should be missing in their portfolio.

Take Retail Food Group ((RFG)), for example. For years its shares had been a solid performer on the ASX, until the central holding company was exposed for what it is; a badly managed, profits-above-everything, let's squeeze the franchisers to their last breath kind of operation that, in hindsight, was always going to come unstuck at some point.

It's somewhat hard to believe today, but the shares were exchanging hands on the ASX at a price tag of around $7.50 a piece as recently as March 2015. Today, Retail Food Group shares are trading around 21.5c and they almost certainly are not going anywhere in a hurry.

Meanwhile, the negative news flow simply keeps on generating more revelations. If ever Hamlet's statement about something being rotten at the core applied to one company on the ASX, it must be this one.

The point here is that any scrutiny from an ethical or ESG filter perspective should have prevented fund managers such as Pengana (or Hunter Hall in its previous existence) to go anywhere near an investment in Retail Food Group, irrespective of the company's immediate prospects and general popularity at that time.

This is, in essence, the most valuable aspect of using ESG (ethical, social & governance) as a filter in the investment process. Badly managed companies are most likely to attract bad news flow and operational disasters, and badly managed companies score badly on ESG score cards.

A similar case can be made for past assessment of investing in AMP ((AMP)), IOOF ((IFL)), and even the Big Four Banks (though I doubt whether anyone would have scored the banks accurately on ESG measures pre-Royal Commission). Since PIA does not invest in the Australian share market, there should be plenty of suitable examples on offshore exchanges.

I remember reading how the Deepwater Horizon oil spill in 2010 had been preceded by numerous indications BP was not the world's most prudent and risk-conscious operator, to put it mildly. And it certainly seems the bad news flow, and potential financial ramifications from the 737 Max plane disasters for Boeing is nowhere near its end.

Stringently applied ESG filters should keep such disasters out of the portfolio; a message that will be understood by every kind of investor, irrespective whether they have experienced portfolio disaster first hand or not.

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The story below is an example of how the managers of Pengana International Equities use ESG filters and considerations in their investment process.

Ethics focus: Axon Enterprises

With unmatched market dominance, a compound annual growth rate of 16% over the last seven years and a mission statement to “obsolete the bullet”, Axon Enterprises appeared on our potential investment opportunity radar recently.

The manufacturer of TASER, a conducted energy weapon, Axon recognised a gap in law enforcement for ‘non-lethal’ weapons back in 1993 . Today, 17,000 out of 18,000 US police agencies procure TASER devices , and the company is quickly expanding globally, with TASERs deployed as far field as Mexico, the UK and Australia.

Not content with global product expansion, Axon has been developing an end to end integrated law enforcement solution. Axon already offers digital evidence management and the ability for officers to capture public safety videos through Axon’s body cameras. In the near future, Axon will be expanding its product range to include police agency records management systems and computer-aided dispatch software.

While Axon boasts impressive financial fundamentals, the ethics of investing in such a business aren’t as clear.

Axon describes TASER as "an alternative far superior to using firearms in many contexts”. According to the company, TASERs have saved nearly 200,000 lives, with over 3.7 million uses in the field worldwide.

But research to back such claims is, at best, inconclusive. Described by the United Nations Committee Against Torture as “a form of torture…that in certain cases could also cause death” , labelling TASER a 'non-lethal weapon' is a misnomer. In the US alone, reportedly over 1,000 deaths have occurred following the police use of TASERS , and there is growing evidence of the risk of cardiac failure from TASER use.

Research by the University of Chicago found that the Chicago Police Department's adoption of TASER resulted in a reduction in officer injury but no effect on firearm use by law enforcement. The study found that "police injuries fell, but neither injury rates nor the number of injuries to civilians were affected."

Further ethical and privacy issues present themselves from Axon’s shift to data capture, management and retention. Live-streaming of incidents and real time facial recognition, tracking and matching technology is less of a technology challenge than an ethical one.

Although Axon has established an Artificial Intelligence Ethics Board to help guide the development of Axon's AI-powered devices and services, its members include law enforcement representatives, the very sector that faces growing scrutiny over how it uses Axon products.

Ultimately, these unresolved ethical issues surrounding Axon led us to the decision not to add the company to the portfolio.

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FNArena is proud about its track record and past achievements: Ten Years On

Weekly Ratings, Targets, Forecast Changes

By Rudi Filapek-Vandyck, Editor FNArena

Guide:

The FNArena database tabulates the views of eight major Australian and international stock brokers: Citi, Credit Suisse, Deutsche Bank, Macquarie, Morgan Stanley, Morgans, Ord Minnett and UBS.

For the purpose of broker rating correlation, Outperform and Overweight ratings are grouped as Buy, Neutral is grouped with Hold and Underperform and Underweight are grouped as Sell to provide a Buy/Hold/Sell (B/H/S) ratio.

Ratings, consensus target price and forecast earnings tables are published at the bottom of this report.

Summary

Period: Monday May 13 to Friday May 17, 2019 Total Upgrades: 7 Total Downgrades: 22 Net Ratings Breakdown: Buy 40.31%; Hold 43.58%; Sell 16.11%

The dichotomy between a share market that wants to move higher and Australian companies that are unable to provide better profit results continues to show up in FNArena's daily monitoring of eight leading stockbrokerages.

For the week ending Friday, 17th May 2019, FNArena registered but seven upgrades in recommendations for ASX-listed stocks against 22 downgrades against a background of more disappointments than upward surprises from the local out-of-season results season, and a slew of profit warnings from predominantly small and mid-cap companies.

Only one of the eight stockbrokers still carries more Buy-rated stocks than either Hold/Neutral or Sell and one wonders whether this can be partially explained by the fact Ord Minnett has five ratings for stocks of which two - Buy and Accumulate- are being treated as a 'Buy' in FNArena's data assessment.

In what can only be a positive signal, all seven upgrades moved to Buy. On the negative side of the week, all of Mayne Pharma, St Barbara, Sydney Airport and Xero received multiple downgrades.

Few companies are enjoying positive revisions to earnings expectations and CYBG, Xero and Flight Centre all stood out during the week. Plenty of negative adjustments form the offset with the week delivering large reductions to forecasts for Mayne Pharma, Adelaide Brighton, Reliance Worldwide and St Barbara.

With exception of gold miner St Barbara, which announced an acquisition not liked by everyone, these reductions all followed a profit warning by the companies involved.

The market's fundamental dillemma continues this week as a (no doubt) positively received federal election result battles with ongoing out-of-season profit reports, AGM updates and, no doubt, further profit warnings.

May investors live through interesting times.

Upgrade

DEXUS PROPERTY GROUP ((DXS)) Upgrade to Buy from Neutral by Citi .B/H/S: 1/3/1

Citi upgrades to Buy from Neutral and raises the target to $14.10 from $12.02. This reflects recent transaction activity and increased longer-term office re-leasing spreads because of a longer office cycle.

The broker believes a re-rating is likely to continue in a low interest rate environment, given the solid growth profile and high degree of distribution sustainability.

EVOLUTION MINING LIMITED ((EVN)) Upgrade to Add from Hold by Morgans .B/H/S: 2/3/3

Morgans upgrades to Add from Hold, given recent share price weakness, with macro events implying further global economic uncertainty and, hence, an increased probability the gold price will appreciate.

The broker notes the company's costs and production guidance have been met for the past seven years and costs are among the lowest in the industry. Target is reduced to $3.55 from $3.85.

A consistent history, along with well-run operations and conservative assumptions provides long-term investors with a lower risk/value proposition, in the broker's view.

FORTESCUE METALS GROUP LTD ((FMG)) Upgrade to Outperform from Neutral by Credit Suisse .B/H/S: 3/3/2

Credit Suisse lifts iron ore price forecasts by 21% for 2019 and 33% for 2020. The broker expects the price to peak at US$110/t in the September quarter when China's port inventory is expected to be at its tightest.

This drives an increase to Fortescue Metals' price target to $8.20 from $6.40, and the rating is upgraded to Outperform from Neutral.

The company has also declared a $0.60 dividend, payable June 14, which is outside the standard February/August dividend announcements that typically come with results.

Credit Suisse considers the dividend is pulling forward all or part of the dividend that otherwise would have been announced in August. The payment makes sense to the broker, in light of any potential changes to the franking credit regime that may, or may not, occur after the federal election.

FLEXIGROUP LIMITED ((FXL)) Upgrade to Outperform from Neutral by Macquarie .B/H/S: 5/1/0

The highlight of FlexiGroup's update on the progress of its "humm" retail rollout, Macquarie suggests, is that there was no downgrade to FY guidance. This led to a positive market reaction.

From here it will all be about the "humm journey", which is still in its early stages and will result in a multi-year strategic reset. With the rollout supported by existing market stabilisation, Macquarie believes the stock can trade strongly ahead of execution and financial benefit. Upgrade to Outperform, target rises to $2.04 from $1.34.

INTEGRAL DIAGNOSTICS LIMITED ((IDX)) Upgrade to Buy from Accumulate by Ord Minnett .B/H/S: 2/1/0

Ord Minnett believes investors have woken up to the prevailing tailwinds and adjusts models to account for indexation. Revenue growth has been supported by long-term average growth in benefits of 6% and this is now supplemented by indexation of almost 80% of medical benefit services from FY21.

The broker considers the sector appealing for the long-term. The broker also revises its view of the potential contribution from the soon-to-be-opened Prostate Centre of Excellence clinic.

Rating is upgraded to Buy from Accumulate and the target raised to $3.30 from $2.99.

NEW HOPE CORPORATION LIMITED ((NHC)) Upgrade to Outperform from Neutral by Credit Suisse .B/H/S: 1/2/0

Credit Suisse has become more bearish on thermal coal because of increased competition from displaced European coal, which it believes is undermining the Newcastle price. A mild winter in Europe has meant coal inventory has built up and an LNG glut is driving down gas prices.

The broker lowers Newcastle F.O.B. thermal coal forecasts by -8% in 2019 to US$87/t and by -6% to US$80/t for 2020. Nevertheless, the broker upgrades to Outperform from Neutral because of recent underperformance in the share price. Target is reduced to $3.50 from $4.00.

SCENTRE GROUP ((SCG)) Upgrade to Outperform from Neutral by Credit Suisse .B/H/S: 1/2/3

The stock has underperformed the A-REIT index by -7% since its February result, Credit Suisse observes. Underperformance has been driven by a deterioration in retail trading conditions as well as concerns around the balance sheet and ability to fund future developments.

The broker is of the view that these factors are now reflected in the share price and the stock is again offering material value. Rating is upgraded to Outperform from Neutral. Target is steady at $4.20.

Downgrade

AGL ENERGY LIMITED ((AGL)) Downgrade to Sell from Neutral by Citi .B/H/S: 1/3/4

Citi revamps its model, largely because of updates to consumer market electricity and gas discounts and revenue rates. The broker also marks to market the wholesale electricity prices to reflect the continued rally.

Citi suspects FY20 core net profit will more likely be down than flat. The company has called out specific headwinds for FY20, such as lower electricity prices, higher input fuel costs for thermal generation and the regulated default offers in retail electricity.

Citi considers FY19 is the peak in earnings for AGL and the share price does not reflect this. Rating is downgraded to Sell from Neutral. Target is reduced to $20.87 from $22.48.

ANSELL LIMITED ((ANN)) Downgrade to Hold from Buy by Deutsche Bank .B/H/S: 3/5/0

Deutsche Bank envisages risks to earnings from slowing global economic growth. Execution risks also exist with the rationalisation and expansion of manufacturing facilities.

The stock has re-rated and now offers 7% compound growth in earnings per share between FY19-22. The broker downgrades to Hold from Buy. Target is $27.19.

AUSNET SERVICES ((AST)) Downgrade to Sell from Neutral by Citi .B/H/S: 0/6/1

Post FY19 results release, Citi analysts have added 14% to their target price, but they also downgraded to Sell from Neutral with the share price up 19% year-to-date. Also, the increase in target reflects a short term view on interest rates and bond yields, explain the analysts.

Further out, Citi's valuation has actually declined by -6%, thanks to weaker cash flow forecasts. Revised forecasts are -8% below market consensus, on the analysts' assessment. The FY19 report itself proved pretty much in-line on just about every metric.

AusNet's FY20 dividend guidance proved better-than-expected. Citi continues to forecast 3% growth in dividends per annum. Price target moves to $1.71 from $1.50.

COMMONWEALTH BANK OF AUSTRALIA ((CBA)) Downgrade to Hold from Add by Morgans .B/H/S: 1/4/3

The March quarter trading update was softer than Morgans expected, largely because of the re-basing of non-interest income. Non--interest income was down -10% versus the first half.

Morgans reduces cash estimates for earnings per share for FY19 and FY20 by -9.1% and -6.2% respectively. Rating is downgraded to Hold from Add because of a lower target and share price strength over the past month. Target is reduced to $74 from $76.

COCHLEAR LIMITED ((COH)) Downgrade to Neutral from Buy by Citi .B/H/S: 0/3/4

The share price has rebounded significantly since the company announced the launch of the new MRI compatible implant, Citi observes. The broker downgrades to Neutral from Buy on valuation. Target is steady at $198.

The company's investor briefing has focused on growing the adult market in developed countries where the penetration rate is only 3% and the children's market in developing countries where the penetration rate is around 10%.

CYBG PLC ((CYB)) Downgrade to Hold from Add by Morgans .B/H/S: 2/1/0

The company is scheduled to release first half results on May 15, which will reflect the acquisition of Virgin Money. Morgans continues to expect net interest margins will be affected by intense competition in the mortgage and customer deposit segments.

Amid Brexit-related uncertainty and the commencement of legal action on fixed rate tailored business loans, along with downgrades to underlying earnings forecasts, Morgans reduces the target to $3.64 from $4.39 and downgrades to Hold from Add.

GWA GROUP LIMITED ((GWA)) Downgrade to Sell from Hold by Deutsche Bank .B/H/S: 0/4/1

Deutsche Bank expects falling home sales and listings data to affect earnings from FY20. While alterations and additions are more stable than new construction, this is closely linked to new home listings and sales.

The broker does not expect the decline to reverse in the near term and envisages similar, although not as negative, risks in New Zealand. Rating is downgraded to Sell from Hold. Target is $2.85.

MAYNE PHARMA GROUP LIMITED ((MYX)) Downgrade to Neutral from Buy by Citi and Downgrade to Neutral from Outperform by Credit Suisse .B/H/S: 0/3/1

Citi had expected a more stable generic pricing environment would eventually lead to a recovery in trading but this is not the case for the start of the second half.

As a result of incorporating heightened deflationary pressures, the broker reduces FY19-21 estimates for earnings per share by -63% and -55% respectively.

Rating is downgraded to Neutral/High Risk from Buy and the target lowered to $0.60 from $0.95. The company will review the carrying value of its generic business and development assets at the full year results in August.

The company has announced a significant deterioration in the performance of its generic products since the first half results because of increased competition and -US$4m in one-off adverse items. The high-margin specialty brands revenue is also weaker than expected.

Revenue declined -15% in January to April and gross profit was down -20%. The company is currently reviewing the carrying value of generic assets which could result in an impairment.

Credit Suisse downgrades to Neutral from Outperform and reduces the target to $0.64 from $1.00. The broker envisages merit in the strategy to pivot towards the more stable earnings profile in specialty brands, but the outlook for FY20 remains unclear.

OIL SEARCH LIMITED ((OSH)) Downgrade to Hold from Buy by Deutsche Bank .B/H/S: 2/5/1

Deutsche Bank downgrades to Hold from Buy, believing the positive catalysts are factored into the stock and there are growing risks around geopolitics, Alaska and strain on the balance sheet.

Target is reduced to $8.00 from $9.50.

RELIANCE WORLDWIDE CORPORATION LIMITED ((RWC)) Downgrade to Hold from Add by Morgans .B/H/S: 3/2/0

The company's trading update disappointed Morgans, as FY19 underlying operating earnings (EBITDA) guidance was reduced by -7% to $260-270m. The main concern for the broker is that there are issues across all regions and the near-term outlook is uncertain.

US customers are reducing inventory, particularly in the retail channel, and there is a sharper-than-expected decline in Australian residential construction activity. Certain product lines have been exited in the UK and there is slower growth in Spain. The main positive is that John Guest integration remains on schedule.

The company will seek to mitigate the impact of US tariffs, which could negatively affect FY20 earnings, through customer price increases and/or negotiated supplier price reductions. US tariffs on imports from China are not expected to have a material impact on FY19 earnings.

Morgans downgrades to Hold from Add and reduces the target to $3.94 from $5.56.

ST BARBARA LIMITED ((SBM)) Downgrade to Underperform from Neutral by Credit Suisse and Downgrade to Underperform from Neutral by Macquarie .B/H/S: 2/1/2

St Barbara will acquire Canadian gold producer, Atlantic Gold. Credit Suisse observes exploration success is needed to create value, assessing the CAD802m price is a 28% premium to the valuation.

The company has been assessing potential acquisitions over the past two years and Atlantic Gold is the first to meet criteria. While it withstands due diligence it falls short on value considerations, the broker suggests.

Nevertheless, the assets look good, adding long life and low-cost gold production. Credit Suisse downgrades to Underperform from Neutral and reduces the target to $2.72 from $3.30.

St Barbara will acquire Canadian-listed Atlantic Gold, with the Moose River gold mine the primary asset. Given the 39% premium St Barbara paid, plus some C$300m in capital required to lift production at Moose River, Macquarie downgrades to Underperform.

Target falls to $2.70 from $3.40.

SIMS METAL MANAGEMENT LIMITED ((SGM)) Downgrade to Equal-weight from Overweight by Morgan Stanley .B/H/S: 3/3/1

Scrap prices in key markets have declined in the face of soft demand, Morgan Stanley observes. The stock is unlikely to outperform while this continues. Hence, the broker downgrades to Equal-weight from Overweight and lowers the target to $10.50 from $12.50.

Global scrap prices have declined from first quarter 2019 highs in all key markets. The broker continues to believe in the long-term opportunities for Sims Metal. Industry view is Cautious.

SENEX ENERGY LIMITED ((SXY)) Downgrade to Neutral from Outperform by Credit Suisse .B/H/S: 2/4/0

Credit Suisse believes Senex Energy is well positioned to benefit from higher domestic gas prices, as Project Atlas ramps up over the next two years. Yet, while the company has been touted as a takeover target, no bid has

emerged.

This is of concern to the broker, signalling there may be technical "skeletons" at the flagship Western Surat Gas Project in particular. Rating is downgraded to Neutral from Outperform and the target is reduced to $0.36 from $0.50.

The broker asserts the upside is offset by risks to production/cost metrics and sustainability, particularly at WSGP.

SYDNEY AIRPORT HOLDINGS LIMITED ((SYD)) Downgrade to Sell from Neutral by UBS and Downgrade to Hold from Add by Morgans .B/H/S: 2/2/4

UBS observes international traffic momentum was weak in the March quarter, even after taking into account the timing of Easter. Airline schedules now suggest capacity declines for the remainder of 2019.

The broker observes lower bond yields have also widened the gap between price and fundamentals. Ongoing traffic disappointment in 2019 has potential to drive underperformance and UBS downgrades to Sell from Neutral. Target is $7.

The share price has surged 20% since mid January. Morgans points out government bond rates falling to historical lows and the market appetite for yield were probably the key drivers. Weakness in short-term traffic growth appears to have been disregarded by the market.

The broker downgrades to Hold from Add as the share price has compressed the total return potential. Morgans notes significant valuation upside exists if the market starts to factor in a lower-for-longer interest rate scenario. Target rises to $7.61 from $7.55.

UNIBAIL-RODAMCO-WESTFIELD ((URW)) Downgrade to Sell from Neutral by Citi .B/H/S: 0/2/2

Citi analysts, who are covering this stock from Europe, have downgraded to Sell from Neutral as further analysis has made them worried about asset values longer term. With online sales poised to take more market share in years ahead, the analysts believe values for shopping centres can potentially deflate by as much as -50%.

In addition, it has become clear to the analysts that retailers are using rent decline to maintain their margins in an attempt to please their shareholders. This smells like trouble, doesn't it? The analysts note the share price rallied recently, despite EPS forecasts actually declining. Target price falls to EUR125 from EUR142.

WESFARMERS LIMITED ((WES)) Downgrade to Neutral from Outperform by Macquarie .B/H/S: 0/4/2

Macquarie believes a further move into EVs, were Wesfarmers to take over Kidman Resources ((KDR)), makes sense. While oversupply will likely lead to lower lithium prices over the next 12 months, over five years lithium, cobalt and nickel should all be winners on battery demand. Kidman's 50% owned Mt Holland project is substantial, but not without risk.

Meanwhile, the broker believes the market is being too cautious over Bunnings, yet total shareholder return upside is becoming limited and risks are moving to the downside. Downgrade to Neutral from Outperform. Target unchanged at $37.13.

WOOLWORTHS LIMITED ((WOW)) Downgrade to Neutral from Buy by UBS .B/H/S: 0/6/2

UBS notes the Australian grocery market has become more rational while inflation has returned. While believing an improved inflation outlook provides near-medium term upside risk to forecasts, this appears to the broker to be priced in.

UBS downgrades Woolworths to Neutral from Buy and now prefers Metcash ((MTS)) in the grocery sector. Target is raised to $32.90 from $30.80.

XERO LIMITED ((XRO)) Downgrade to Sell from Neutral by UBS and Downgrade to Lighten from Buy by Ord Minnett .B/H/S: 1/2/2

The company has achieved positive free cash flow in FY19, which UBS suggests is representative of the end of a loss-making start-up period as Xero becomes a self-funding business.

While comfortable with the growth prospects and supportive of the strategy, the broker believes the valuation has overshot the level at which there is a fair risk/reward trade-off for investors.

Particularly in the context of a 10% re-rating on an essentially in-line result. Rating is, therefore, downgraded to Sell from Neutral. Target is raised to $50 from $47.

The company reported a FY19 normalised net loss of -NZ$27.1m, weaker than Ord Minnett expected. Excluding the UK, the broker suspects investors may have shifted their focus to the US where growth was less than 10% half on half. This is typically more than 20%.

Ord Minnett downgrades to Lighten from Buy and increases the target to $53 from $49. The broker remains concerned that the stronger-than-expected growth in the UK could be a one-time benefit.

Total Recommendations Recommendation Changes

Broker Recommendation Breakup

Broker Rating Order Company New Rating Old Rating Broker Upgrade 1 DEXUS PROPERTY GROUP Buy Neutral Citi 2 EVOLUTION MINING LIMITED Buy Neutral Morgans 3 FLEXIGROUP LIMITED Buy Neutral Macquarie 4 FORTESCUE METALS GROUP LTD Buy Neutral Credit Suisse 5 INTEGRAL DIAGNOSTICS LIMITED Buy Buy Ord Minnett 6 NEW HOPE CORPORATION LIMITED Buy Neutral Credit Suisse 7 SCENTRE GROUP Buy Neutral Credit Suisse Downgrade 8 AGL ENERGY LIMITED Sell Neutral Citi 9 ANSELL LIMITED Neutral Buy Deutsche Bank 10 AUSNET SERVICES Sell Neutral Citi 11 COCHLEAR LIMITED Neutral Buy Citi 12 COMMONWEALTH BANK OF AUSTRALIA Neutral Buy Morgans 13 CYBG PLC Neutral Buy Morgans 14 GWA GROUP LIMITED Sell Neutral Deutsche Bank 15 MAYNE PHARMA GROUP LIMITED Neutral Buy Citi 16 MAYNE PHARMA GROUP LIMITED Neutral Buy Credit Suisse 17 OIL SEARCH LIMITED Neutral Buy Deutsche Bank 18 RELIANCE WORLDWIDE CORPORATION LIMITED Neutral Buy Morgans 19 SENEX ENERGY LIMITED Neutral Buy Credit Suisse 20 SIMS METAL MANAGEMENT LIMITED Neutral Buy Morgan Stanley 21 ST BARBARA LIMITED Sell Neutral Macquarie 22 ST BARBARA LIMITED Sell Neutral Credit Suisse 23 SYDNEY AIRPORT HOLDINGS LIMITED Neutral Buy Morgans 24 SYDNEY AIRPORT HOLDINGS LIMITED Sell Neutral UBS 25 UNIBAIL-RODAMCO-WESTFIELD Sell Neutral Citi 26 WESFARMERS LIMITED Neutral Buy Macquarie 27 WOOLWORTHS LIMITED Neutral Buy UBS 28 XERO LIMITED Sell Neutral UBS 29 XERO LIMITED Sell Buy Ord Minnett Recommendation Positive Change Covered by > 2 Brokers Order Symbol Company New Rating Previous Rating Change Recs 1 GNC GRAINCORP LIMITED 75.0% 50.0% 25.0% 4 2 PPH PUSHPAY HOLDINGS LIMITED 50.0% 25.0% 25.0% 3 3 EVN EVOLUTION MINING LIMITED -19.0% -38.0% 19.0% 8 4 SCG SCENTRE GROUP -33.0% -50.0% 17.0% 6 5 IDX INTEGRAL DIAGNOSTICS LIMITED 67.0% 50.0% 17.0% 3 6 FXL FLEXIGROUP LIMITED 83.0% 67.0% 16.0% 6 7 TPM TPG TELECOM LIMITED -25.0% -33.0% 8.0% 6 8 DLX DULUXGROUP LIMITED -14.0% -21.0% 7.0% 7 9 S32 SOUTH32 LIMITED 63.0% 57.0% 6.0% 8 Negative Change Covered by > 2 Brokers Order Symbol Company New Rating Previous Rating Change Recs 1 MYX MAYNE PHARMA GROUP LIMITED -25.0% 25.0% -50.0% 4 2 XRO XERO LIMITED -30.0% 17.0% -47.0% 5 3 SBM ST BARBARA LIMITED -10.0% 30.0% -40.0% 5 4 CYB CYBG PLC 67.0% 100.0% -33.0% 3 5 URW UNIBAIL-RODAMCO-WESTFIELD -50.0% -25.0% -25.0% 4 6 RWC RELIANCE WORLDWIDE CORPORATION LIMITED 50.0% 70.0% -20.0% 5 7 QAN QANTAS AIRWAYS LIMITED 14.0% 29.0% -15.0% 7 8 ABC ADELAIDE BRIGHTON LIMITED -29.0% -14.0% -15.0% 7 9 WES WESFARMERS LIMITED -36.0% -21.0% -15.0% 7 10 SGM SIMS METAL MANAGEMENT LIMITED 29.0% 43.0% -14.0% 7 Target Price Positive Change Covered by > 2 Brokers Order Symbol Company New Target Previous Target Change Recs 1 CYB CYBG PLC 4.470 3.545 26.09% 3 2 XRO XERO LIMITED 51.000 44.933 13.50% 5 3 FXL FLEXIGROUP LIMITED 1.770 1.653 7.08% 6 4 IDX INTEGRAL DIAGNOSTICS LIMITED 3.207 3.103 3.35% 3 5 WOW WOOLWORTHS LIMITED 29.850 29.588 0.89% 8 6 S32 SOUTH32 LIMITED 3.918 3.899 0.49% 8 7 URW UNIBAIL-RODAMCO-WESTFIELD 11.625 11.610 0.13% 4 8 ANN ANSELL LIMITED 26.216 26.205 0.04% 8 Negative Change Covered by > 2 Brokers Order Symbol Company New Target Previous Target Change Recs 1 MYX MAYNE PHARMA GROUP LIMITED 0.598 0.858 -30.30% 4 2 ABC ADELAIDE BRIGHTON LIMITED 3.729 4.471 -16.60% 7 3 RWC RELIANCE WORLDWIDE CORPORATION LIMITED 4.708 5.472 -13.96% 5 4 SBM ST BARBARA LIMITED 3.284 3.560 -7.75% 5 5 SXY SENEX ENERGY LIMITED 0.435 0.450 -3.33% 6 6 GNC GRAINCORP LIMITED 9.305 9.563 -2.70% 4 7 QAN QANTAS AIRWAYS LIMITED 5.864 6.021 -2.61% 7 8 SGM SIMS METAL MANAGEMENT LIMITED 11.579 11.864 -2.40% 7 9 OSH OIL SEARCH LIMITED 8.485 8.635 -1.74% 8 10 DLX DULUXGROUP LIMITED 9.623 9.741 -1.21% 7 Earning Forecast Positive Change Covered by > 2 Brokers Order Symbol Company New EF Previous EF Change Recs 1 XRO XERO LIMITED 15.850 -7.367 315.15% 5 2 DCN DACIAN GOLD LIMITED 4.250 3.100 37.10% 3 3 AOG AVEO GROUP 12.733 9.733 30.82% 3 4 CYB CYBG PLC 48.387 46.328 4.44% 3 5 RIO RIO TINTO LIMITED 971.992 940.077 3.39% 8 6 CRN CORONADO GLOBAL RESOURCES 62.504 60.868 2.69% 3 7 ORI ORICA LIMITED 93.989 92.859 1.22% 8 8 QBE QBE INSURANCE GROUP LIMITED 87.921 86.954 1.11% 8 9 EVN EVOLUTION MINING LIMITED 13.194 13.051 1.10% 8 10 NWS NEWS CORPORATION 53.024 52.478 1.04% 5 Negative Change Covered by > 2 Brokers Order Symbol Company New EF Previous EF Change Recs 1 GNC GRAINCORP LIMITED -12.465 -2.015 -518.61% 4 2 MYX MAYNE PHARMA GROUP LIMITED 1.258 3.318 -62.09% 4 3 EPW ERM POWER LIMITED 17.300 24.300 -28.81% 3 4 ABC ADELAIDE BRIGHTON LIMITED 25.127 29.660 -15.28% 7 5 RWC RELIANCE WORLDWIDE CORPORATION LIMITED 19.325 21.138 -8.58% 5 6 CBA COMMONWEALTH BANK OF AUSTRALIA 486.057 521.557 -6.81% 8 7 SBM ST BARBARA LIMITED 30.745 32.690 -5.95% 5 8 SXY SENEX ENERGY LIMITED 0.682 0.720 -5.28% 6 9 APE AP EAGERS LIMITED 46.343 48.445 -4.34% 4 10 CTX CALTEX AUSTRALIA LIMITED 190.167 195.620 -2.79% 7 Technical limitations

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Uranium Week: Doldrums

The uranium spot price continues to drift lower.

-Uranium market in limbo -232 decision due July 14 (not guaranteed) -Buyers unwilling to commit

By Greg Peel

It's rather difficult to maintain interest in a market for which, week after week, the story remains the same. But unfortunately that is the case for uranium at present. Until there is a decision on section 232, buyers are unwilling to commit.

This was again the story last week. While 500,000lbs U3O8 did change hands in an off-market transaction, on-market prices continued their downward drift last week on low interest. Industry consultant TradeTech reports only three transactions. Sellers continue to lower prices in an attempt to flush out any buying interest.

TradeTech's weekly spot price indicator has fallen another -US20c to US$24.50/lb.

The US Department of Commerce has submitted its (as yet confidential) recommendation with regard section 232 to the White House. A response from the president is due on July 14.

Or is it?

If the waiting game has not already worn down market participants, there may be more pain to come. July 14 is only an arbitrary deadline.

Section 232 covers the broad notion of "national security" and is that which President Trump invokes when implementing his trade tariffs. Two weeks ago Trump shocked a world expecting a US-China trade deal at any moment when he increased the tariff on US$200m of goods imported from China to 25% from 10% -- a deadline that had been extended, and extended, and extended again as negotiations continued.

On the flipside, last week Trump announced a postponement of a decision on a tariff increase for imported European cars, and last night he ended tariffs on steel and aluminium for Canada and Mexico.

With regard the uranium market, the president is being asked to decide whether US nuclear power generators should be forced by law to buy 25% of their uranium requirements from US uranium producers, rather than a 25% tariff be imposed on cheaper uranium imports. But it is still a 232 decision, as is all of the above.

Thus while decisions on steel, aluminium and autos are unrelated to the uranium market, "developments in these investigations serve to illustrate the wide-ranging discretion afforded the US President by the supporting legislation," notes TradeTech. "Recent developments in these investigations also demonstrate both the varied paths these negotiations may take, as well as the array of legal mechanisms available to the US President to impose, delay, or defer decisions regarding foreign imports".

Conclusion? Don't hold your breath for July 14. Meanwhile, buyers remain on the sidelines.

There were no transactions reported in uranium term markets last week. TradeTech's term price indicators remain at US$28.50/lb (mid) and US$32.00/lb (long).

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The Short Report

Guide:

The Short Report draws upon data provided by the Australian Securities & Investment Commission (ASIC) to highlight significant weekly moves in short positions registered on stocks listed on the Australian Securities Exchange (ASX). Short positions in exchange-traded funds (ETF) and non-ordinary shares are not included. Short positions below 5% are not included in the table below but may be noted in the accompanying text if deemed significant.

Please take note of the Important Information provided at the end of this report. Percentage amounts in this report refer to percentage of ordinary shares on issue.

Stock codes highlighted in green have seen their short positions reduce in the week by an amount sufficient to move them into a lower percentage bracket. Stocks highlighted in red have seen their short positions increase in the week by an amount sufficient to move them into a higher percentage bracket. Moves in excess of one percentage point or more are discussed in the Movers & Shakers report below.

Summary:

Week ending May 16, 2019

Last week saw the ASX200 tumble on renewed trade war fears before recovering alongside a continually optimistic Wall Street, with a bit of help from growing RBA rate cut expectations.

Note that week in question ends last Thursday (latest ASIC data) so the impact of the election and the RBA's near confirmation of a rate cut were not yet in play. Indeed all bar one of the noted short position changes below represent minor bracket creep.

Activity was restrained ahead of Labor's election victory, as was assumed at the time.

The only move of one percentage point or more was reserved for Bingo Industries ((BIN)), which saw its shorts rise to 9.9% from 8.2%. See below.

Weekly short positions as a percentage of market cap:

10%+ SYR 17.2 ING 16.6 NUF 15.5 JBH 15.3 NXT 14.6 GXY 14.1 BAL 12.9 ORE 12.3 MTS 11.7 SDA 10.2 BWX 10.2

In: SDA

9.0-9.9

BIN, IFL, SUL, BKL, KGN, PPT, CSR

In: BIN, CSR Out: SDA, PLS, IVC, HVN 8.0-8.9%

PLS, IVC, HVN, DMP, MYR, SGM, HUB, RWC, AMC

In: PLS, IVC, HVN, RWC Out: CSR, BIN, BOQ

7.0-7.9%

BGA, BOQ

In: BOQ Out: RWC

6.0-6.9%

AMP, WSA, CGF, SEK, MSB

In: SEK

5.0-5.9%

RSG, GMA, COE, NEC, BEN, HT1

Out: SEK, MLX, CGC, LNG Movers & Shakers

The share price of Bingo Industries has been clawing its way back over recent months following the stock's big plunge in the February result season. Daily share price moves have become quite volatile but the trend has been up, albeit to still below where it was pre-result release.

The waste manager provided a trading update two weeks ago which held no surprises. The housing downturn is a headwind for residential waste collection while Australia's infrastructure boom provides some waste offset. Bingo was this week among those companies benefitting from the election win and RBA rate cut hint as well as APRA's plan to reduce the mortgage serviceability threshold, given all of the above are supportive of a bottom in the housing downturn.

But it was before this week that shorters increased their positions to 9.9% from 8.2%, with the caveat, as always, of the assumption the ASIC data are accurate.

ASX20 Short Positions (%)

Code Last Week Week Before Code Last Week Week Before AMC 8.2 8.2 RIO 4.5 4.6 ANZ 1.1 1.2 S32 1.1 1.1 BHP 3.4 3.4 SCP 0.9 1.0 BXB 0.1 0.1 SUN 0.2 0.3 CBA 1.7 1.7 TCL 1.3 1.3 COL 1.5 1.7 TLS 0.5 0.5 CSL 0.2 0.2 WBC 2.5 2.2 IAG 0.6 0.6 WES 1.9 1.9 MQG 0.4 0.4 WOW 2.4 2.5 NAB 1.2 1.0 WPL 0.6 0.7 To see the full Short Report, please go to this link

IMPORTANT INFORMATION ABOUT THIS REPORT

The above information is sourced from daily reports published by the Australian Investment & Securities Commission (ASIC) and is provided by FNArena unqualified as a service to subscribers. FNArena would like to make it very clear that immediate assumptions cannot be drawn from the numbers alone.

It is wrong to assume that short percentages published by ASIC simply imply negative market positions held by fund managers or others looking to profit from a fall in respective share prices. While all or part of certain short percentages may indeed imply such, there are also a myriad of other reasons why a short position might be held which does not render that position "naked" given offsetting positions held elsewhere. Whatever balance of percentages truly is a "short" position would suggest there are negative views on a stock held by some in the market and also would suggest that were the news flow on that stock to turn suddenly positive, "short covering" may spark a short, sharp rally in that share price. However short positions held as an offset against another position may prove merely benign.

Often large short positions can be attributable to a listed hybrid security on the same stock where traders look to "strip out" the option value of the hybrid with offsetting listed option and stock positions. Short positions may form part of a short stock portfolio offsetting a long share price index (SPI) futures portfolio – a popular trade which seeks to exploit windows of opportunity when the SPI price trades at an overextended discount to fair value. Short positions may be held as a hedge by a broking house providing dividend reinvestment plan (DRP) underwriting services or other similar services. Short positions will occasionally need to be adopted by market makers in listed equity exchange traded fund products (EFT). All of the above are just some of the reasons why a short position may be held in a stock but can be considered benign in share price direction terms due to offsets.

Market makers in stock and stock index options will also hedge their portfolios using short positions where necessary. These delta hedges often form the other side of a client's long stock-long put option protection trade, or perhaps long stock-short call option ("buy-write") position. In a clear example of how published short percentages can be misleading, an options market maker may hold a short position below the implied delta hedge level and that actually implies a "long" position in that stock.

Another popular trading strategy is that of "pairs trading" in which one stock is held short against a long position in another stock. Such positions look to exploit perceived imbalances in the valuations of two stocks and imply a "net neutral" market position.

Aside from all the above reasons as to why it would be a potential misconception to draw simply conclusions on short percentages, there are even wider issues to consider. ASIC itself will admit that short position data is not an exact science given the onus on market participants to declare to their broker when positions truly are "short". Without any suggestion of deceit, there are always participants who are ignorant of the regulations. Discrepancies can also arise when short positions are held by a large investment banking operation offering multiple stock market services as well as proprietary trading activities. Such activity can introduce the possibility of either non-counting or double-counting when custodians are involved and beneficial ownership issues become unclear.

Finally, a simple fact is that the Australian Securities Exchange also keeps its own register of short positions. The figures provided by ASIC and by the ASX at any point do not necessarily correlate.

FNArena has offered this qualified explanation of the vagaries of short stock positions as a warning to subscribers not to jump to any conclusions or to make investment decisions based solely on these unqualified numbers. FNArena strongly suggests investors seek advice from their stock broker or financial adviser before acting upon any of the information provided herein.

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The Wrap: APRA, Cash Rate & Financials

Weekly Broker Wrap: banks & APRA; RBA cash rate; diversified financials; and building materials.

-APRA's lending rules changes likely to underpin property market -Reserve Bank ratchets up chance of cash rate cut in June -Large disparity in provisions for advice remediation across diversified financials -Cautious outlook prevails in US housing market

By Eva Brocklehurst

Banks & APRA

The Australian Prudential Regulatory Authority (APRA) has proposed revisions to the lending rules, which should provide support for the property market and, in turn, the banks. The proposal, designed to loosen up the availability of credit, is for the removal of quantitative guidance on the level of serviceability, the floor rate, and an increase in the serviceability buffer to 2.5% from 2.0%.

Under the proposal, banks would be free to review and set their own floor, with guidance from the regulator. JPMorgan considers this a pragmatic response, given the differential that has opened up in recent years between mortgage rates and serviceability requirements, and should remove a binding constraint on some lending.

The broker suggests this will provide a modest boost to housing credit growth and a partial offset to ongoing credit tightening in other areas. It should also level the playing field a little between the banks and non-banks. Still, JPMorgan cautions against becoming too optimistic about benefits from the changes, given demand side factors.

Macquarie estimates that removing the lending floor would increase owner-occupier borrowing capacity by around 9% and investor capacity by 3-6%. If property prices were to stabilise or even rise from current levels, Macquarie envisages upside to conservative credit growth expectations.

Moreover, should the decision alleviate the pressure on the Reserve Bank to cut official rates it would be an additional positive for the banking sector. Nevertheless, the broker notes recent weakness in lending activity was predominantly driven by the investor group, which is not a significant beneficiary from the change in the floor.

Macquarie envisages limited upside for the housing market, although recognises that in the near term investor repositioning may affect relative share price performance. Credit Suisse agrees the changes are likely to be taken positively by the market, although this is not the only constraint on borrowing capacity.

Commentary from the banks has indicated that of -1% reduction in the floor could increase borrowing capacity by 10%. The broker believes, along with the re-election of the Coalition government, that APRA's proposal removes the majority of tail risks for the banking sector. Given their greater exposure to housing, Commonwealth Bank ((CBA)) and Westpac Banking Corp ((WBC)) are likely to be the main beneficiaries.

Banks have typically been using an interest rate of 7.25% to determine the ability of a potential borrower to service the loan. Shaw and Partners notes many owner occupier loans pay an interest rate of 4% per annum. The broker, putting the serviceability test at an interest-rate of 6.5% instead, calculates the new proposals could increase loans by 6% for owner occupiers, but the increase for investors would be more muted in view of the higher interest rates they pay.

UBS was surprised by this easing of policy by APRA and considers it a positive for housing, materially reducing the downside risk for the broader economy as well. However, given ongoing expense verification, this is unlikely to reflate housing on its own. Nevertheless, the broker revises down its forecast peak-to-trough drop in house prices to closer to -10% rather than -14%.

The more meaningful impact from APRA's proposed changes is on confidence, Citi asserts. While borrowing capacity would increase for all, only a small cohort borrow to their maximum capacity. Upgrader borrowers and investors alike may also be spurred on to increase their loan size, bringing more firepower to asset markets. Since the federal election and APRA's decision, Citi observes housing investors have had a dramatic reversal of fortunes with regards to credit availability and the tax treatment of housing investment.

RBA Cash Rate

UBS believes the Reserve Bank is almost certain to cut the cash rate by -25 basis points in June and probably in August as well. The governor, Philip Lowe, appeared unusually clear in his recent statement, saying that a lower cash rate would support employment growth and bring forward the time when inflation is consistent with the target, while the case for lower interest rates would be considered at the next board meeting.

The governor's speech signals to UBS a cut to the cash rate in June is the path of least regret to stabilise the economy. In the event the unemployment rate does not move lower with current policy settings, the governor cited further options including additional fiscal support through expenditure on infrastructure and structural policies that support expansion, investment and employment.

Morgan Stanley moves its forecasts for cash rate reductions to June and August from August and November. The broker notes the governor suggests an unemployment rate below 5% is desirable and achievable, and that monetary policy has a role to play.

From now on, the broker assesses sentiment is the key to upside, although the bear case remains live, linked to the extent of job losses. Morgan Stanley points out trade tensions remain a serious exogenous risk to the growth outlook.

Diversified Financials

The disparity in provisions for advice remediation across AMP ((AMP)) and its peers provides little comfort in regard to adequacy, in Morgan Stanley's view. Analysis reveals the disparity may reflect varying degrees of conservatism, different approaches to valuing losses as well as different stages in the process.

IOOF ((IFL)) is due to update the market in September on its fee for no service (FFNS) provisions following a statistically significant sample review. The risk for losses has heightened given the duration of the project. The broker points out the Australian Securities and Investments Commission (ASIC) states the burden of proof lies with the licensee to provide records showing service was provided, otherwise the client should be compensated. Morgan Stanley estimates IOOF's charge could be $200-400m.

UBS observes major platforms are shedding funds under management at an increasing rate, as advisers turn to more contemporary and independent offerings. Recent cuts to administration fees from the major providers are, in the broker's view, a short-term solution. UBS lowers earnings estimates for both AMP and IOOF to reflect the pressures and has downgraded IOOF to Sell.

Although platforms are only one component of the wealth management value chain, they are the largest contributor to profit and crucial to downstream investment and other earnings. IOOF is a higher relative exposure and has had a slower response on fees as well as greater advice remediation risk, in the broker's view.

Building Materials

UBS notes US building industry participants have expressed cautious optimism on activity in 2019. Almost unanimously, expectations are for low growth of 1-3% and there is no indication activity will go back to the 2015-17 rates of 7% per annum. The optimism is underpinned by a recent decline in US 30-year mortgage rates. There is also increased foot traffic, although conversion rates appear low.

Compared with prior cycles, UBS considers the supply of new homes is constrained by tight labour markets and migrant labour leaving the US, as well as infrastructure connection constraints. Local planning officers are also demanding higher quality homes and greater community integration.

New home construction is a key long-term driver of the share price for James Hardie ((JHX)), despite only one third of US volumes going into new homes. As 2019 housing activity is also likely to be weaker in Australia, UBS has downgraded James Hardie to Neutral. The company is facing issues that are common to a maturing business and this is weighing on growth. Boral ((BLD)) is facing the same headwinds but UBS considers this largely factored into the share price and there is also upside from fly ash.

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