WEEK 19

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Friday, 12 May 2023

Rudi's View: Markets Weigh Plenty Of Positives, And Negatives

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Financial News, Data & Analysis

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AUSTRALIA

Woolworths Or Coles: Which Supermarket?

In the wake of March quarter sales numbers, which is the better investment, Woolworths or Coles? Brokers are polarised not between them, but on both.

-Sales growth surprised, but barely beat inflation
-Woolworths ahead in online, but maybe not for long
-Shoppers trading down to cheap brands
-Ratings equally split on both

By Greg Peel

The battle between Woolworths ((WOW)) and Coles ((COL)) is not akin to the battle between Holden and Ford at Bathurst in days gone by, except between managements. There may be some shoppers fiercely loyal to one or the other but other than which supermarket is closer to home or more convenient, shoppers have shown in the past they're willing to shop at one or the other when it suits them.

Over the decades one has always enjoyed a period of outperformance over the other, before that quietly switches around into a new phase, back and forth. Over the years we've seen one winning on being first to offer petrol discounts for example, who is offering the most attractive pricing (down, down; $2 milk), who is offering the best pester-power toy handout (Little Shop), or who has the most efficient online delivery service or click & collect in more recent times.

There appears no great loyalty.

And typically a period of one finding itself superior over the other is accompanied by analysts pointing out why, and largely agreeing. But in the wake of recent March quarter sales updates from both, currently there is no agreement at all.

If there is agreement on anything, it's that food inflation generally remains elevated and that shoppers facing cost of living pressures are "trading down" to cheaper own-brand lines from premium well-known brands. This introduces a battle between the two to provide the greatest range of own-brands, but analysts agree the leader in this field is competitor Aldi.

Aldi has never put a huge dent in what is still seen as a supermarket duopoly in this country, but perhaps its discount offerings are about to make a real difference, and analysts see this as a threat.

<u>Inflation</u>

In the March quarter, Woolworths reported 6.6% like-for-like supermarket sales growth, beating expectations but aligning with Coles on 6.5%.

Yet the key driver of sales growth at both, notes Ord Minnett, was still "extraordinarily" high price inflation. Food shelf prices (ie wholesale cost) rose 6% at both supermarkets, which rather puts 6.6% and 6.5% retail sales growth into perspective. Ord Minnett notes this sub-1% margin lagged population growth in the period.

Aside from lower income shoppers trading down to own-brands, Woolworths highlighted shoppers higher up the income scale are also trading down, from out-of-home eating back to home cooking, and still buying the premium brands. Coles, on the other hand, did not see much of a shift in the quarter.

If the breakdown of the March quarter headline CPI is anything to go by, eating out is still thriving – it's "things" we've stopped buying, because we loaded up in lockdowns.

Lockdowns also forced many to shift to online shopping, and click & collect (for which one would stand in a queue of other click & collectors being covid invested while waiting – never quite got the point of that one), and appears that trend is remaining "sticky".

UBS notes Woolworths' online growth surprised at 8.0%, above in-store growth of 7.4%, but this also includes a "direct to boot" option rather than expensive delivery, which makes a lot more sense when parents have an overflowing trolley, a couple of toddlers at hand and a sloping parking lot.

Online sales of 8% and a lift in online penetration from 9.3% to 9.9% sequentially is consistent with ongoing improvements to customers' perception of Woolworths' online, suggests Citi.

So there's one distinction. Of course as a group, the two differ beyond supermarkets. Coles still sells liquor, while Woolworths has Big W, for example. But on the online front, Coles has teamed up with Ocado.

Ocado is providing Coles with a "comprehensive and customised suite of support and engineering services to enable a smooth launch and sustainable e-commerce operations".

"The improvements and experience and efficiency they have achieved thus far further validates our decision made in 2019 to partner strategically with Ocado. We look forward to bringing Ocado's leading technology and differentiated service to the Australian market very soon," boasts Coles. Analysts are waiting with anticipation.

So, from an investment point of view, which is preferred?

<u>No Consensus</u>

The short answer to that is neither. The FNArena broker database shows one Buy (or equivalent) rating for Woolworths, three Hold and two Sells. Coles is marginally better on three Buys, one Hold and two Sells.

Coles also scores marginally better on range of target prices, which range from $14.00 (Ord Minnett; Sell) to $20.20 (Citi; Buy) for a consensus of $17.76 (last $18.06).

Woolworths' targets range from $27.00 (Ord Minnett; Sell) to $42.20 (Citi; Buy) for a consensus of $35.86 (last $38.33).

I sense a trend, and we note both consensus targets are below the last trading price.

On a market basis, Macquarie draws on the "we all have to eat" theme of staples offering relative safety at a time of high cost of living. This theme is quite clear in both supermarkets growing sales, but only marginally above food inflation. Macquarie has an Outperform on Coles and is Neutral on Woolworths.

Looking forward, UBS notes food inflation is expected to moderate but to remain the primary driver of sales growth in 2023, highlighting ongoing supply chain and input cost pressures in dry grocery, although volume growth should continue to increase due to the shift from out-of-home and immigration. UBS is Neutral on both.

Looking further forward, most positive is Citi, unsurprisingly (Buy on both), who believes the market's FY24 sales growth forecast of 3.5% looks too low given the benefits from around 2% population growth and food inflation still likely to be in the mid-single digits.

In the shorter term, Ord Minnett (Sell on both) expects June quarter sales to continue to benefit from food price hikes, albeit less meaningfully than in the first half, but in the first half of FY24 forecasts the inflation rate to drop significantly as the supermarkets cycle near 8% inflation in the first half FY23.

Despite considering both groups to be currently overvalued, Ords expects the market shares of the "big three" chains to remain stable over the next decade, and estimates Woolworths' share at 36%, Coles at 28% and Aldi at 9%.

COMMODITIES

Material Matters: Iron Ore, Copper, Lithium & Nickel

A glance through the latest expert views and predictions about commodities: iron ore price forecast under pressure, bearish copper price outlook, Chinese lithium spot prices rally & upcoming surplus for nickel.

-Iron ore price forecasts coming under pressure
-Citi grows bearish on the copper price
-Chinese lithium spot prices stage a rally
-A large surplus anticipated for nickel

By Mark Woodruff

Price forecasts by brokers for iron ore coming under pressure

Property-related steel demand is a key pillar of China's steel industry, yet headwinds remain despite improving property sales.

Unfortunately, new property starts measured by square metres have remained weak, and **Morgan Stanley anticipates further downside for the iron ore price through the second half of 2023.**

Steel production is catching up with the reality of sluggish underlying demand, suggests the broker.

While the recent US$106 spot iron ore price remains above cost support, there is room for additional downside to Morgan Stanley's third and fourth quarter forecasts for 2023 of US$110/t and US$90/t, respectively.

Also under threat is Credit Suisse's iron ore price forecast of US$120/t in 2023, which was originally based on a gradual improvement in steel demand, led by property restarts. Now, this broker points to a worrying decline in China's April manufacturing Purchasing Managers Index (PMI), which showed weakness in both exports and domestic demand.

Moreover, UBS is predicting the iron ore market will fall back into surplus this month, based on the broker's high-frequency global iron ore shipment data, which is pointing to rising global supply.

The UBS iron ore price forecasst for 2023-25 are US$111/t, US$91/t and US$76/t, respectively.

This broker has Sell ratings for BHP Group ((BHP)), Rio Tinto ((RIO)) and Fortescue Metals Group ((FMG)), and a Neutral rating for Mineral Resources ((MIN)).

China has applied the steel production handbrakes, and the first (voluntary) cuts are coming through, ending China's peak steel output season about a month earlier than during the last two years, observes Morgan Stanley.

These curbs won't be sufficient to offset demand weakness, in the broker's opinion, as falling Chinese steel prices means these recent cuts haven't provided any relief so far for steel margins.

On top of this, the analysts expect a seasonal supply uptick from the four global iron ore majors in the second half of 2023, along with first ore at Fortescue's Iron Bridge magnetite mine, though this is expected to ramp up slowly.

Optimists in the market point out that ore inventories at China's mills remain precariously low, yet Morgan Stanley questions why a large restock would be needed when production cuts are on the horizon.

Providing some hope, economists at Credit Suisse believe Beijing may intervene with policies to accelerate a demand recovery.

China's steel sector and iron ore prices would be assisted if the government mandates steel output cuts, suggests the broker, which cites a media report suggesting restrictions are already being discussed.

Citi grows bearish on the copper price

Base metal prices are highly sensitive to China growth expectations and sentiment surrounding the US Federal Reserve monetary policy, notes Citi.

In the wake of softer recent global PMI readings, the broker forecasts metal consumption growth rates will decelerate in the near-term.

In particular, the analysts are bearish on copper and expect consumption in China, which accounts for around 40% of global copper consumption, will fall year-on-year in April.

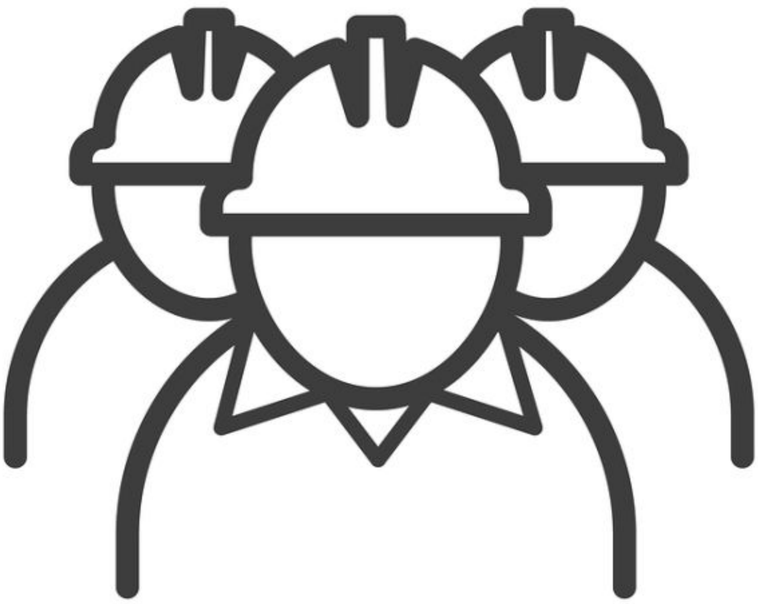
Another 35% of total copper consumption occurs in the US and Europe, where central bankers are hiking interest rates, with resultant negative impacts for business investment and consumption, observes Citi.

Finished goods inventories are reported to be high and rising in the US and Europe, likely resulting in lower metals offtake, explain the analysts. Meanwhile, new orders continue to disappoint in both regions with no signs of abatement owing to the lagged impact of high interest rates on the construction sector and business investment.

Citi expects the Fed will raise rates by 25bp in May, June and July to a terminal policy range of 5.5-5.75%.

After incorporating these negatives into forecasts, the broker lowers its 0–3-month copper estimate to US$8,000/t from US$8,500/t.

While Citi considers more policy support is likely in China if weakness persists, this may not come until US/European weakness plays out.



Chinese lithium spot prices rally

Sentiment is improving in lithium markets, according to Morgan Stanley, as midstream inventories have fallen, and actual supply growth has disappointed in 2023.

Spot prices for lithium chemicals in China are rallying, with carbonate and hydroxide rallying from their

respective lows by 30% and 20%, though the spodumene concentrate price (SC6) continues its downward trajectory.

Canaccord Genuity anticipates a powerful catalyst for a recovery in ASX-listed lithium shares due to lithium price rises in the second half of 2023, driven by a rebound in China.

Despite global macroeconomic risks, March quarter electric vehicle deliveries and implied 40% year-on-year growth supports the broker's near-term demand view. Moreover, growth in planned battery factory capacity is thought to underpin the longer-term outlook.

While cathode and battery cell producers in China are still not fully back buying in the spot market, Morgan Stanley suggests sentiment is clearly improving and the lithium inventories of these producers appear to have eroded.

On average, ASX lithium miner share prices have fallen by -25-30% since highs attained in 2022, in a period when Chinese "spot" prices have declined by over -65% to around US$23,000/t.

However, **the market is not as weak as Chinese price and market sentiment suggests, according to Canaccord.** For example, South American export/European import prices remain at greater than US$50,000/t.

Additionally, the broker feels a baseline has been set for implied asset/strategic values in the Lithium sector following recent M&A activity.

Canaccord's medium to longer term forecasts allow for structural market deficits and elevated pricing. Longer-term risks to supply are noted, given 50% of the broker's estimate is related to greenfield projects that typically carry high permitting, financial and technical risks.

While Canaccord lowers its FY23 lithium price estimates, chemical and concentrate pricing estimates rise by 40% over FY24-27.

The broker's long term price forecasts for chemicals and spodumene concentrate (SC6) remain at US$22,500/t and US$1,500/t, respectively.

Meanwhile, Morgan Stanley still models a full-year lithium market deficit for 2023 and expects the recently oversupplied lithium market will become tighter again for the remainder of 2023.

This broker sees some upside risk to its second half 2023 base case forecast of an average China lithium carbonate price of US$25/kg.

The higher lithium price forecasts by Canaccord result in a lift for its 12-month target prices across all stocks under its coverage in Australia. Please refer to the FNArena Broker Call Extra Report for individual target price changes.

From among the lithium producers the analysts prefer Allkem ((AKE)) and Pilbara Minerals ((PLS)), as well as the developers ioneer ((INR)) and Leo Lithium ((LLL)).

For early-stage businesses that are developing or completing studies on resources, Canaccord likes Global Lithium Resources ((GL1)), Green Technology Metals ((GT1)) and Delta Lithium ((DL1)).

Macquarie's preferred producers are Mineral Resources and Pilbara Minerals, while Patriot Battery Metals ((PMT)) and Global Lithium Resources are the key exploration picks.

This broker also believes Liontown Resources ((LTR)) and Allkem ((AKE)) represent value, with the latter offering unique exposure to both lithium brine in South America and spodumene production in Australia.

Macquarie believes there is valuation upside for all lithium shares it researches.

<u>A large surplus anticipated for nickel</u>

China is the world's largest nickel sulphate and stainless-steel producer and its imports of metals/powders have plunged this year.

The resilience of LME nickel prices during April was in stark contrast to the trend in prices for nickel pig iron and nickel sulphate, observes Macquarie, which traded at growing discounts to the LME price average.

At a meeting of the International Nickel Study Group recently, the broker notes consensus was for a large surplus of global nickel production, equating to around 7.6% of usage.

The sub-markets of nickel pig iron and ferronickel (both used exclusively to make stainless steel) are clearly in over supply, explains the analyst.

The April price average for Chinese nickel pig iron dipped below 60% of the LME price average for the first time ever, amid ongoing weakness in global stainless-steel production and surging nickel pig iron production.

China accounts for around 85% of global production of nickel sulphate and ternary precursor production, and is a big exporter of precursors, which is used to produce ternary materials (composed of three or more elements) for power and digital batteries.

The widening discount of spot nickel sulphate prices to LME prices followed an acceleration in Chinese nickel sulphate production in the fourth quarter of last year, explains Macquarie. This was then followed by a -25% quarter-on-quarter fall in demand for nickel sulphate in making ternary precursors in the first quarter of 2023, as electric vehicle sales fell globally.

While Macquarie anticipates a rebound in global stainless-steel markets in the second half of 2023, orders have recently weakened in Europe, China and the US, dashing hopes of an immediate recovery.

ESG FOCUS

ESG Focus: Hope For Green Hydrogen

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https://www.fnarena.com/index.php/financial-news/daily-financial-news/category/esg-focus/

ESG Focus: Hope For Green Hydrogen?

The Federal Government appears to have confirmed its commitment to Australia's nascent green hydrogen industry in this week's budget, but the low dollar commitment at a critical juncture raises a big question mark.

-Breakdown of the Federal Budget Commitment
-Government reiterates its commitment to green hydrogen
-Gladstone, Whyalla and the Hunter targeted as recipients
-List of major ASX companies with green hydrogen plans in targeted regions
-Analysts response

By Sarah Mills

The Australian Federal Government appears to have confirmed its commitment to Australia's nascent green hydrogen industry, announcing a $2bn Hydrogen Headstart program.

The funding is the government's first salvo against the US Inflation Reduction Act and European Green Deal subsidies to protect Australia's pipeline of green hydrogen projects - the largest in the world.

But the relatively low dollar commitment in the global scheme of things at a critical juncture in the industry's development suggests considerable timidity on behalf of the government.

Fortescue Metals Group ((FMG)) Chief Executive Elizabeth Gaines tactfully described it in an ABC interview "as a good start".

But it falls well short of the $15.5bn industry investment that consultancy Deloitte Economics estimated in a February report is needed to combat global subsidies. Deloitte advised a failure to respond would cause Australia to export -65% less a year than it would otherwise.

To add insult to injury, only $156m of that will be spent in the next four years, with the bulk of the $2bn to be deferred past the next election cycle.

This hardly indicates support, particularly coming at a time when Australia's green hydrogen industry most needs support and incubation.

In the Albanese Government's defence, it is early days in its term, and the tender process alone is likely to take a year or two.

The government is also starting well behind the eight-ball given the general disinterest of its predecessors.

But one would assume that would be all the more reason to up the ante – if one was truly committed that is.

Breakdown Of The Federal Budget Commitment

The government's $2bn Hydrogen Headstart program represents half of the Federal Budget's total renewable energy spending package, which is in itself a strong "sign" of support.

The program does not target capital investment but revenue support, the government allocating an undisclosed credit per kilogram on the price of production.

The project attempts to bridge the gap between the market price of hydrogen and the production cost of hydrogen for large-scale renewable contracts.

The green hydrogen credit would need to equate to $2kg price to be competitive with US prices.

To put this in perspective, the US government has announced a hydrogen production credit of up to US$3kg.

Without a specific dollar-commitment the government's Hydrogen Headstart program is essentially meaningless, so one assumes a second, more material announcement will be forthcoming in the not-too-distant future.

The government explained its choice to adopt a production credit over capital investment.

It said that industry consultation highlighted that capital expenditure support was less critical than near-term operating costs, given green hydrogen is above the market price of hydrogen (something we all know).

However, the industry has been very vocal in the past year about the acute need for capital investment as well. IRA subsidies can fund up to 50% of the capital costs of a project.

Only $156m of the total $2bn Hydrogen Headstart package will be spent over the next four years.

Of that, $38.2m will be allocated to a Guarantee of Origin scheme (an emissions certification scheme) for clean energy, "in particular hydrogen" says Treasury, to boost the country's green hydrogen export credentials.

Another $5.6m will fund a Department of Climate Energy Environment and Water-led analysis of the implications of global competition for clean energy industries for Australia – better late than never – due at the end of 2023.

The study, conducted in conjunction with the Australian Renewable Energy Agency, will identify actions to "further catalyse clean energy industries, ensure Australian manufacturing competitiveness and attract capital investment".

It would be reasonable to expect the study should clarify the government's position and options in relation to green hydrogen, paving the way for further industry announcements in early 2024.

Meanwhile, the Capacity Investment Scheme to unlock about $10bn of investment in clean dispatchable power to supply grid reliability and security is still in play, and the budget makes mention of Capacity Investment scheme auctions in 2023.

A month ago, the Federal Government passed its $15bn manufacturing investment scheme, the National Reconstruction fund, through the Senate, which aims to invest in renewables and low-emissions technologies, among other things. The investment can be in the form of loans, equity and guarantees, and could help bridge a potential finance gap during a period of tighter monetary policy. An initial $5bn is available, with the balance to be made in installments from June 2029.

And there is the Clean Energy Finance Corporation in the mix, which received $1bn in the budget (albeit for home upgrades).

Gladstone, Whyalla And The Hunter Targeted As Beneficiaries

The Hydrogen Headstart program aims to fast-track large-scale renewable hydrogen projects to position it for 1 gigawatt of electrolyser capacity by 2030 through two or three flagship projects.

A competitive tender will be undertaken to select the projects and the government has identified Gladstone, Whyalla and The Hunter region as the most likely beneficiaries.

Expressions of interest are expected to open in the first quarter of 2024.

Fortescue Metals is the odds on bet for subsidies in the Gladstone region. Fortescue Future Industries owns Squadron Energy at the North Queensland Super Hub, and its $913m electrolyser factory's first stage is due for completion this year.

South Australia plans to build Australia's first 200MW green hydrogen power plant at Whyalla. Fortescue Future Industries is understood to be one of roughly 60 international companies bidding to participate in the $593m project.

In the Hunter Valley, Origin Energy ((ORG)) has signed an agreement to collaborate on a Hunter Valley Hydrogen Hub and to use a grid-connected electrolysis to produce green hydrogen for the industry's heavy transport operators.

AGL Energy ((AGL)) plans to develop the Hunter Energy Park and the Hunter Energy Hub and is exploring developing a hydrogen and ammonia facility at the Liddell and Bayswater power station sites.

Woodside Energy ((WDS)) appears to have missed out, given it has green hydrogen plans for Perth, Tasmania and Oklahoma, but Bell Bay has been nominated an area of potential support by the Albanese Government.

Rio Tinto ((RIO)) also has interests in Bell Bay and Pilbara, another area more broadly targeted as an area of government support.

Macquarie Group ((MQG)) also has an interest in the Pilbara's Australian Renewable Energy Hub.

ReNu Energy ((RNE)) has an interest in Bell Bay.

A further breakdown of Australia's green hydrogen projects can be found at this link: https://www.fnarena.com/index.php/2023/04/26/esg-focus-aust-hydrogen-projects-left-hanging/

Government Reiterates Its Commitment To Green Hydrogen

The major positive to be drawn from the package was the government's avowed commitment to Australia's Hydrogen Industry.

Federal Treasurer Jim Chalmers described the global shift to clean energy as "Australia's biggest opportunity for growth and prosperity", and said the government was making the "biggest ever investment in Australia's energy transformation".

He added the program would enable Australia to be a "world leader in producing and exporting hydrogen power".

"Seizing these kinds of industrial and economic opportunities will be the biggest driver and determinant of our future prosperity," said Chalmers.

This follows earlier pronounced commitments to the industry.

The Albanese Government has promised $40bn to make Australia a renewable energy superpower. Australia has the largest pipeline of renewable energy projects in the world.

The government has committed to spend more than half a billion dollars to build regional hydrogen hubs across

Gladstone, the Hunter, Bell Bay and Pilbara.

Analysts' Response Muted

Given the relatively small dollar amounts involved, analysts' responses were understandably muted given it is unlikely to shift the money dial in the near term.

Macquarie identified Fortescue Metals, Viva Energy ((VEA)) and Origin Energy as likely beneficiaries.

Morningstar believes the funding falls short of that needed to incentivise Australian hydrogen production, but expects more support is likely to emerge in the form of tax breaks.

This analyst also believes Fortescue Metals Group stands to be a major winner from the announcement, but adds that iron ore is likely to dominate the company's earnings for the foreseeable future.

Otherwise, immediate commentary was thin on the ground.

Economy And Inflation Likely To Weigh

Much also depends on the global economy and domestic inflation.

The government announced its expectation of a $4bn budget surplus, thanks to strong commodity prices, a strong jobs market and a boost in net migration.

Should global demand for iron-ore, copper and other critical minerals remain strong, a surplus might continue (although the pundits are expecting social welfare expenses will weigh heavily going forward).

If so, and should domestic inflation cool, it could free up funding to invest in the broader green transition, firing growth (surpluses typically imply a withdrawal of funds from the economy and slower growth, which might be a preferred option should inflation persist).

Meanwhile, State governments are also in play.

Australia will not want to wait long. Industry members and experts have warned Australia is at a tipping point due to the US subsidy scheme and that we will ignore the green hydrogen prospect at our peril.

So yes, hopes for Australia's green hydrogen industry remain, but the industry cannot live on hope, and high promises alone.

Port Of Newcastle's Hydrogen Hit

The news was good timing for the Port of Newcastle, which announced today (May 10), it would collaborate with 10 global energy "enablers" to accelerate the energy transition through the Platform Zero Global Partnership for Hydrogen Innovation.

CEO Craig Carmody says the collaboration will allow the Port and Region to learn from international Port and to contribute to the development of a scalable clean energy trade pathway, supporting storage, transportation and scaling of innovative hydrogen technologies.

The alliance includes ports and innovators from Australia, Brazil, Chile, Portugal, the UK and the Netherlands.

Yesterday, the Port of Newcastle was named one of four finalists at the World Hydrogen 2023 Awards in the Port of the Future Award category.

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-Another update (RaaS): https://www.fnarena.com/index.php/download-article/?n=F7462949-B378-9BBE-A809E059CF6449FC

-**Armour Energy** ((AJQ)) by Research as a Service (RaaS): https://www.fnarena.com/index.php/download-article/?n=F7636817-E2AF-8C1D-D04BF98948548204

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-Another update: https://www.fnarena.com/index.php/download-article/?n=F7AAABFD-E99F-8D43-6C518AA946DFDBB8

-**Harvest Technology Group** ((HTG)) by Research as a Service (RaaS): https://www.fnarena.com/index.php/download-article/?n=F7B3CC70-D4CE-626C-29608E0444B77CD0

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-**Paradigm Biopharmaceuticals** ((PAR)) By Edison Research: https://www.fnarena.com/index.php/download-article/?n=F882F1D3-B112-2AA9-719D10B5D03CAC56

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-**Vection Technologies** ((VR1)) by Edison Research: https://www.fnarena.com/index.php/download-article/?n=F8A256D4-A8BC-5559-D4D92C088688B7EE

Reports with a broader focus:

-Industrials - Small & Micro Caps - Movers & Shakers - Monthly sector update (IIR): https://www.fnarena.com/index.php/download-article/?n=F69A8293-B21A-A02A-83CB87BD42C8402C

-Listed Managed Investments (LMI) - Monthly sector update (IIR): https://www.fnarena.com/index.php/download-article/?n=F5C4A3AB-9BD1-642A-EF7ED0041F3F4200

-Pharma & Biotech - Movers & Shakers - Monthly sector update (IIR): https://www.fnarena.com/index.php/download-article/?n=F684E1D4-ACC1-058A-3B7532C7791B62CE

IIR = Independent Investment Research

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RUDI'S VIEWS

Rudi's View: Markets Weigh Plenty Of Positives, And Negatives

By Rudi Filapek-Vandyck, Editor

All is not what it appears to be, in particular not in financial markets today.

At face value, it seems US equities are well and truly on their way to wiping out last year's negative performance with the S&P500 gaining 7.7% and the Nasdaq recovering by nearly 17% since January 1st.

Both strong numbers suggest US equities are back on track to seemingly doing what they do best: outperforming most of the rest of the world, including the Australian share market, while climbing the proverbial Wall of Worry.

But look under the hood and virtually all those gains stem from a small group of index heavyweights only. Unless investors own an index tracking ETF, missing out on one or two of the world's largest companies means the year-to-date experience probably looks a whole lot less positive.

Which opens up the logical debate: is the US really outperforming when it's done through a handful of megacaps only? With large swathes of US equities deep under water still, it can just as easily be argued last year's bear market is still alive and rolling on.

To add a little more juice to that latter argument, consider small caps in the US are still trading in negative territory year-to-date, as well as from twelve months ago, and so are all kinds of micro-cap measurements as published by index provider Dow Jones.

In contrast, the situation in Australia has been a lot easier to navigate for investors. As I explained early last month (see: https://www.fnarena.com/index.php/2023/04/12/rudis-view-wesfarmers-wisetech-worley/), small caps and micro-cap stocks in Australia are equally still waiting for liquidity to return, but at least most large caps on the ASX are participating in this year's positive trend.

It's not difficult to back up those observations with some real-life stats: since January 1, the ASX200 is up 2.5% (week ending May 5), but those gains stand despite banks losing -7% and the energy sector trading more than -5% lower.

Admittedly, most income-hungry investors do own bank shares, likely more than they should, which makes these observations rather subjective, I agree.

One tool that is available to avoid your typical index-related shenanigans is to look at **equal-weighted indices**. S&P Dow Jones has one each for the US and the Australian market. The first one is up 1.19% year-to-date and down -3.64% over twelve months. The second one is only down -2.62% from a year ago and up 4.84% since the start of 2023.

Take away the "perception" and it can just as easily be argued Australia is winning the race thus far in 2023.

Equally worth highlighting: if it wasn't for a solid rally on Friday, US equities without the skew of a few megacaps wouldn't even be up for the year to date.

Just goes to show the all-importance of face value appearances, and how they guide our views and conclusions.

Head Up/Head Down

As is typical at these market junctures, human eyes are inclined to see what they want to see.

With uncertainty dominating and markets in general showing more resilience than many had expected, one of the popular chartist views on equities is that indices are forming a so-called Head-and-Shoulders formation, which, if confirmed, serves as a precursor to the next wave of selling, taking indices possibly down to last year's low.

Of course, that is one possibility and those who pay religious attention remain on alert. The other possibility is indices can equally still carve out a so-called inverse Head-and-Shoulders, which is the same formation but upside down, and this would be a very positive signal, if it comes to pass.

Take your pick, which is not unusual given the time of the year, the many opposing narratives and market forces, and the variety in scenarios that still lay on the table for the quarters ahead.

<u>A Crisis To Bank On?</u>

One thing that has had me puzzled recently is the resilience shown by US markets.

Not only has the prospect of economic recession not suddenly evaporated (I still see quite the number of economists insisting their modeling continues to point towards negative GDP growth) but the USA is also, yet again, facing another nasty banking crisis.

According to some expert insights on the sector, nearly half of the country's 4800 banks have by now burnt through their capital buffers and are running on negative equity.

Under US accounting rules, the banks are not required to mark to market and reveal to the outside world the extent of their capital losses, but somebody, somewhere, sometime will have to compensate for the mismatch between capital and liabilities. As this is predominantly caused by negative movements in US bonds, lower interest rates might just be what the doctor ordered in the not too far out distance.

A **Hoover Institution** report recently stated more than **2315 US banks now have assets worth less than their liabilities**. Total market value of these banks' loan portfolios is -US$2trn below the published book value.

These are not just small-cap, regional lenders only. According to the Hoover report, that troubled basket includes one globally systemic entity with assets of over US$1trn, plus three other large-sized banks.

The Federal Reserve just added 25bp in extra burden for its domestic banks. All this once again confirms my view that forecasting what is likely to occur is difficult, but forecasting what the response from financial markets will be is a completely different matter.

I think institutional investors in the US are all too aware of the depth and the complications of this year's emerging banking crisis. They also expect the Fed and the US government to stand ready and be the cavalry once again that comes rallying over the hill when defence walls are about to break.

This, I believe, is why US bond futures are suggesting the Fed will be cutting interest rates and reverting back to stimulating the economy in a few months from now.

US bonds are suggesting three rate cuts before year-end. Meanwhile, very unsurprisingly, the S&P500

Regional Bank index has sunk to its lowest level since March 2020, when covid panic was all the rage.

US banks and commercial property also received a mentioning from Charlie Munger and Warren Buffett at Berkshire Hathaway's annual Omaha gathering over the weekend.

I think everyone's aware of the problems, but nobody knows what follows next or how the next crisis will be prevented or dealt with.

Under different circumstances, in a different context, this level of uncertainty, with real prospects for calamity, would be sufficient to start selling stocks. Not this time. Today we trust the authorities will act swiftly and decisively, and on time.

Other positives supporting this year's resilience are the **peak in official interest rates is near**, with inflation on the way south, and a net **positive performance from US companies** this quarterly reporting season (circa 85% has reported).

While the end of central bank tightening can be a positive for equities -with the emphasis on '*can*'- the all-important factor that is still missing is whether there follows an **economic recession or not**. The positive thesis is built on the premise there won't be a recession. If this is false, any rally post the Fed pausing will be short-lived.

For obvious reason. History suggests the second condition is non-negotiable.

As far as US corporate results are concerned, performances have on balance beaten forecasts, with the market average EPS growth improving to -2.9% from -6.7% at the start of the current quarterly season.

While this is noticeably better-than-expected, the more appropriate definition might be better-than-feared. The outcome is still negative, leaving the choice to investors: half-full or half-empty?

The **US government approaching its debt ceiling** over the weeks to follow is a clear and present danger to markets, but given history shows there's always a deal agreed upon at the very last moment, markets might just take this in their stride this time. Unless things really run out of control. (One would hope not).

Other factors that are potentially making a contribution too include:

-**Market positioning**; multiple indicators are suggesting investors are already lightly positioned on equities, with a defensive skew and lots of cash on the sidelines

-**Economic data** are still relatively resilient

-**Short covering**; last week's rally in regional banks is one prime example, but surely megacap profits beating forecasts has been a positive factor this season

-**Bond markets**; lower bond yields are now treated as a positive for valuations for technology companies and so-called long duration assets (think REA Group in Australia)

-**Liquidity**: the Federal Reserve has been providing additional liquidity when the downside was beckoning

Ultimately, none of these positives will matter much if authorities will not be able to contain the US banking crisis or prevent the US economy from slowing into negative growth in the quarters ahead.

<u>Australia's Confession Season Can Hurt</u>

Over in Australia, where the chances for banking calamity and economic recession are notably lower, the irony is corporate profits seem more vulnerable. See profit warnings from AdBri ((ABC)), Amcor ((AMC)), Ramsay Health Care ((RHC)) and Synlait Milk ((SM1)) recently, while margin vulnerability is also the key word that dominates the local bank results.

Here the notable observation is that both AdBri and Amcor shares seem to have encountered solid buying interest once the bad news was out in the open and the share price punishment in the past, but not for the latter two.

Close to half of ASX-listed companies worth following need a solid second half to meet forecasts in August.

This almost by definition means there will be **more downward guidances and confessions** in the weeks ahead.

Which is one major reason as to why the FNArena All-Weather Model Portfolio is still happily sitting on 23% in cash, with no urge to allocate it in a hurry.

Even **Jun Bei Liu**, lead portfolio manager for the **Tribeca Alpha Plus Fund**, in a column for the Australian Financial Review on Monday titled '*Why Australian equities are set for a strong rally*', anticipates the coming months will see ASX-listed companies fessing up that sales and momentum have slowed down.

Her advice to investors, however, is not dissimilar from what has been written down in these Weekly Insights on numerous occasions: look for good-quality businesses at cheaper prices in the volatility that may well continue for longer.

Bei Liu specifically mentions a2 Milk ((A2M)) and Xero ((XRO)).

Stock pickers at **Wilsons** like Aristocrat Leisure ((ALL)), CSL ((CSL)), IDP Education ((IEL)), Qantas Airways ((QAN)), and Worley ((WOR)).

<u>All-Weather Portfolio</u>

The **FNArena/Vested Equities All-Weather Model Portfolio** is experiencing one of its quietest periods since its start in early 2015.

With 23% in cash and some 5% in gold, the performance in April ran up to a positive 2.60% versus the ASX200 Accumulation index gaining 1.85% for the month.

The performance equally favours the non-banks and non-resources portfolio over the past three months (3.57% versus -0.77%), six months (10.25% versus 8.57%) and twelve months (4.61% versus 2.89%).

If anything, the All-Weather Portfolio is proving being cautious, patient and not fully invested in equities need not be a major disadvantage at a time when many vital questions remain unanswered.

One thing I agree with Bei Liu & Co is that further weakness in the months ahead should provide investors with great buying opportunities on a medium-to-long term horizon.

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For more insights as to how others are weaponising portfolios against potentially more negatives forthcoming:

https://www.fnarena.com/index.php/2023/05/04/rudis-view-rba-hikes-us-recession-portfolio-adjustments/

<u>More reading:</u>

-https://www.fnarena.com/index.php/2023/05/03/rudis-view-seeking-quality-growth-offshore/

-https://www.fnarena.com/index.php/2023/04/26/rudis-view-investing-in-megatrends-the-other-ones/

-https://www.fnarena.com/index.php/2023/03/22/rudis-view-all-weather-stocks-back-in-fashion/

<u>Conviction Calls and Best Ideas:</u>

-https://www.fnarena.com/index.php/2023/04/19/rudis-view-bond-market-says-regime-change-is-upon-us/

-https://www.fnarena.com/index.php/2023/04/12/rudis-view-wesfarmers-wisetech-worley/

-https://www.fnarena.com/index.php/2023/03/17/rudis-view-dominos-pizza-newcrest-qantas/

-https://www.fnarena.com/index.php/2023/02/10/rudis-view-aub-group-endeavour-lottery-corp-suncorp/

-https://www.fnarena.com/index.php/2023/02/03/rudis-view-csl-mineral-resources-ridley-readytech/

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examples below.

(This story was written on Monday, 8th May, 2023. It was published on the day in the form of an email to paying subscribers, and again on Wednesday as a story on the website).

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In addition, since FNArena runs a Model Portfolio based upon my research on All-Weather Performers it is more than likely that stocks mentioned are included in this Model Portfolio. For all questions about this: contact us via the direct messaging system on the website).

SMALL CAPS

Judo Capital Offers Differentation

Brokers continue to rate Judo Capital highly despite looming macroeconomic headwinds.

-Brokers are unanimous in their support for Judo Capital
-Morgan Stanley likes the bank's differentiated business model
-Will the challenging operating backdrop weigh?
-A review of first half and third quarter results

By Mark Woodruff

The name for the modern Japanese martial art of Judo stands for the "gentle way".

In a similar manner, it seems pure-play Australian business bank Judo Capital ((JDO)) is quietly garnering additional positive research in the FNArena database.

This increasing vote of confidence by brokers may be even more relevant for prospective value investors, given an ugly share price performance since Judo listed in November 2021 at $2.10 per share.

After an initial rally above $2.40, the stock has consistently drifted lower to be currently trading around $1.20.

Back at the beginning of February this year, Morgan Stanley initiated coverage with an Overweight rating, noting Judo's differentiated business model would enable strong growth and a mid-teens return on equity (ROE).

The bank combines a 'relationship-led' model with a sole focus on small and medium enterprises (SMEs), explained the broker, who also praised the deep experience of the founder-led senior management team.

As Judo is competing against large incumbent banks, the analysts noted Judo's advantage in being a cloud-native bank with no legacy systems, products or infrastructure.

Morgan Stanley acknowledged the bank's business model was untested, and it had relatively high exposure to consumer-facing and housing-linked industries.

As these industries and the consumer have been further pressured by macroeconomic conditions since this broker initiated research, it is timely to review subsequent research updates by other brokers in the FNArena database.

During the February reporting season, Outperform-rated Macquarie noted Judo's first half result outpaced consensus forecasts by 11%. Management also reiterated FY23 profit guidance.

While the average 12-month target price in the database was slightly increased, brokers were generally cautious on the outlook.

Citi (Buy) described first half conditions as ideal, but an aberration, with rising interest rates and strong business profitability allowing the bank to grow its loan book above 20% as funding costs declined sharply.

If we now roll forward to third quarter results in early May, Judo upgraded underlying net interest margin (NIM) guidance for the second half of FY23 to a range of 3.3-3.5% from 3.1-3.3% and stated the remainder of FY23 guidance metrics were on track.

The bank's co-founder and CEO Joseph Healy also noted "our asset quality remains strong with no write-offs during the quarter."

Underlying margins of 3.57% were better than Macquarie expected, underpinned by improving term deposit spreads coupled with treasury optimisation.

Results also exceeded Citi's expectations. Despite looming headwinds for interest margins and asset quality through FY24, this broker felt the share price was inexpensive and retained its Buy rating and $1.65 target.

Third quarter performance continued

Judo Capitals' $86.7m profit before tax for the nine months to March 31 represented around 90% of Goldman Sachs' FY23 expectation, implying 20-25% upgrades to the broker's forecast.

One disappointing aspect of the update for the analysts was an update on impaired assets. While still at low levels, the ratio of impaired assets/loans increased to 0.41% from 0.2% at December 2022. Also, the ratio of over 90 days past due/loans increased to 0.22% from 0.17%.

However, the 1.11% ratio of total provisions/total loans is now ahead of the broker's June 2023 forecast of 1.09%.

While upgraded guidance implied 10-15% upside to FY23 consensus forecasts, Macquarie introduced a note of caution by suggesting the margin beat was transitory as term deposit spreads had normalised to long-term averages, implying a deposit margin unwind in FY24.

Given the challenging operating environment, this broker expected lending growth would be impacted and continued to see challenges for the bank in meeting its at-scale cost to income target.

However, in a similar vein to Morgan Stanley, Macquarie reminded investors of the bank's differentiated proposition compared to the major banks. When strong provisioning is also taken into account, it's felt Judo Capital is well placed to manage near-term challenges.

Goldman Sachs has a Buy rating and $1.79 target price. Within the FNArena database, the average target price of Morgan Stanley, Macquarie and Citi (all with Buy or equivalent ratings) is $1.65, which suggests 37.5% upside to the latest share price.

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WEEKLY REPORTS

Uranium Week: Volatility Remains

After sparking up the week before, volatility as again evident in the uranium spot market last week.

-Spot uranium bouncing around
-Delivery location a factor
-Reactor building continues apace

By Greg Peel

Volatility continued in the uranium spot market last week, industry consultant TradeTech reports. After closing out April at US$53.75/lb U3O8, the spot price dropped to US$53.00/lb last Monday following the conclusion of a transaction at that price level. The price rebounded on Tuesday, as buyers motivated by the unexpected drop in the price stepped into the market to pick up material.

Other buyers continued to acquire material through Thursday at the US$53.35/lb level, which is where TradeTech's weekly spot price indicator closed out the week, down -US40c from the week prior.

However, the weekly volatility is not as much about a wild market as it is a mismatch between buyers' preferred delivery location, with lower priced material available at delivery points in France and Canada than in the US.

TradeTech's weekly spot price indicator is up 6% in the last two months on increased transaction volumes. The indicator is down -3% from one year ago and is up approximately 9% from the beginning of the year.

The average weekly spot price in 2023 is US$50.86/lb U3O8 -- 2.4% above the 2022 average.

Demand

The prospects for the nuclear power industry continue to increase globally, TradeTech reports, as countries and policy makers announce or confirm commitments to include nuclear in their energy portfolios in an effort to forge energy independence and reduce their carbon footprint.

India, in particular, continues to advance plans for new nuclear plants as the nation's reliance on coal-fired power plants works against future climate goals.

Reactor technology also continues to forge ahead, with US-based Westinghouse launching its newest nuclear technology last week -- the AP300 small modular reactor (SMR), which is a a 300MW single-loop pressurised water reactor, in case you were wondering.

In addition, the Korea Trade Insurance Corp and the Export-Import Bank of Korea have each signed agreements with a US-based Holtec International-Hyundai Engineering & Construction joint venture to provide financial backing for global project to build Holtec's SMR, the SMR-160.

In the term uranium market, utilities and suppliers are faced with growing optimism combined with concerns over the ability of the market to meet the demand challenges in a timely and cost-effective manner, TradeTech reports.

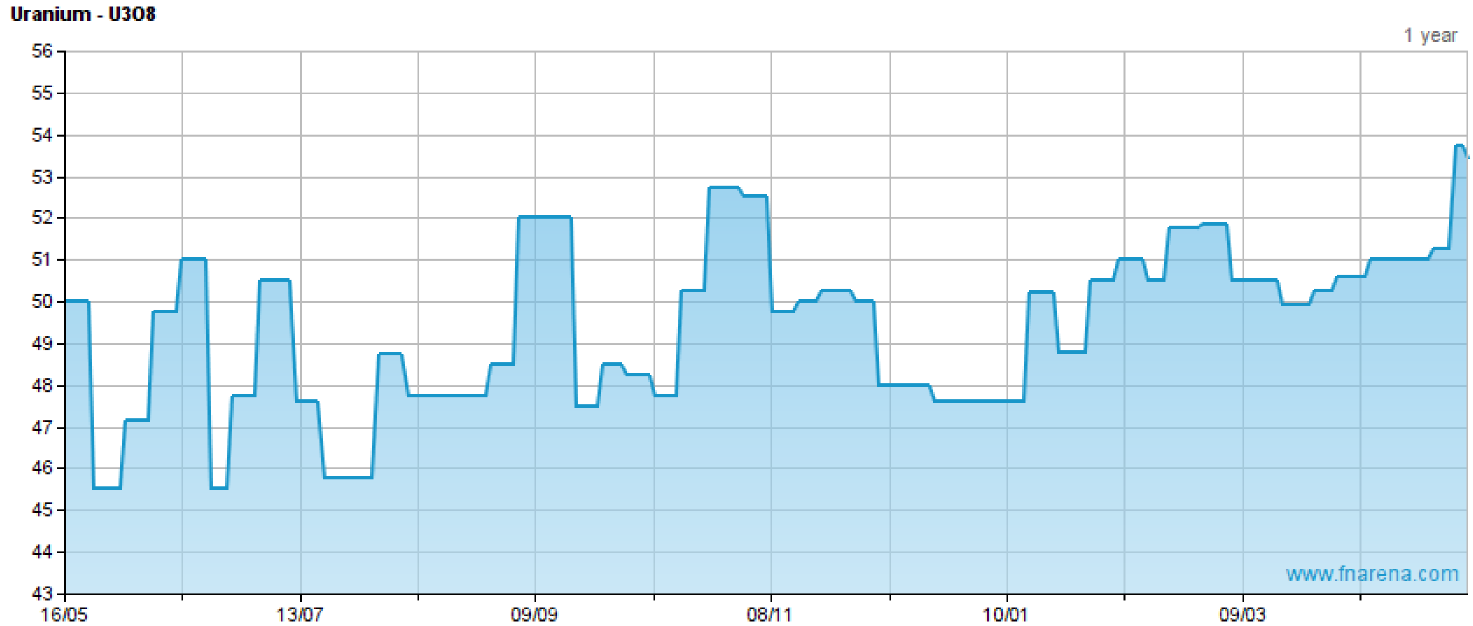
Offers were due last Friday to a US utility seeking over 6mlbs U3O8 for delivery contained in enriched uranium product (EUP) or components for reloads over the 2025-2030 period.

TradeTech's term price indicators remain at US$54.00lb for both mid- and long-terms.

Uranium companies listed on the ASX:

ASX CODE	DATE	LAST PRICE	WEEKLY % MOVE	52WK HIGH	52WK LOW	P/E	CONSENSUS TARGET	UPSIDE/DOWNSIDE
AGE	08/05/2023	0.0350	▲ 9.38%	$0.08	$0.03			
BKY	08/05/2023	0.3700	0.00%	$0.46	$0.25			

BMN	08/05/2023	1.3900	▲ 4.91%	$2.49	$0.15			
BOE	08/05/2023	2.6900	▲ 6.75%	$3.03	$1.61		$3.310	▲23.0%
DYL	08/05/2023	0.5700	▲10.68%	$1.25	$0.48		$1.040	▲82.5%
EL8	08/05/2023	0.3500	▲ 9.38%	$0.64	$0.30			
ERA	08/05/2023	0.0390	▼- 4.88%	$0.34	$0.04			
LOT	08/05/2023	0.1900	▲ 5.56%	$0.30	$0.15		$0.350	▲84.2%
NXG	08/05/2023	5.7800	▲ 0.52%	$7.51	$0.00			
PDN	08/05/2023	0.6550	▲ 3.97%	$0.96	$0.53	-19.5	$1.097	▲67.4%
PEN	08/05/2023	0.1550	▲10.71%	$0.22	$0.12	155.0	$0.340	▲119.4%
SLX	08/05/2023	3.4200	▲ 4.27%	$5.32	$1.22		$5.000	▲46.2%



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WEEKLY REPORTS

The Short Report - 11 May 2023

See **Guide** further below (for readers with full access).

Summary:

By Greg Peel

Week Ending May 4, 2023.

Last week the ASX200 plunged on the RBA's "surprise" rate hike. This week the index has recovered around half of that fall.

The big short position mover last week was Megaport ((MP1)), with shorts falling to 7.5% from 11.1%. See below.

Otherwise we note Credit Corp ((CCP)) last week issued a relatively dour quarterly update but managed to retain FY guidance via cost cutting. Credit Corp fell out of the table last week from 6.2% shorted.

Notably coming into the table last week was Appen ((APX)), on 5.6%. The AI company delivered its quarterly update yesterday and promptly fell -28%.

Weekly short positions as a percentage of market cap:

10%+

FLT 12.1
ZIP 10.4

Out: MP1

9.0-9.9%

JRV, CXO

In: CXO Out: SYA

8.0-8.9%

SYA, PBH, LKE, AMA, TPW

In: SYA, PBH Out: CXO

7.0-7.9%

MP1, SHV, JBH, BRG, BRN

In: MP1 Out: PBH

6.0-6.9%

BET, VUL, ACL, NVX, INA, IEL

In: NVX, INA Out: CCP, BOQ, NXT

5.0-5.9%

NXT, BOE, ARB, PLS, BOQ, APX, DOW, AWC, OBL, ABB, IMU, LTR

In: NXT, BOQ, APX, IMU Out: NVX, INA, MCR, WEB, FFX, SGR

Movers & Shakers

Digital connection service Megaport has seen its share price fall from a high of $9.69 in July last year to $5.28 currently, but last week had traded as low as $4.02.

The company then issued March quarter numbers that were weak, as largely expected. The stock shot up 40% on the day.

It was all about FY24 guidance, which proved materially higher than broker forecasts. The company recently completed an organisational review which led to a -16% reduction in workforce, but it will bring in more direct sales people. Prices will also be lifted, leading to a positive impact on cash flow, or more specifically, less cash burn.

The bottom line is brokers no longer see a risk of Megaport having to raise capital, assuming all of the above works.

Megaport had been entrenched at the top of the table for a period with shorts in excess of 10%, but clearly a short-covering scramble followed the update to helped the stock up 40%, with shorts now down to 7.5%.

ASX20 Short Positions (%)

Code	Last Week	Week Before	Code	Last Week	Week Before
ALL	0.3	0.3	NCM	0.6	0.7
ANZ	0.6	0.6	RIO	1.1	1.2
BHP	0.4	0.5	S32	0.8	0.8
CBA	1.6	1.6	STO	1.0	0.8
COL	0.5	0.4	TCL	0.6	0.7
CSL	0.4	0.4	TLS	0.2	0.2
FMG	1.4	1.4	WBC	1.8	1.6
GMG	0.6	0.6	WDS	1.0	1.0
MQG	0.6	0.6	WES	0.8	0.9
NAB	0.9	0.7	WOW	0.7	0.6

To see the full Short Report, please go to this link

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.

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.

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WEEKLY REPORTS

In Brief: Lithium, Retail & US Debt

Lithium merger may prompt industry consolidation; preferred lithium stocks; Amazon's threat to Aussie retailers & the US debt negotiations.

-Will the Allkem merger prompt further industry consolidation?
-Wilsons' preferred lithium exposures
-The threat posed by Amazon to local retailers
-US debt limit compromises may bring forward rate cuts

By Mark Woodruff

Will the Allkem merger lead to further industry consolidation?

Following the announced merger of Allkem ((AKE)) and US-based Livent Corp, Wilsons anticipates consolidation will become an ongoing theme for the Lithium sector globally.

The new merged company will become the third largest lithium producer globally and have exposure across the spectrum of spodumene, carbonate, hydroxide and specialty lithium chemicals.

Scale is needed across the industry, in the broker's view, to meet de-carbonisation and energy transition needs, and the merger may prompt increasing interest from traditional mining houses that have been reluctant to invest in the space.

The almost complete lack of presence from major miners to date is because the lithium market lacks size, explains Wilsons, something the bigger players prefer so they may utilise strong balance sheets, which provide a key point of differentiation.

Smaller markets such as lithium also screen poorly because large-scale additions to supply can have an outsized impact on market dynamics, which often presents an unacceptable risk, explains the broker.

As the industry "grows-up", Wilsons expects this situation will evolve as certain key strategic advantages accrue from achieving scale. These include diversification of project risk and more cost-effective access to capital.

Scale also allows greater access to early-stage exploration opportunities, notes the analyst, and broader technical capacity to pursue and develop them.

Wilsons on the Lithium sector and preferred stocks

This week, Wilsons initiated coverage on the Lithium sector and five individual stocks.

The broker's view of the industry may be best summarised as follows: "we remain principally focussed on the longer-term structural thematic drivers and are confident that **the low-carbon energy transition will drive expected compounding deficits in supply over the coming decades, which will underpin robust pricing over the longer term."**

Wilsons expects lithium prices will exceed consensus estimates because most forecasters are reverting to long-term incentive price-driven forecasts, which is totally unsuited for application to the lithium market at present.

Before such a forecasting technique is adopted, markets must be in long-term equilibrium, explains the analyst. It's thought even those with a bearish stance wouldn't consider lithium supply/demand is even remotely close to attaining equilibrium over the next 5-10 years.

From stocks under its research coverage, Wilsons maintains its preference for Leo Lithium ((LLL)) and Atlantic Lithium ((A11)).

The broker also has an Overweight rating on ioneer ((INT)), while Liontown Resources ((LTR)) and Core Lithium

((CXO)) are assigned Market-weight status.

To find the broker's newly-set 12-month target prices for these companies, please refer to today's Broker Call *Extra* Edition on the FNArena website.

The threat posed by Amazon to local retailers

Should Amazon Australia attain metrics in the long term similar to those already achieved in the UK and the US, it would become the fourth largest retailer behind Woolworths Group ((WOW)), Wesfarmers ((WES)) and Coles Group ((COL)).

Having raised this possibility, Jarden is cautious on companies with exposure to household goods such as JB Hi-Fi ((JBH)), Harvey Norman ((HVN)), Nick Scali ((NCK)), Kogan.com ((KGN)) and Temple & Webster ((TPW)), as well as those lacking clear competitive differentiation.

Some small Retail REITS are also likely at risk, suggest the analysts, if they do not invest in distribution capabilities.

A near-term game changer for Amazon in Australia is its Prime service which will open up new markets and impact incumbents with exposure to office, electronics, fashion, house & garden and recreation, explains Jarden.

The broker points out consumers are increasingly citing value as a key driver of engagement with Amazon Australia.

The value proposition is being driven by free delivery with Prime and the streaming offer, as well as the extensive range and low pricing. Same-day delivery across Sydney and Melbourne is also increasing the total addressable market and lifting customer retention.

Jarden observes consumers are trading down in grocery and delaying big purchases, and Amazon is increasingly becoming the first port of call for price comparison.

Jarden now expects Australian gross merchandise value (GMV) for Amazon will be close to $5bn in 2023, up more than 25% year-on-year, and will account for around 15% of all non-food retail growth. The sub-sector impact on Retail will be most significant across the categories of Office, Grocery and Fashion.

Given the immediacy imperative for Office customers, the analysts expect Officeworks (which accounts for around 5% of Wesfarmers' earnings) will likely be most impacted.

Grocery is expected to suffer most across categories such as health, beauty and baby, while the categories of footwear, apparel and accessories are most at risk with Fashion.

US debt limit compromises may bring forward rate cuts

Oxford Economics currently forecasts the US Federal Reserve will begin cutting interest rates at the beginning of 2024.

Yet this date could be brought forward to mitigate the impact of potential spending reductions to achieve compromise on the US debt limit, suggests Oxford. The economists had recently estimated the US Treasury would be able to manage without a debt limit increase or suspension until mid-to late-July.

However, Treasury Secretary Yellen now suggests the Department may not be able to pay all its obligations as soon as June 1, and Oxford thinks it will be extremely difficult to negotiate a large fiscal package before that date.

Unfortunately, talks earlier this week between President Biden and House and Senate leaders from both parties failed to resolve differences around raising the US$31.4tr debt limit. [A second meeting scheduled for tonight has been postponed - Ed]

Oxford runs the numbers of a hypothetical compromise package through its global economic model.

An assumed reduction in spending of around US$2.4tr (a little more than half the reductions in the House Republican plan) results in around US$200bn of interest savings, but results in a more severe recession than Oxford originally anticipated.

Under this scenario, the peak-to-trough decline in GDP would rise to -2.3% from -1.5%. The spending cuts would also raise the short-term unemployment rate, which would remain elevated relative to the baseline over the next ten years, explains the economist.

Although a discharge petition has been used successfully only twice in the last 25 years, Oxford notes the potential for a coalition of Democrats and a handful of moderate Republicans to bypass House Republican leaders and act on the debt limit.

Other ways to circumvent the limit include invoking the 14th Amendment, minting a platinum coin, or selling premium bonds with high interest rates, which could raise cash with a minimal impact on public debt, explains Oxford.

There’s also a chance both sides of politics could agree on a short-term debt limit increase or suspension to expire on September 30, the end of the current fiscal year.

While there are several ways Treasury can avoid a near-term default, Oxford believes lawmakers will try to negotiate a compromise bill first if they are still at a stalemate when the debt limit is at risk of being breached. A short-term increase, or suspension, is considered the most likely scenario in that case.

It’s believed a short-term raise or suspension would most likely run to the end of the fiscal year in September, raising the odds that a government shutdown and a default occur at the same time.

This approach would give the Democrats camouflage to say they negotiated spending cuts as part of the regular budget process, suggests Oxford Economics, rather than having to make concessions as part of a debt limit deal.

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