

Week  
**12**

# Stories To Read From FNArena

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## What Future For Wesfarmers Without Coles?

Wesfarmers will break with its supermarkets business, Coles, listing it on ASX while retaining a stake, a move largely welcomed by brokers.

-Retention of 20% could be a source of capital for future growth -Subsequently, Wesfarmers would generate over 80% of earnings from non-food retailing -Coles likely to appeal to defensive investors with need for stable long-term returns

By Eva Brocklehurst

In order to pursue higher returns from remaining businesses and open up opportunities, the Wesfarmers ((WES)) conglomerate will de-merge its Coles supermarkets. Coles will become a separate entity, to be listed on ASX, subject to regulatory and shareholder approvals.

Coles represents around 34% of Wesfarmers' earnings and, once a leader for the company, is now slotted in behind Bunnings Australasia. Wesfarmers intends to retain a 20% interest in Coles and will be targeting a strong investment-grade credit rating.

The de-merger makes sense to Morgans, given the long-term structural headwinds in the supermarket sector, while it frees up Wesfarmers to invest in higher returning businesses, or pursue acquisition opportunities.

Macquarie points out the limited vote risk is a good idea, as Wesfarmers will not escrow the 20% stake, and this could be a source of capital for future growth. If supported, the de-merger should be completed in FY19.

Following the de-merger, and assuming completion of the Curragh sale, Morgan Stanley estimates that in FY19, 55% of earnings will be generated from Bunnings (currently circa 33%), 22% from Kmart/Target, 17% from industrial business and 6% from Officeworks, which means Wesfarmers will generate over 80% of its earnings from non-food retailing.

It should also become easier to value the remaining parts of Wesfarmers, although Shaw and Partners warns that for every successful de-merger, e.g. Amcor ((AMC))/Orora ((ORA)), there is also a poor one, e.g. Toll Holding/Virgin Australia ((VAH)).

Credit Suisse speculates that the defensive rationale for the ownership of Kmart and Target will disappear with the de-merger of Coles, expanding the opportunity for Wesfarmers to own more department stores.

The decision signals to Deutsche Bank that new management is taking an active approach to managing the portfolio and Coles will be better placed to succeed in the long-term outside of Wesfarmers, while in the short-to-medium term the company be more considerate of industry profitability.

Ord Minnett suggests that while the company is seeking to access higher growth, this is not evident in its existing operations and acquisitions may be required and, indeed, appear more likely with the de-merger. Wesfarmers may become a higher-multiple business, excluding Coles, but the expansion opportunity is considered modest.

### Supermarket Segment

The announcement is good news for Woolworths ((WOW)), in Deutsche Bank's opinion, as in the short term the disruption from management changes at Wesfarmers and the de-merger process for Coles could enable Woolworths to extend its leadership in sales growth.

Moreover, Coles will have far less ability to be aggressive on price and so the industry is is likely to be more rational. The broker acknowledges that this dynamic could extend to Metcash ((MTS)) but this may be offset by a loss of talent, as its supermarkets CEO, Steven Cain, will depart to head up Coles.

Credit Suisse agrees that as Coles moves out from under Wesfarmers funding, supermarket industry rationality should improve.

The turnaround of Coles is finished and growth will be more elusive, in Morgan Stanley's view. Since acquisition in 2007, Wesfarmers has sold the Coles credit card business and released around \$850m in working capital.

The broker considers Coles a relatively low growth company that faces increase competition from both Woolworths and discounters, and does not believe separating Coles will drive either accountability or performance, maintaining an Underweight rating on Wesfarmers.

### Bunnings UK & Ireland

Credit Suisse suggests, although these are independent decisions, the emergence of a slimmed down Wesfarmers could increase the likelihood the company cuts loose the underperforming Bunnings UK business, which would also be greeted positively by the market.

Ord Minnett also reiterates a view that an exit of the UK business for Bunnings is a preferred strategy. The broker considers much of the potential upside is factored into the stock and therefore maintains a Hold rating.

Macquarie, on the other hand, suspects closure of Bunnings UK is now less likely although had hoped it would occur. The broker believes Wesfarmers would be an attractive business without Coles, and still considers the share price is under appreciating the Bunnings business.

With a smaller profit base in each business, the broker also believes strategic initiatives will be more material to earnings, also a positive. Coles will probably appeal to more defensive investors that are interested in stable returns over time.

### Leases & Debt

The structure of leases should provide no material issues, Shaw and Partners suggests, and Coles will continue to develop its property portfolio, with the majority of stores leasehold. The broker, not one of the eight monitored daily on the FNArena database has a Hold rating and \$43.50 target.

Deutsche Bank notes, as is the case with all retailers, lease obligations have more of a bearing on credit metrics than the level of debt, particularly in a low interest rate environment. The broker believes the annual lease expense for Coles, while not disclosed, is around \$1.25bn, which suggests Coles could feasibly accommodate \$1-2bn in debt.

Macquarie believes it makes sense for Coles to carry more debt, given it generates substantial cash and is more stable. The broker estimates that the Wesfarmers business, without Coles, has \$4bn in balance-sheet capacity which could be 5% accretive if \$2bn is deployed.

Despite the problems with Bunnings UK, the broker suggests the group is keen to buy more business. Macquarie has held a view for some time that there is hidden value in Wesfarmers and maintains an Outperform rating.

FNArena's database shows two Buy ratings (Macquarie, Credit Suisse) five Hold and one Sell (Morgan Stanley). The consensus target is \$43.06, signalling -0.4% downside to the last share price. This compares with \$41.85 ahead of the announcement.

Targets range from \$40.00 (Deutsche Bank, Morgan Stanley) to \$50.03 (Macquarie). The dividend yield on FY18 and FY19 forecasts is 5.0% and 5.1% respectively.

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## Brambles Invests To Strengthen Pallets

Brambles is investing in technology to strengthen its network advantage in the US and meet structural problems head-on.

-Margin improvement to come from price increases and cost savings -Technology already delivering value in pallet tracking -Opportunity to expand in relatively under-penetrated US market

By Eva Brocklehurst

Cost inflation continues to plague Brambles ((BXB)) and the company has grappled with the issues, outlining a detailed plan for turning around its US business. The company is guiding for second half margins in the Americas to be above the first half (16.2%), albeit below the 19.1% achieved in FY17.

Margin improvement will come from price increases, via transport and lumber surcharges, and cost savings from automation. The company is targeting medium-term revenue growth in the mid single digits, which is in line with estimates, although UBS suspects there is near-term upside from the pricing strategies outlined at the recent investor briefing.

### Technology

The broker believes Brambles has met concerns about cost inflation and outlined a clear plan to offset the impact. There is also upside from the investment in digital technology.

Pricing actions, automation and procurement initiatives are expected to generate a 2-3 percentage point improvement in CHEP's US margin over the next three years, a more optimistic outcome than UBS previously assumed. Management is also targeting a reduction in capital intensity by moderating its pooling expenditure to 17% of sales from 19%.

Credit Suisse upgrades to Outperform from Neutral, believing the company has a credible plan to improve value. The broker is impressed with management and believes it can deliver a significant improvement to the business over the next few years.

The broker observes technology investment is already delivering value, as pallet tracking indicates where pallets are being lost, damaged and used without payment. It also enables the company to add value to customers by finding opportunities to reduce their transport and logistics costs. This, in turn, makes customers stick with Brambles and strengthens its market position.

Credit Suisse points out that input cost inflation - labour, lumber and transport - is an even bigger challenge for competitors which typically have much lower margins. In the US market, Brambles has lumber cost related surcharge clauses in 60-70% of its pallet contracts and can be seen to obtain benefit from these surcharges.

Brambles has already automated the European pallet business to around 85% of operations and, Credit Suisse suggests, has proved its worth.

In contrast, the US business is only 20% automated and the company intends to reach 85% within three years. This will require a US\$150-160m investment and a four-year pay-back is expected. Management has calculated this should reduce repair costs by -15% and increase capacity by 30%.

Ord Minnett expects growth in European business to be driven by both new and existing customers, while margins could deteriorate slightly because of short-term cost inflation. Transport costs have risen 7% over the past year and the broker believes there are structural reasons why this may be sustainable, more so than many expect.

Still, in the US, there remains a relatively large under-penetrated market and the company has ample opportunity to expand. Ord Minnett expects 2-5% constant currency revenue growth over the medium term but retains lingering suspicions that investors may not be able to separate the short-term cyclical pressures from the long-term structural issues.

Macquarie likes the company's longer-term opportunities but retains concerns about the ability to pass on increase costs, particularly in transport, and maintains a Neutral rating.

In the wake of the first half results, several other brokers, including Morgans and Deutsche Bank, also consider the stock fully valued at current levels.

There are three Buy ratings and four Hold on FNArena's database. The consensus target is \$10.45, suggesting 6.4% upside to the last share price. Targets range from \$9.60 (Citi) to \$12.25 (Ord Minnett).

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## Smiggle, Online Buoys Premier Investments

An increasing online contribution, as well as rent reductions, drove strong like-for-like sales growth for retailer Premier Investments in the first half.

-Smiggle and Peter Alexander now account for 45% of the company's retail sales -Significant online growth in Smiggle UK suggests change in channel mix -Valuation considered undemanding in the context of global growth

By Eva Brocklehurst

Despite a tough domestic retail environment, Premier Investments ((PMV)) continues to maximise trading outcomes for its portfolio of brands. The driver of growth in the company's retail footprint is Europe, where Smiggle stores will be launched in the Netherlands in the second quarter of FY19.

Flagship brands Smiggle and Peter Alexander performed ahead of expectations in the first half and online sales in the UK exceeded management's forecasts. Legacy apparel brands Portmans, Jacquie E and Just Jeans also performed strongly.

First half results were supported by like-for-like sales growth, up 2.4%, the online contribution as well as cost reductions. Like-for-like sales grew in all brands other than Dotti (fast fashion) and Just Jeans, although UBS notes the latter has turned positive since the balance sheet date. Also, new management at Dotti is targeting a turnaround in the first half of FY19.

The stock is a key sector pick for Macquarie, underpinned by the potential in Smiggle as it rolls out globally in Europe and the US/Canada. Peter Alexander is solid while the momentum in legacy brands is improving, although risks from domestic competition continue. Macquarie also notes the strong omni-channel capability, where the company is investing ahead of the curve.

The result highlights for Deutsche Bank the resilience of the group in a weak market for apparel. Smiggle and Peter Alexander are the highest margin and highest growth brands and now account for 45% of retail sales.

The Smiggle UK footprint of 125 stores has firmly established the company's global credentials and this represents a tipping point in scale, whereby operating leverage is more than compensating for pressures elsewhere in the portfolio, the broker asserts.

Credit Suisse agrees Smiggle continues to underwrite value and its significant online growth suggests a potential mix change in channel along with the UK expansion.

Still, the broker remains wary that the company's online model in Australia does not subsidise delivery fees and returns, unlike pure-plays online. The company's argument with respect to the latter indicates returns to store provide a competitive alternative to free returns and the broker maintains a watching brief in this regard.

### Margins

Gross margins were under pressure from apparel discounting, which more than offset the positives in the shift in mix to Smiggle and Peter Alexander, Citi notes. Traditional bricks and mortar sales declined -0.8% while online sales grew 72%. While gross margins declined, the company managed to lift its earnings (EBIT) margin on the back of lower operating costs.

Citi points out that over 80% of the cost savings came from tight control of staff levels. There are other factors at play, too, as the mix is shifting online, which has lower staffing costs as do Smiggle stores, and the company has held wage growth in check.

The company has made a strong start to the year, although Morgan Stanley notes its second half is reliant on a fourth quarter which includes the variable winter season for apparel and Mother's Day. While competition remains intense in core brands, the broker does not bank on an immediate improvement to gross margins. Wage cost increases are expected to hold back costs/sales improvements compared with the first half.

### Rents

UBS notes the company has made progress in negotiating reductions in rent and first half rent/sales fell -34 basis points. Given rapidly increasing online sales and reports of substantial reductions in rent, the company is considered

well placed to negotiate further reductions across its domestic apparel portfolio. Morgan Stanley also points to the hard line the company has taken with landlords and its focus on reducing rent as a percentage of sales.

## Valuation

UBS believes a discount to market for the core brands is justified and, given where international peers are trading, believes potential fair value is \$15.62-17.53 per share.

A valuation issue arises in relation to what the company will do with its 10.8% stake in Myer ((MYR)). UBS estimates a takeover could be more than 17% accretive but remains wary of the long lease tail for Myer, where the average tenure of stores is over 12 years.

Macquarie believes the valuation is undemanding in the context of the global growth opportunities, although limited value is being ascribed to the legacy portfolio.

Citi downgrades to Neutral from Buy because of the rise in the share price over the past four months. The broker remains cautious on a 12-month horizon because of slow sales growth, and the potential distractions from the stake in Myer. The broker's bull case shows upside to \$19.68 (Citi has a target of \$16.40) if a new country can be found for Smiggle and there is a -10% reduction in rents.

FNArena's database shows three Buy ratings and three Hold. The consensus target is \$15.96, suggesting 3.6% upside to the last share price targets range from \$13.20 (Morgan Stanley) to \$17.30 (UBS).

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## Eroding Margins Still Critical For TPG Telecom

TPG Telecom has boosted FY18 guidance, partly because of the delay in transfer to the NBN. Yet brokers remain keenly aware of the margin risks.

-Offsetting margin erosion from NBN migration remains critical -Could bypass NBN over time but requires substantial spectrum -May need to be more aggressive with consumer pricing and customer acquisition

By Eva Brocklehurst

Fierce competition prevails for TPG Telecom ((TPM)), which has seen broadband subscribers decline for the first time. Brokers were pleased with the first half results but voiced concerns regarding the soft consumer segment.

The company has boosted FY18 guidance by 2.5%, partly because of the delay in the transfer to the NBN. FY18 operating earnings (EBITDA) are now expected between \$825-830m. TPG Telecom has an improved outlook for NBN margins, stemming from the resilience of average revenue per unit, lower CVC charges and a shift to NBN50 plans.

Yet the margin erosion that will come from the migration to the NBN and the ability to offset this through cost reductions remains the critical issue for the company. UBS warns that the NBN migration lag is not a permanent benefit, while upgrading estimates for FY18 and FY19 operating earnings by 2.5% and 1.5% respectively, ex mobile.

The temporary NBN delay, and reduced overheads, may boost current earnings at the expense of future profits but, given the poor margin outlook for the NBN, this is the right choice in Citi's view, because it will help to fund a mobile network.

Morgans believes TPG has done a commendable job to reduce costs and simplify its acquired businesses. iiNet is a predominantly a consumer-facing business with high customer advocacy, so the broker believes TPG needs to tread carefully in respect of integration and cost reductions. CLSA is expecting more synergies from iiNet and improved margins, because of a shift to higher-end products.

Credit Suisse suggests net profit in FY19 will be significantly affected by the timing of the start up of TPG mobile services in Australia and the requirement to start amortising spectrum and depreciating the capital investment.

The broker does foresee an opportunity for TPG to use its mobile network to bypass the NBN over time, but visibility on the upside is limited and any bypass strategy would require substantial amounts of additional spectrum.

### Mobile

The company remains fully committed to its Singapore and Australian mobile expansion. This, Morgans believes, is the meaningful medium-term upside opportunity. The company intends to secure a mobile roaming deal although no details are forthcoming at this stage.

Excluding the debt drawn for capital expenditure on mobile, the broker believes the stock is attractive, although this does depend on the success of the mobile venture.

UBS suspects there could be further capital expenditure that has not been factored into current guidance. The company could possibly purchase spectrum in the 3.6 GHz auction and will also need to consider rolling out a 5G mobile network. The broker estimates, if it needs to purchase spectrum or invest in 5G before FY20, there is only around \$650m available.

CLSA believes mobile will be de-risked through a roaming deal and next-generation network architecture, suggesting the risk of an equity raising is lower because the company will have more than \$1bn in head room for potential investment in 5G. CLSA, not one of the eight stockbrokers monitored daily on the FNArena database, has an Outperform rating and \$6.85 target.

Current capital expenditure plans are manageable, but Citi suggests the balance sheet could be stretched and, if spectrum auctions are highly competitive, TPG will have to raise more capital. The broker believes the stock will be a more attractive investment once the bulk of the mobile capital expenditure has passed through.

### Subscribers

Broadband subscribers fell by -8,000 in the first half. Management has indicated that subscriber trends have improved a little since the NBN50 plans were launched late last year but Macquarie believes sustainability is dependent on competition going forward. If pressures persist, the company may need to be more aggressive with pricing or customer acquisition strategies.

Credit Suisse calculates the company's iiNet market share was down to 24.3% at the end of 2017 and the decline reflects ongoing competition to capture broadband subscribers as the NBN rolls out. Moreover, competition in the price sensitive segment is particularly intense.

Citi agrees TPG could deliver the better subscriber growth outcome with a larger marketing campaign but this would not be a good use of funds at present. The broker expects cutting back on marketing in order to fund mobile capital expenditure will prove to be a positive in the long run.

Management remains upbeat about the rolling out of fibre in Adelaide. The company will build a fibre network capable of 10 gigabytes per second over 1000 sites and the footprint will enable around 3,500 businesses to access the infrastructure.

FNArena's database shows one Buy rating (Morgan Stanley), three Hold and four Sell. The consensus target is \$5.68, suggesting -5.3% downside to the last share price. Targets range from \$4.55 (Credit Suisse) to \$7.00 (Morgan Stanley).

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## Oboz Footwear Fits Kathmandu

Kathmandu pleased brokers with its first half performance, announcing the acquisition of US-based Oboz Footwear.

-More targeted promotions and better product management noted -Acquisition of Oboz strengthens international growth strategy -Relationship with GoOutdoors (UK) expands range of Kathmandu products

By Eva Brocklehurst

Kathmandu ((KMD)) improved its trading momentum in the first half. Gross margins improved strongly in February, which partly reflects a weak comparable period in New Zealand, although Deutsche Bank cautions that this is a small sample in a low season.

All metrics suggest to Canaccord Genuity the company is managing its inventory well and not having to discount stock aggressively via clearances. Sales momentum appears to have accelerated into the early weeks of the second half, although winter sales remain key to the broker's expectations for 18% net profit growth in the full year.

Sales growth was driven by Australia, up 3.7%, while New Zealand sales growth slipped -6.4%. Canaccord Genuity notes an interesting dynamic in New Zealand early in the financial year where the company likely lost share through the first clearance, as it had -40% less clearance stock than the prior year.

The flipside is that Kathmandu was selling current season product at full price, and this contributed to better gross margins. Meanwhile, international sales grew 97%, emanating from both the wholesale and direct consumer channels. Online sales growth was 13.9% and comprised 8.0% of group sales.

The results highlight good execution across many initiatives, Deutsche Bank believes, in particular more targeted promotions and better product management. The broker expects the company's business will outperform the retail market.

Canaccord Genuity likes the fact management has pursued a strategy of diversifying away from a maturing Australasian retail market, and in this regard highlights the relationship with GoOutdoors (UK), which has resulted in an expanded range of Kathmandu product across that retailer's 55 stores.

### Oboz Footwear

The company has announced the acquisition of US-based Oboz Footwear, which designs and sells hiking footwear via a wholesale distribution channel to North American outdoor chains. Consideration is NZ\$107.1m and brokers believe it complements the company's international growth strategy.

The transaction will be funded via a NZ\$40m institutional placement, NZ\$8m shareholder purchase plan and NZ\$70m in debt. The acquisition price suggests to Macquarie that management is confident about its ability to increase the contribution from this business in FY19 and beyond.

Around 45% of Oboz sales are derived from the leading US outdoor retailer, REI Co-Op. Kathmandu is the exclusive retailer of Oboz in Australasia and the product is also sold in GoOutdoors and Blacks in Europe.

Credit Suisse considers the acquisition strategically sound, presenting opportunities for expansion through the existing Kathmandu store network while leveraging the US distribution and retail relationships to build the wholesale business.

Credit Suisse believes the transaction also moves the mix away from a somewhat risky core that consists of an integrated mono-branded retail business. The broker's assessment of the company's enterprise value increase by 20% applying the transaction economics.

Importantly, Canaccord Genuity suggests this established international wholesaler with a category-leading product will enhance negotiations with retailers as Kathmandu seeks to penetrate its brand offshore. The broker, not one of the eight stockbrokers monitored daily on the FNArena database, upgrades to Buy from Hold. Price target is \$2.52.

While the acquisition is not without risks, Deutsche Bank considers management has demonstrated a strong track record in managing brand, noting Kathmandu already distributes Oboz product. Given the company has strong visibility on the near-term expectations for Oboz, and with the stock trading on a price/earnings ratio on FY19 forecasts of 10x, the broker believes there is value on offer.

FNArena's database shows two Buy and two Hold ratings. The dividend yield on FY18 and FY19 forecasts is 5.7% and 6.2% respectively.

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## Nufarm's Positive Outlook Gains Momentum

Nufarm is expected to sustain a period of growth from FY19 as recent acquisitions are consolidated and the Omega-3 commercialisation accelerates.

-Several factors driving earnings and cash flow beyond seasonal conditions -Organic growth achieved despite little or no market growth across core geographies -Scope for upside as Omega-3 expected to contribute from FY19

By Eva Brocklehurst

Nufarm ((NUF)) is bedding down recent acquisitions and moving forward on its Omega-3 project. First half earnings revealed a better performance in North America which offset a weaker contribution from Europe.

The results were a little weaker than many expected, largely because of a plant shutdown at Laverton in Australia and the challenges in Latin America. Earnings are skewed significantly towards the second half so full year guidance is not changed.

The business will always be exposed to seasonal fluctuations but Bell Potter observes a period of growth is very likely over FY19-21, as recent acquisitions are consolidated and the initiatives around working capital and Omega-3 accelerate.

There are several primary drivers of earnings and cash flow beyond seasonal conditions, the broker points out, including delivery on cost reduction targets, further working capital releases from investment in systems, delivery on the Omega-3 initiative and delivery on earnings targets for the Century and FMC European acquisitions. Bell Potter, not one of the eight stockbrokers monitored daily on the FNArena database, has a Buy rating and \$10.05 target.

The result allayed some concerns, Macquarie acknowledges, and confirms there is still positive underlying momentum. The company now needs to deliver on expectations. Australia disappointed in the first half, although the broker notes the Laverton plant is now up and running and brand merging of Nufarm and Crop Care has been completed.

Seasonal conditions will now be in focus, particularly in Australia, as the winter crop planting gets underway in April. The broker notes positive feedback from the distribution channel regarding the European acquisitions amid the increased scale and relevance that these opportunities provide Nufarm across key product areas.

Organic growth was achieved across core geographies, despite little or no market growth over recent periods, Ord Minnett observes, and further opportunities exist with the commercialisation of Omega-3 canola and the recent acquisitions.

Margin uplift should provide benefits once the company's performance improvement program is finished and the broker notes increased valuation support for the stock, upgrading to Buy from Hold.

### Valuation

Deutsche Bank goes against the grain, with a Sell rating, noting the stock is trading at a sizeable 27% premium to the broker's \$6.85 valuation. The broker was disappointed with the European market in the first half, although North America and the seeds business surprised to the upside. FY18 earnings estimates are downgraded by -6% to reflect lower expectations from Australia, Asia, Europe and Latin America as well as higher interest costs.

In contrast, Morgans believes the market should start to soon appreciate the company's attractive growth profile, finding the valuation undemanding. A material improvement in seed technologies was the highlight of the result, with a first half profit that compares with a usual seasonal loss. The stock remains the broker's key pick for exposure to the agriculture and chemical sector.

Credit Suisse also expects a little more upside can be squeezed out from the stock. With pressure on farm incomes unlikely to ease soon, the company continues to benefit from a preference for lower-cost commodity product that has driven market share expansion in Australia and North America. The broker finds it hard to envisage growth commensurate with the risk in Latin America, although some easing of margin pressures is expected in the second half.

### Omega-3

While Morgans reduces FY18 estimates because of the timing of the European acquisitions, importantly, there is no change to FY19 forecasts, which is the first full year to benefit from the European acquisitions. Longer term, the broker believes the Omega-3 program could be a game changer.

CLSA believes the current share price effectively includes a free option on the Omega-3 project that could deliver both material profit upside from 2020 and lift the quality of earnings. The broker, not one of the eight monitored daily on the database, has an Outperform rating and \$10 target.

Citi, too, believes the company is poised to enter a growth phase, supported by the recent acquisitions together with Omega-3. The stock is trading below historical valuation multiples and global peers and the broker reiterates a Buy rating.

The growth outlook is robust and Omega-3 is on track so there is scope for upside to valuation, in Morgan Stanley's opinion. The company has highlighted Australian regulatory approvals for the Omega-3 initiative and positive results in application trials, anticipating US and Canadian regulatory approvals in 2019. Morgan Stanley believes the potential upside associated with Omega-3 is not yet captured in the share price.

The database shows six Buy ratings and one Sell (Deutsche Bank). Consensus target is \$9.78, suggesting 12.3% upside to the last share price. Targets range from \$6.85 (Deutsche Bank) to \$11.50 (Morgan Stanley).

See also, Brighter Outlook Emerges For Nufarm on March 8 2018.

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## Material Matters: Steel, Alumina And Cobalt

A glance through the latest expert views and predictions about commodities. Steel & iron ore; aluminium raw materials; cobalt; copper; and coking coal.

-Short-term pressure, but steel & iron ore markets considered well supported -Rising supply makes Macquarie bearish on alumina & bauxite -Cobalt requirements likely to be increasingly supplied by DRC -Credit Suisse takes more positive view on copper -Includes risk of lower Queensland coking coal railings in forecasts

By Eva Brocklehurst

### Steel & Iron Ore

ANZ analysts observe the lull that usually follows Chinese New Year will place pressure on steel and iron ore prices. In the short term, a lifting of winter steel restrictions could mean prices weaken as steel inventory is drawn down. There is also a risk iron ore prices ease back through US\$70/t.

US trade tensions are also likely to continue. The analysts do not expect a major impact on Chinese steel exports as a result of the US steel tariffs. Rather, the greater risk is for a trade war as key trading partners retaliate.

Further out, supply-side reforms are expected to support these markets over the remainder of the year particularly as the National People's Congress has raised its target for capacity closures. The government has confirmed it is targeting GDP growth of 6.5%. Combined with growth in developed markets, the analysts envisage demand for these commodities will remain supportive this year.

Macquarie believes concerns about China's steel stockpiling are overdone. The build-up appears connected to a delayed pick up in demand. The broker expects a rise in construction steel demand at some point over the next two weeks, which should start to impact on inventory and support steel prices.

Raw material inventory has also increased although, provided crude steel production expands in April in line with seasonal trends, this should not weigh on prices. The broker continues to expect raw material demand to improve in coming weeks.

Macquarie has long argued that iron ore port stocks are a weak market signal and there have been plenty of times when changes did not correspond to an equivalent move in iron ore prices.

Nevertheless, the broker does flag the fact iron ore port stocks are the highest they've been since 2012. Looking ahead, the broker observes Chinese sentiment so far remains relatively bullish and there is no sign of a let-up in demand.

### Aluminium Raw Materials

Rising supply is providing a bearish perspective on the seaborne markets of alumina and bauxite. Macquarie believes these markets are likely to stay soft. Bauxite prices have recently started to drop and the availability of Guinean material has worked to keep a lid on prices.

As with aluminium production, alumina output in China has also recovered after reductions that were ordered were less onerous than initially feared. Bauxite imports, as a result, also began to recover, with Guinea contributing close to an average of 3mt per month of material in November and December. This increased to 3.5mt in January.

Macquarie expects bauxite prices to stay under pressure, as seaborne volume rises and operations geared to export ramp up. The possibility also exists that Malaysia will relax some of its export ban.

Over a longer horizon, Macquarie observes the alumina market is experiencing rising process capacity with no constraints on the availability of bauxite. The broker believes the future trend for alumina prices in the longer term is downward.

### Cobalt

Canaccord Genuity expects large-scale operation such as Kamoto and Kolwezi in the Democratic Republic of Congo will provide the majority of near-term supply of cobalt and increase reliance on that country's mined production to 72% in 2021 from 65% currently. This comes at a time of increased sovereign risk.

Product is likely to improve, as artisanal ore supply is curbed, as is payability associated with the building of refined cobalt capacity. The broker notes a recent approach to miners by Apple and Samsung for long-term cobalt supply, which indicates a willingness to directly invest in supply and reflects these companies' aggressive growth plans.

Prices over 2017 were sustained into 2018 and Canaccord Genuity suggests a supply/demand imbalance, rather than speculation, is likely to be the main influence over the medium term.

Cobalt demand forecasts are largely unchanged and the broker believes a revised Chinese policy on electric vehicles is likely to favour a larger battery size. The broker has already factored into forecasts the potential for thrifting cobalt for nickel within NMC cathode formulations but slows the speed at which this is assumed to occur.

Cobalt remains critical to retaining crystalline structure within the cathode and demonstrating replaceability with nickel is critical for product acceptance. This is the focus of ongoing research. In terms of using manganese as a transition metal, Canaccord Genuity notes its advantages need to be traded off with reductions in performance.

Demand for traditional markets will be satisfied through existing refined metals while meeting the growth segment in battery powder will be contingent on chemical capacity coming on line.

Overall demand is expected to continue to grow at 8% annually to 2025. Industrial applications such as super alloys are assumed to only grow 0.5% per annum as end-users are expected to reduce cobalt content within chromium alloys.

The broker revises its pricing method to reflect recoverable cobalt supply and demand. Long-term prices are lifted 32% to US\$49/lb. Over the short term the broker envisages a strong likelihood for structural deficits, which may exacerbate the inclination to stockpile.

The LME cobalt price is expected to breach US\$50/lb in 2019 and companies that have near-term development projects or physical exposure are seen as best placed to benefit.

#### Copper

Credit Suisse upgrades copper price forecasts for 2018 and the first half 2019 because of a change in its macro view on China. Previously, the broker took a view that China's property construction boom would fade over 2018, reducing copper demand. However, following a visit to China in October/November Credit Suisse has returned with a more positive view.

The broker believes the backlog of projects in housing and infrastructure will support metal demand irrespective of new orders. Credit Suisse expects the copper price to hover close to current levels for much of the year as there are no upcoming catalysts to move the price either up or down.

#### Coking Coal

Credit Suisse now includes the risk of lower Queensland coal railing in its forecasts for seaborne hard coking coal, as Aurizon ((AZJ)) is expected to cut 20mtpa from its shipments because of a new maintenance plan.

The broker raises price forecasts for the remainder of 2018 by US\$20/t to US\$195/t. By 2019 the broker expects that higher exports from the US could offset the reduction in Queensland railings and makes no changes to forecasts beyond 2018.

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## Trump Builds Economic And War Machine

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.

Trump builds economic and war machine

*Si vis pacem, para bellum* - From the Latin, "If you want peace, prepare for war."

On March 1 Donald Trump announced that his Administration would implement a 25% tariff on all steel imports and a 10% duty on aluminum. President Trump initially said the tariffs would apply to all steel and aluminum exporters but a week later, facing pressure from Republican free-traders, temporarily excluded Mexico and Canada while NAFTA talks continue.

The tariffs were needed for national security reasons, argued Trump, based upon an investigation by the US Commerce Department which found in January that cheap foreign steel was indeed a threat to America:

The continued rising levels of imports of foreign steel threaten to impair the national security by placing the U.S. steel industry at substantial risk of displacing the basic oxygen furnace and other steelmaking capacity, and the related supply chain needed to produce steel for critical infrastructure and national defense. - US Commerce Department

The announcement caused an immediate drop in stock markets and a chorus of outcries from US trading partners, who said they would impose retaliatory tariffs on American exports and fight the trade restrictions at the World Trade Organization.

But they shouldn't have been surprised. During the election campaign Trump blasted China for a host of American economic ills including an artificially low exchange rate, dumping steel into the US market, and funnelling billions of dollars in subsidies to its steel mills.

Chinese steel companies, which produce half of the world's steel, have long been a target of US import duties, and the 25% tariff was clearly aimed at them. There are currently 169 antidumping and countervailing duty orders on steel, with 29 of them against China.

The largest exporter of steel to the US is Canada at around 17% of the total, or 5.5 billion tonnes in 2017, followed by South Korea, Mexico and Brazil. China exported 1.9 billion tonnes, although this number may be much higher, considering that China often flouts trade rules by sending steel and aluminum to the US through third countries.

Michael Stumo, CEO of the Coalition for a Prosperous America, points out in an op-ed that "While the United States once pioneered the world's steel industry, it is now the largest importer of steel, importing nearly four times as much as its exports." Stumo notes that the glut of steel being churned out by China has caused the loss of 50,000 US jobs since 2000, closed a number of key steel-making plants, and decimated steel used in electrical transformers where only one US producer remains.

The effects of the tariffs on the US economy and its trading partners are the subject of considerable debate right now, but to examine why Trump is doing it, we have to go beyond the economic headlines. In doing so, we find that the protection of steel and aluminum, and the recent, long-overdue call for the domestic production of 35 strategic metals, is part of a greater plan to build up the American military to counter increasing threats from two historical adversaries: Russia and China.

The real reason for steel tariffs

"Our steel industry is in bad shape," Trump tweeted. "IF YOU DON'T HAVE STEEL, YOU DON'T HAVE A COUNTRY!"

Trump is 100% correct. Although he could have taken it one step further, and said without steel, you don't have a military.

The Commerce Department has said the current US dependence on steel imports puts the country in a position where it would be unable to meet demands for national defense and critical industries in a national emergency. It would not have the legal authority to commandeer supplies, as it could within the US, points out Lawrence Solomon in an excellent piece from the National Post. In it, Solomon notes that during the Korean War President Harry

Truman seized the US steel industry to maintain production for the war effort, and during World War II, citizens were asked to donate their automobile bumpers to make scrap steel.

Like Reagan before him, Trump believes in peace through strength: *Si vis pacem, para bellum*. While Reagan's Evil Empire was Russia, Trump's is China. His chief trade advisor Peter Navarro said as much in two books he's written, one titled *Death by China* and the other *The Coming China Wars*. In *Death by China* he writes "China's perverse form of capitalism combines illegal mercantilist and protectionist weapons to pick off American industries, job by job. China's emboldened military is racing towards head-on confrontation with the U.S."

Referencing Navarro, Solomon observes that "[Trump] wants a military so dominant, and an economy so robust, that no adversary would ever dare challenge it. At the same time, Trump wants to take on today's Evil Empire, the country that represents a future existential threat to the U.S. - China."

The first step in such a confrontation is a trade war. Zero Hedge sets out the conditions that are right now ripe for an economic war between the United States and its trading partners. Author Tyler Durden put together a collection of charts that include a rise in populism leading to a movement against globalization and towards nationalism (often accompanied with protectionism), rising income/wealth inequality, and the growing number of displaced persons, putting pressure on countries to absorb immigrants and adding to social tensions.

Project Syndicate points out that, apart from slowing the flood of Chinese subsidized steel and aluminum finding its way into the United States at low prices, the tariffs put pressure on China to stop requiring US companies to transfer their technology to Chinese firms as a condition of market entry. The Americans see this as a form of extortion and the tariffs are a way to persuade China to abandon technology transfers, thereby stopping the theft of US technology and intellectual property. The stealing has mostly been done by the People's Liberation Army (PLA) which has sophisticated cyber-espionage capabilities. Other measures to prevent intellectual property theft are reportedly being considered by the Office of the US Trade Representative.

Historical perspective - before, we put America first

While many believe that world wars are consigned to the dust bin of history, Trump is clearly not one of them. In fact a deeper reading of history shows that the Founding Fathers of the United States of America were focused squarely on the importance of maintaining a ready supply of materials necessary for the defense of the nation and war-making capabilities.

In the 1780s the US knew what it needed for war. When President George Washington signed the Tariff Act of 1789, he told Congress, "A free people ... should promote such manufactures as tend to make them independent on others for essential, particularly military supplies."

Alexander Hamilton's Report on Manufactures, written in 1791, said "Every nation ought to endeavor to possess within itself all the essentials of national supply. These comprise the means of subsistence, habitat, clothing and defence." This would be achieved by implementing moderate tariffs on imports which would be used to fund local industries, without decreasing supply or increasing prices. The goal of the subsidies was to make US companies, and the nation, competitive and independent.

During the Irish potato famine of the 1840s the United Kingdom took the opposite approach, repealing the Corn Laws which protected the domestic food industry (including grain) by imposing tariffs on agricultural imports from its colonies - thus ushering in a period of free trade which Britain has held to ever since.

Conservative commentator Pat Buchanan said in a recent column that "Britain's folly became manifest in World War I, as a self-reliant America stayed out, while selling to an import-dependent England the food, supplies and arms she needed to survive but could not produce."

In another column Buchanan noted that the US relied on tariffs to convert its agrarian economy into the world's greatest manufacturing power by 1900, an approach replicated by Bismarck's Germany in the 1870s and Japan in the 1980s. "There's nothing in the world that we cannot produce here. And if it can be made in America, it should be made in America," Buchanan concludes, echoing Trump's Make America Great Again mantra.

Unfortunately globalization has completely turned the tide of economic history, so that now the United States is dependent on most materials necessary for the defense of its borders and projection of military force including steel, manganese, vanadium, chromium, lithium and until very recently, oil. The Founding Fathers would have been horrified at the currently weak situation the country finds itself in.

Why the world is a more dangerous place

In the 19th and 20th centuries the world was more stable, with clearly marked spheres of influence. The Monroe Doctrine invoked by President James Monroe stated that any effort by European nations to control any independent state in North or South America would be viewed as "an unfriendly disposition towards the United States."

The intent of the Monroe Doctrine was to free the newly independent colonies of Latin America from mostly Spain and Portugal, so that the States could exert its influence undisturbed. Now, the real influencer in Latin America is China. During the 19th century Great Britain and European nations carved Asia, Africa and the Caribbean into colonies or protectorates, with the British controlling India and North Africa, the French and Dutch in Indochina, and the Spanish in the Americas, the Caribbean and the Philippines.

The onset of the Cold War and the dissolution of European empires in the 1950s split the world in two, with the USSR controlling the vassal states surrounding the Soviet empire and the United States defending Latin America and North Asia (Japan, South Korea). Flash points like the Vietnam War occurred in places where these spheres of influence collided, but it was always clear who the enemy was. Today we are not so sure. Is the new foe China, which is becoming increasingly aggressive both economically and militarily, Russia, whose persistent meddling (Eg. the US election, the Crimea, and most recently, a chemical attack on British soil) keeps the US in a state of perennial confusion, or ISIS? It appears that spheres of influence have been eclipsed by globalism, with Russia, China and the US each competing to control the most territory and resources in a world dominated by multi-lateralism and free trade. We are in a power vacuum, as multi-national bodies like the UN and NATO look increasingly incompetent in preventing atrocities like Syria or nuclear threats from places like Iran and North Korea. If we had to pick two adversaries that the US needs to prepare a strong military response for though, they would be China and Russia.

#### Threat #1: Russia

The headlines are full of news about the chemical attack on a former Russian spy and his daughter in Salisbury, England. British officials say Russia was responsible for using a military-grade nerve agent to poison the pair - a charge the Kremlin denies. German Chancellor Angela Merkel and UK Prime Minister Teresa May have agreed to counter Russian aggression and the US will back Britain if the situation escalates. Twenty-three Russian diplomats have been expelled. The attack is particularly alarming since it's the first use of a nerve agent on Alliance territory since NATO's formation; demands are being made of Russia to disclose its stockpile of chemical weapons.

The incident is the latest in a series of attempts by Russia to exert its power in a world bereft of clear battle lines. Examples include the annexation of Crimea in the Ukraine, military support of Syrian dictator Bashar Al Assad, and Russian meddling in the US Presidential election through Internet trolls. On Thursday the US slapped Russia with sanctions for the alleged election interference and cyber-attacks on US companies.

In Syria a UN ceasefire continues to be ignored and on Tuesday the Russian military threatened action against the United States if it strikes Damascus.

#### Threat #2: China

Trump's steel and aluminum tariffs are an economic response to the Chinese threat but conflict between the two superpowers has over the years spilled into the military realm.

China has been involved in territorial disputes with Japan and Taiwan over the Senkaku islands, and Vietnam over the Spratly islands.

China has also ramped up its naval presence in the South China Sea. Why? China is energy-starved and the areas off the coast of the Philippine province of Palawan are oil rich. In mid-2012, the Philippines and China came dangerously close to an armed conflict over the Scarborough Shoal in the South China Sea.

China's increasingly contentious showdown with Japan in the East China Sea could prove to be even more dangerous. At issue are disputed Islands (Senkakus to the Japanese, Diaoyu to China) and the fishing rights and natural resources those islands would deliver to their owner.

The standoff has already resulted in several direct confrontations between China and Japan.

The US has treaty obligations to Japan. President Obama's Secretary of Defense Chuck Hagel warned China that any attack on the disputed islands would "fall under our security obligations."

Obama's "pivot to Asia" was designed to curb Chinese territorial ambitions which include the reunification of Taiwan with China - a hornet's nest that Trump walked into when he accepted a phone call from Taiwanese President Tsai Ing-wen soon after inauguration. But the pivot, to be realized through increased trade like the Trans Pacific Partnership and increasing its regional military profile, has been a failure. The US could not prevent China from building islands and annexing 80% of the South China Sea, stop China-backed North Korea from conducting nuclear tests, or defend freedom of navigation through the \$5-trillion annual trade corridor. On assuming power Trump pulled the US out of the TPP and began a dangerous war of words with North Korea's Kim Jong-un as the reclusive nation successfully tested its first intercontinental ballistic missile capable of hitting the US mainland.

Meanwhile China continues to expand its military. In early March it was reported that China plans to boost military spending by 8.1% in 2018, compared to a 7% increase in 2017. While 2016 spending of \$215 billion is about a third of

that spent by the US in the same year - \$611 billion - a modernization drive has accelerated in recent months. Developments include the PLA launching its first aircraft carrier, the opening of China's first military base in Djibouti, a new J20 stealth fighter, and most worrying, the Dongfeng-41 intercontinental ballistic missile capable of carrying nuclear warheads. Last summer while celebrating the 90th anniversary of the PLA, Chinese President Xi Jinping boasted that China is now capable of vanquishing all invading enemies. China has the largest ground forces in the world, bigger than those of the United States.

### Russian-Chinese cooperation

Separate Chinese and Russian aggression is overt, but the two countries have also begun cooperating in more subtle ways, one wonders if an attempt to join forces to throw the United States off base and assert global power is underway. Of course Russia and China have since 1950 agreed to defend one another against an attack from US-backed Japan or its allies (China backed North Vietnam and North Korea) so continued cooperation is unsurprising. In 2001 Russia's Vladimir Putin and then-Chinese President Jiang Zemin signed a 20-year agreement to "increase trust between their militaries". The two countries now regularly participate in joint maneuvers including joint naval exercises to counter US influence in the Asia Pacific region.

Economic ties are also growing closer. On New Year's Day a second Sino-Russian oil pipeline began operating, doubling the amount of Russian crude being shipped to China, while in 2014 Beijing and Moscow signed a 30-year, \$400-billion deal for Gazprom to deliver gas to China. The latest evidence of Chinese-Russian business ties involves the launch of a crude oil futures contract, priced in Chinese yuan and convertible into gold. The contract will allow oil exporters like Russia and Iran to dodge US sanctions against their countries by trading oil in yuan rather than US dollars.

### Building the war machine

In World War I severe material shortages (tungsten, tin, chromite, optical-grade glass, and manila fiber for ropes) played havoc with production schedules and caused lengthy delays in implementing programs. This led to development of the Harbord List - a list of 42 materials deemed critical to the military.

After World War II the United States created the National Defense Stockpile (NDS) to acquire and store critical strategic materials for national defense purposes. The Defense Logistics Agency Strategic Materials (DLA Strategic Materials) oversees operations of the NDS and its primary mission is to "protect the nation against a dangerous and costly dependence upon foreign sources of supply for critical materials in times of national emergency."

The NDS was intended for all essential civilian and military uses in times of emergencies. Guerrilla warfare in Zaire during the 1970s caused the worldwide price of cobalt to increase from \$6 to \$45 a pound, and a UN trade boycott of Zimbabwe stopped legal exports of chromium from the country.

In 1992, Congress directed that the bulk of these stored commodities be sold. Revenues from the sales went to the Treasury General Fund and a variety of defense programs - the Foreign Military Sales program, military personnel benefits, and the buyback of broadband frequencies for military use.

Since then, a variety of factors I've covered before, including restrictive environmental regulations and a sharp decline in US mining investment, has made the United States dependent on foreign mines for a number of strategic metals - a situation I have dubbed "A Nation's Metallurgical Achilles Heel".

If Trump is in fact bolstering the US Military by rebuilding the US steel industry and allowing for a greater projection of American war-making prowess, what materials would be necessary for the country to have? By no means exhaustive, the list below would be a good start.

**Manganese** - Aside from iron, manganese is the most essential mineral in the production of steel. You can't produce steel without adding 10 to 20 pounds of manganese per ton of iron. The US has no Mn mines. **Rare earths** - There are numerous military applications of rare earths, everything from battle tanks, drones, lasers, radar, missile-guidance systems, satellites and aircraft electronics. In 2015 Mountain Pass, the only rare earths mine in the US, went bankrupt and in 2017 it was sold to a Chinese-led consortium for \$20.5 million. **Lithium** - Lithium batteries are recognized as the perfect battery for military equipment because they can be recharged from a variety of power sources, including portable solar panels. In 2015 the US Navy paid \$81 million for the development of an energy storage system that can power an "electromagnetic railgun", which uses electricity to hurl projectiles over long distances. More recently the US Army awarded a contract to supply a 24-volt 6T battery. The lithium-ion 6T versions are half the weight and pack twice the energy of traditional lead-acid 6Ts, which are used in 95% of tactical ground-vehicle platforms. **Oil** - You can't fight a war without oil, and while the United States under Trump appears to have become overly-dependent on shale oil, the resurgence of the US oil industry means that the States is considerably better off than just a few years ago when oil exports were still banned and the country was more dependent on foreign sources than currently. Still, the US imports around 6 million barrels of oil a day while producing close to 10 million bopd, meaning the country is unlikely to ever become oil-independent, as many sources are predicting.

## Conclusion

President Trump like Reagan before him is a nationalist who recognizes that the United States has bumbled into a situation of weakness and potentially dangerous dependence on foreign countries for critical materials necessary for the defense of the nation and the projection of military force. His steel and aluminum tariffs therefore make sense if the goal is to build up the American steel industry while at the same time subtly attacking a longstanding trade irritant and growing military threat: China. The current drive to overtake Russia in oil production might also be seen as a geopolitical strategy to counter Russian aggression by beating them at their own game.

After years of neglect from previous administrations, the Trump White House finally understands that the United States needs to pump more money into domestic mineral exploration especially key commodities needed for military applications and the new electrified economy.

If we go back to the Founding Fathers, the goal of tariffs is not to punish trading partners (though in our globalized world this is the inevitable reaction), but to make the nation more competitive and independent. If tariffs serve to strengthen US mining then they will have served their purpose, but there are more direct ways for governments to encourage mining, such as the rolling back of over-regulation (something Trump has already done through limiting the powers of the EPA), providing tax incentives for mining, and streamlining leasing and permitting of new mines.

Becoming aware of what Trump is doing to encourage domestic mineral production puts resource investors one step ahead of the herd as the US becomes more pro-mining in its efforts to improve security of metals supply. I'm keeping a close eye on what boosting domestic output of critical minerals and reducing import reliance on them really means.

I've got a handful of the resource companies set to supply the US on my radar screen. Do you?

If not, perhaps you should.

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# 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 March 12 to Friday March 16, 2018 Total Upgrades: 10 Total Downgrades: 4 Net Ratings Breakdown: Buy 43.59%; Hold 41.16%; Sell 15.25%

A hesitant local share market continues to find support from stockbroking analysts who issued ten upgrades and only four downgrades for ASX-listed entities during the week ending Friday, 16th March 2018. Further enlarging the direct support for share prices, eight of the ten upgrades lifted the rating to an equivalent of Buy. On the flipside: three of the four downgrades sank ratings to Sell.

All three receivers of a Sell rating are resources stocks: Newcrest Mining, OZ Minerals, and Sandfire Resources. Among the receivers of a Buy rating we find Wesfarmers, on the news of spinning off Coles and becoming a higher growth conglomerate again, James Hardie, Sydney Airport, South32 and Regis Resources.

Changes to price targets and valuations remained rather mute, given the February reporting season already has inflicted major amendments to forecasts. This leads to WiseTech Global commanding pole position for the week with a net gain of no more than 2.4%. The negative side has Charter Hall and Newcrest Mining suffering a blow in excess of -4% each.

The table for positive revisions to earnings forecasts has energy producer under corporate interest, AWE Ltd, on top with a 11% gain, but then things go quieter quite quickly; OZ Minerals' forecasts gained 2.8%, for OceanaGold the impact is no more than 1.6%. The week's numbers are larger on the negative side where Newcrest Mining, plagued by yet another operational hiccup, has taken a blow in excess of -17%, followed by Japara Healthcare suffering -7.7% and WiseTech Global's prospects losing -2%.

All in all, it appears underlying profit growth forecasts are trending lower, but it's happening at avalanche speed. And the balance in ratings upgrades and downgrades suggests there's still value to be found. This week sees a series of out-of-season corporate results being released with Premier Investments' update on Friday well received.

## Upgrade

**AURIZON HOLDINGS LIMITED ((AZJ))** Upgrade to Outperform from Neutral by Credit Suisse .B/H/S: 2/3/2

Credit Suisse upgrades FY18 estimates for earnings by 3% because of cost reductions in the network. The broker suspects the network is likely to surprise to the upside in 2018.

Given recent weakness, the rating is upgraded to Outperform from Neutral. Target is raised to \$4.85 from \$4.75.

**BANK OF QUEENSLAND LIMITED ((BOQ))** Upgrade to Add from Hold by Morgans .B/H/S: 1/3/3

Morgans expects the strong capital position and surplus franking credits will result in special dividends. The broker also believes the bank's interim CET1 ratio target of 9.25% will prove too conservative. This creates potential for capital management initiatives in addition to the forecast for special dividends.

Rating is upgraded to Add from Hold. The broker reduces cash earnings forecasts by -2.0% for FY18 and -4.0% for FY19. A discounted dividend reinvestment plan is now expected to operate over the forecast period. Net interest margin forecasts have also been lowered. Target is \$12.00.

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

Capitol Health ((CAJ)) will not be increasing or extending the takeover bid for Integral Diagnostics and the offer is now expected to lapse. The outcome was increasingly apparent to Ord Minnett given an acrimonious relationship between the companies and some key shareholders.

The broker considers each business positively on a standalone basis. Both are trading at discounts to health care peers, which Ord Minnett considers unjustified given the avenues to growth. Rating is upgraded to Buy from Hold and the target is \$2.39.

**JAMES HARDIE INDUSTRIES N.V. ((JHX)) Upgrade to Outperform from Neutral by Credit Suisse .B/H/S: 4/1/0**

Credit Suisse is more confident in the outlook after reports from the company's customers confirm that US housing and renovation activity is robust. US home builders have reported revenues that are slightly above consensus forecasts amid growing order books.

In the retail channel both Home Depot and Lowes have beat sales estimates. Credit Suisse forecasts FY18 net profit of US\$280m. Rating is upgraded to Outperform from Neutral. Target is \$24.75.

**MONADELPHOUS GROUP LIMITED ((MND)) Upgrade to Neutral from Underperform by Credit Suisse .B/H/S: 1/2/2**

Management remains cautious on the FY19 outlook although Credit Suisse expects a win of at least one of the three large iron ore contracts up for grabs in Western Australia in the first half of that year. A revenue benefit is unlikely until the second half.

Because of the weakness in the shares the broker upgrades to Neutral from Underperform. Target is steady at \$15.10.

**REGIS RESOURCES LIMITED ((RRL)) Upgrade to Outperform from Neutral by Macquarie .B/H/S: 1/2/3**

The company has delivered a maiden inferred underground resource estimate for Rosemont of 1.4mt at 5.1g/t for 230,000 ozs, using a 2.0g/t cut-off grade. This may be only an inferred resource but Macquarie suggests it highlights the options the company has in the Duketon portfolio to extend mine life.

Grades at Rosemont Main are particularly encouraging. Macquarie raises the target to \$5.00 from \$4.60. Rating is upgraded to Outperform from Neutral. The addition of the underground resources in FY20 means estimates for earnings per share lift 26% in that year.

**SOUTH32 LIMITED ((S32)) Upgrade to Neutral from Underperform by Credit Suisse .B/H/S: 0/3/4**

Credit Suisse has increased its price expectations for aluminium, up 7-22% for the period to 2021. Copper forecasts for 2018 have also been upgraded by 17%. Metallurgical coal estimates are up 12% for 2018.

Given the pull back in the shares since January, South32's valuation appears more compelling and the broker upgrades to Neutral from Underperform. Target is steady at \$3.30. Operating performance and corporate activity could also likely be key near-term value drivers.

**SOUTHERN CROSS MEDIA GROUP ((SXL)) Upgrade to Outperform from Neutral by Macquarie .B/H/S: 3/1/2**

The stock has sold off since the February result and improved operating momentum in metro radio and regional TV does not appear to be priced in at current levels.

Macquarie suggests, while one rating survey does not guarantee a successful year, if sustained it represents upside risk to forecasts. Rating is upgraded to Outperform from Neutral. Target is \$1.18.

**SYDNEY AIRPORT HOLDINGS LIMITED ((SYD)) Upgrade to Outperform from Neutral by Macquarie .B/H/S: 6/1/0**

Macquarie has reconsidered the outlook for Sydney Airport, expecting management will maintain growth at least until the Western Sydney Airport opens.

The broker upgrades to Outperform from Neutral and raises the target to \$6.85 from \$6.40. Macquarie considers the stock undervalued versus Auckland International Airport ((AIA)) despite a stronger 2018 international passenger growth outlook.

**WESFARMERS LIMITED ((WES)) Upgrade to Outperform from Neutral by Credit Suisse .B/H/S: 2/5/1**

Credit Suisse makes a relative value call based on upgrade to valuation of Bunnings Australasia and on the probability that the underperformance of Bunnings UK and Ireland will be dealt with in the next six months.

On this basis the broker upgrades to Outperform from Neutral and raises the target to \$44.98 from \$40.65. The broker also believes the market has become too negative on Coles.

#### Downgrade

##### **INGHAMS GROUP LIMITED ((ING)) Downgrade to Neutral from Buy by UBS .B/H/S: 3/3/0**

The stock has outperformed the market by around 12% over the last month, UBS observes. While believing a long-term opportunity exists, the broker downgrades to Neutral from Buy on valuation grounds.

Recent industry feedback suggests pressure in the frozen poultry category share and a re-basing of industry volumes. Cost reductions will help offset these pressures, UBS acknowledges, but risks in the short term are on the downside. Target is \$3.70.

##### **NEWCREST MINING LIMITED ((NCM)) Downgrade to Underperform from Neutral by Macquarie .B/H/S: 2/3/3**

The wall of the tailings dam at Cadia failed last Friday in the wake of minor earthquakes recorded in the area. Newcrest has suspended production at the mine which accounts for around 60% of group earnings. Macquarie is factoring in a six week shutdown but it could be less or more.

The failure is a major concern to Macquarie. Given the production issues arising from an earthquake in April last year, the market will likely discount valuation until some certainty in the outlook can be established. Downgrade to Underperform from Neutral.

Target falls to \$19 from \$23.

##### **OZ MINERALS LIMITED ((OZL)) Downgrade to Underperform from Neutral by Credit Suisse .B/H/S: 2/4/1**

Credit Suisse has increased copper price assumptions, raising the 2018 estimate to US\$3.09/lb and the first half 2019 estimate to US\$2.60/lb. Despite increased earnings and valuation the broker still considers OZ Minerals expensive.

Rating is downgraded to Underperform from Neutral. Target is raised to \$8.55 from \$8.25.

##### **SANDFIRE RESOURCES NL ((SFR)) Downgrade to Underperform from Neutral by Credit Suisse .B/H/S: 1/3/2**

Credit Suisse has increased copper price assumptions, raising the 2018 estimate to US\$3.09/lb and the first half 2019 estimate to US\$2.60/lb. Despite increased earnings and valuation the broker still considers Sandfire Resources expensive.

Rating is downgraded to Underperform from Neutral. Target is raised to \$6.10 from \$5.60.

#### Total Recommendations Recommendation Changes

#### Broker Recommendation Breakup

Broker Rating Order Company New Rating Old Rating Broker Upgrade 1 AURIZON HOLDINGS LIMITED Buy Neutral Credit Suisse 2 BANK OF QUEENSLAND LIMITED Buy Neutral Morgans 3 INTEGRAL DIAGNOSTICS LIMITED Buy Neutral Ord Minnett 4 JAMES HARDIE INDUSTRIES N.V. Buy Neutral Credit Suisse 5 MONADELPHOUS GROUP LIMITED Neutral Sell Credit Suisse 6 REGIS RESOURCES LIMITED Buy Neutral Macquarie 7 SOUTH32 LIMITED Neutral Sell Credit Suisse 8 SOUTHERN CROSS MEDIA GROUP Buy Neutral Macquarie 9 SYDNEY AIRPORT HOLDINGS LIMITED Buy Neutral Macquarie 10 WESFARMERS LIMITED Buy Neutral Credit Suisse Downgrade 11 INGHAMS GROUP LIMITED Neutral Buy UBS 12 NEWCREST MINING LIMITED Sell Neutral Macquarie 13 OZ MINERALS LIMITED Sell Neutral Credit Suisse 14 SANDFIRE RESOURCES NL Sell Neutral Credit Suisse Recommendation Positive Change Covered by > 2 Brokers Order Symbol Company New Rating Previous Rating Change Recs 1 MND MONADELPHOUS GROUP LIMITED -20.0% -40.0% 20.0% 5 2 AWE AWE LIMITED -33.0% -50.0% 17.0% 3 3 VVR VIVA ENERGY REIT 100.0% 83.0% 17.0% 3 4 RRL REGIS RESOURCES LIMITED -33.0% -50.0% 17.0% 6 5 JHX JAMES HARDIE INDUSTRIES N.V. 58.0% 42.0% 16.0% 6 6 SYD SYDNEY AIRPORT HOLDINGS LIMITED 86.0% 71.0% 15.0% 7 7 S32 SOUTH32 LIMITED -57.0% -71.0% 14.0% 7 8 BOQ BANK OF QUEENSLAND LIMITED -31.0% -44.0% 13.0% 8 9 WTC WISETECH GLOBAL LIMITED -25.0% -33.0% 8.0% 4 10 GEM G8 EDUCATION LIMITED 67.0% 60.0% 7.0% 6 Negative Change Covered by > 2 Brokers Order Symbol Company New Rating Previous Rating Change Recs 1 CHC CHARTER HALL GROUP 30.0% 63.0% -33.0% 5 2 ING INGHAMS GROUP LIMITED 50.0% 67.0% -17.0% 6 3 OZL OZ MINERALS LIMITED 14.0% 29.0% -15.0% 7 4 NCM NEWCREST MINING LIMITED -19.0% -6.0% -13.0% 8 5 LLC LEND LEASE CORPORATION LIMITED 50.0% 60.0% -10.0% 5 Target Price Positive Change Covered by > 2 Brokers Order Symbol Company New Target Previous Target Change Recs 1 WTC WISETECH GLOBAL LIMITED 10.628 10.373 2.46% 4 2 NST NORTHERN STAR RESOURCES LTD 5.411 5.317 1.77% 7 3 RRL REGIS RESOURCES LIMITED 3.867 3.800 1.76% 6 4 SYD SYDNEY AIRPORT HOLDINGS LIMITED 7.323 7.259 0.88% 7 5 JHX JAMES HARDIE INDUSTRIES N.V. 24.538 24.393 0.59% 6 6 OZL OZ MINERALS LIMITED 9.879 9.836 0.44% 7 Negative Change Covered by > 2 Brokers Order Symbol Company New Target Previous Target Change Recs 1 CHC CHARTER HALL GROUP 6.202 6.523 -4.92% 5 2 NCM

NEWCREST MINING LIMITED 20.436 21.390 -4.46% 8 3 GEM G8 EDUCATION LIMITED 3.688 3.720 -0.86% 6 Earning Forecast Positive Change Covered by > 2 Brokers Order Symbol Company New EF Previous EF Change Recs 1 AWE AWE LIMITED -1.675 -1.900 11.84% 3 2 OZL OZ MINERALS LIMITED 77.529 75.357 2.88% 7 3 OGC OCEANAGOLD CORPORATION 22.294 21.941 1.61% 5 4 A2M THE A2 MILK COMPANY LIMITED 24.736 24.514 0.91% 6 5 RIO RIO TINTO LIMITED 631.825 626.586 0.84% 8 6 SYD SYDNEY AIRPORT HOLDINGS LIMITED 18.205 18.088 0.65% 7 7 S32 SOUTH32 LIMITED 29.133 28.951 0.63% 7 8 JHX JAMES HARDIE INDUSTRIES N.V. 82.396 82.085 0.38% 6 9 SGR THE STAR ENTERTAINMENT GROUP LIMITED 27.531 27.431 0.36% 8 10 CHC CHARTER HALL GROUP 37.800 37.750 0.13% 5 Negative Change Covered by > 2 Brokers Order Symbol Company New EF Previous EF Change Recs 1 NCM NEWCREST MINING LIMITED 66.949 81.542 -17.90% 8 2 JHC JAPARA HEALTHCARE LIMITED 8.000 8.667 -7.70% 3 3 WTC WISETECH GLOBAL LIMITED 14.403 14.803 -2.70% 4 4 BHP BHP BILLITON LIMITED 208.900 213.247 -2.04% 8 5 NUF NUFARM LIMITED 49.696 50.724 -2.03% 7 6 OSH OIL SEARCH LIMITED 32.828 33.392 -1.69% 8 7 RRL REGIS RESOURCES LIMITED 31.924 32.404 -1.48% 6 8 NST NORTHERN STAR RESOURCES LTD 33.117 33.580 -1.38% 7 9 GEM G8 EDUCATION LIMITED 24.250 24.440 -0.78% 6 10 SIQ SMARTGROUP CORPORATION LTD 60.743 60.910 -0.27% 6 Technical limitations

If you are reading this story through a third party distribution channel and you cannot see charts included, we apologise, but technical limitations are to blame.

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## Uranium Week: Talking It Up

Stasis continues in the global uranium market but Canada is taking steps to encourage investment in nuclear power to save the planet.

-Price disparity ongoing -Canada touts its resources -Another reactor restarts in Japan

By Greg Peel

The world continues to await the Trump Administration's final plan with regard trade tariffs, which would be implemented under section 232 of US law relating to national security.

The uranium market continues to await a decision on whether 232 will also be used to force a domestic uranium purchase quota upon the US nuclear industry.

In the meantime, the price gap between spot uranium delivered in the US and delivered in France blew out again last week. Six transactions were reported by industry consultant TradeTech in the spot market last week totalling 700,000lbs U3O8 equivalent. Four involved delivery in France and two in the US.

Typically any price gap between the two delivery locations reflects a simple balance of transportation costs to either site dependent on where the uranium was sourced. If the gap widens too far, intermediaries can step in and exploit a price versus cost arbitrage. However, the strength of demand currently prevailing in Europe, compared to a distinct lack of demand for product in the US, is pushing out price disparity to as much as US75c/lb.

TradeTech's weekly spot price indicator has fallen -US15c to US\$21.85/lb.

Act Global, Think Local

The Canadian government has announced the country will increase its reliance on nuclear energy in order to reduce carbon emissions, and will encourage other nations to do the same. A government spokesperson said Canada will promote nuclear power at a forum in Denmark to be held in May, seizing the opportunity "place nuclear energy at the centre of global efforts to fight climate change".

Very honourable. We won't mention that Canada is the world's second largest producer of uranium and that the world's largest individual uranium production company -- Canada's Cameco -- has been forced to substantially cut production in the face of wallowing uranium prices.

Then there were six

Kansai Electric's Ohi unit 3 was restarted last week, bringing to six the number of Japanese reactors that have satisfied the stringent safety standards required by the regulator in the wake of the Fukushima disaster, which this month marks its seven-year anniversary.

That's six reactors in seven years out of the more than forty in operation before March 2011.

Fukushima also brought to a halt Tokyo Electric's (TEPCO) construction of the Higashidori plant in north-eastern Japan. Now TEPCO would like to commence discussions with other Japanese utilities about a joint venture to complete and operate the reactor. The plan has the backing of the Japanese government, which became TEPCO's majority shareholders in a post-Fukushima bail-out.

TEPCO began building Higashidori only three months before the tsunami hit, so construction progressed no further than the very early stages. The global uranium market won't hold its breath, given TEPCO hopes to have complied a joint venture plan by 2020.

There were no transactions reported in uranium term markets last week. TradeTech's term price indicators remain at US\$25.75/lb (mid) and US\$29.00/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 March 15, 2018

Last week saw the ASX200 fall from over 6000 to above 5900 on both offshore and domestic issues. As Wall Street fretted about trade policy, White House deck chairs, Russia probes and data breaches, Australia was up in arms over Labor's plans to scrap franking cash-backs.

The index has nevertheless entered a period of aimless wandering, without any strong catalysts in either direction. This is reflected in the fact the shorters have gone quiet. Movements below reflect little more than minor bracket creep.

One exception is Retail Food Group ((RFG)), which has continued in a downward trajectory in the wake of franchisee revelations and the planned closure of a couple of hundred of its various stores. RFG shorts fell to 11.2% from 12.9% last week, suggesting some profit-taking.

Another retailer struggling against the tide is Myer ((MYR)), but here the shorters appear happy to hang around a bit longer. Myer shorts ticked up again last week to 10.3% from 9.8%.

Otherwise we might note that while nickel miner Independence Group ((IGO)) retains its place near the top of the most shorted table, peer Western Areas ((WSA)), which at one point sat right up there as well, last week dropped off the 5% plus table altogether.

Hence when once we might have considered the big shorts in both stocks to be a play against the nickel price, now it looks more like playing one miner off against the other.

That's about all for this week. No **Movers & Shakers**.

Weekly short positions as a percentage of market cap:

10%+

SYR 21.3 DMP 17.3 JBH 16.0 IGO 16.0 GXY 14.2 HSO 13.5 HT1 11.6 VOC 11.5 FLT 11.3 RFG 11.2 MYX 10.8 MYR 10.3

In: MYR

9.0-9.9

AAC, GXL, APO, AAD Out: MYR, GXL, AAD

8.0-8.9%

NWS, AAD, BWX, HVN, ORE, NAN, PLS, GXL, TGR

In: AAD, GXL Out: MTS

7.0-7.9%

MTS, BAP, GMA, APT

In: MTS, GMA, APT

6.0-6.9%

BEN, TPM, QUB, KAR, IVC

In: IVC Out: APT, GMA, SHV

5.0-5.9%

JHC, CSR, SEK, SUL, MLX, BGA, NSR, AHG, SHV, WEB, IFL, CCP, RIO, RSG, GEM, WOW, GTY

In: SHV, RSG, GEM Out: IVC, ING, ABC, WSA

Movers & Shakers

See above.

ASX20 Short Positions (%)

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: Retail, Waste, Telcos And Gas

Weekly Broker Wrap: retail; waste management; telcos; east coast gas; and Elixinol Global.

-Retail space grows ahead of population while luxury goods appear insulated from retail woes -Queensland plans to re-introduce a waste levy to combat waste transfer from NSW -UBS puts some concerns regarding mobiles and NBN under scrutiny -Can east coast gas demand be met without imports?

By Eva Brocklehurst

### Retail

Growth in the Australian retail space is expected to continue ahead of population growth, Citi suggests. While supermarkets are the best placed in this situation, furniture retailers are worst placed and need to deal with large increases in available space over the next 18 months. Analysis points to the 40 Home Co sites that will be looking to secure tenants over the next two years.

The research reinforces the broker's Buy rating for Woolworths ((WOW)) and Sell rating for Harvey Norman ((HVN)). The most challenged area has been large format retail stores where space growth historically is very high relative to sales growth. The analysts note most mature retailers have revised down store roll-out numbers.

Planned shopping centre developments signal space growth is near 2% but higher growth in online retailing and weaker demand means like-for-like sales growth for bricks and mortar retailers is closer to 1.5%. Citi observes a challenge for retailers in making online sales incremental without diluted margins.

Meanwhile, luxury retailing has grown at a rapid pace over the past five years despite the majority of retailers suffering from rising competition in online-only traders and weak consumer sentiment. It seems luxury retailing is relatively insulated, in that growth has largely been driven by inbound tourism in Australia, particularly Asian tourists.

IBISWorld analysts suggest changes in marketing techniques by many luxury houses have also contributed to revenue growth, as companies concentrate on becoming a one-stop shop for consumers and providing a special shopping experience.

Chinese visitors to Australia are estimated to have the largest tourism expenditure of any international market and the inbound market is traditionally drawn to heritage luxury labels and large flagship stores rather than niche brands.

### Waste Management

Queensland's government intends to re-introduce a landfill levy after abolishing it in 2012, indicating the levy would be at least \$35/t. The levy has been driven by mounting pressure to reduce the amount of waste Queensland receives from NSW.

NSW has been steadily increasing its landfill levies and the price differential with Queensland has increased to \$136/t, assisting the economics of cross-border transporting of waste. Ord Minnett suspects a mechanism may be put in place whereby some levies are rebated back to Queensland councils and businesses.

While the Cleanaway Waste Management ((CWY)) facility near the Queensland border has been a beneficiary of the interstate trade, the broker does not expect a Queensland levy will have a material impact on earnings.

Additionally, on the basis of the potential acquisition of Toxfree Solutions ((TOX)), Cleanaway's exposure to the NSW/Queensland transfer of waste could be diluted further, although the Toxfree Wanless business in south-east Queensland has likely been a net beneficiary of cheap disposal costs.

Bingo Industries ((BIN)) believes a reintroduced levy would be positive, as its recycling activities would benefit from increased volumes. Ord Minnett suggests a lack of unity among state-based environmental regulators is one of the major issues for waste management and harmonisation of regulation across the country would benefit national, vertically integrated operators.

### Telcos

UBS suggests the market could be overestimating the pace of mobile decline at Telstra ((TLS)). While, at face value, post-paid average revenue per unit (ARPU) fell -4% in the first half, almost half of the fall related to revenue reversal. Underlying post-paid ARPU only fell -1-2%. Declines are therefore expected to moderate in the second half.

Another assumption, the broker discounts, is that NBN economics are declining for both Vocus Group ((VOC)) and TPG Telecom ((TPM)). For Vocus, and potentially TPG, promotional NBN pricing is driving migration to 50mbps plans where the ARPU is around \$10 or more higher and costs only marginally so. The broker acknowledges the NBN under its current guise still offers limited profitability for fixed providers over the long-term.

UBS analyses core costs for Telstra, too, and suggests there is more to come in the fixed and mobile bases. The bulk of first half cost reductions came from the mobile business, the broker notes.

Telstra may never match the overhead costs per subscriber metrics of its value-lead peers but UBS suspects it may not need to as even assuming implied fixed overheads per subscriber are roughly double that of value-lead peers, Telstra should still achieve its \$1.5bn net productivity program.

#### East Coast Gas

With the announcement of a proposed LNG import terminal in NSW, Credit Suisse looks at the current supply outlook on the east coast gas market. In assessing the market, without LNG imports, the broker canvases a range of potential outcomes, not many of which are good and, on a 3-5 year view, struggles with the concept that new supply can fix the shortage that will continue to grow.

With LNG projects making volumes available locally and scrutiny on wholesale suppliers, prices have dropped to below \$15/GJ in most cases from around \$20/GJ seen at times in 2017. What has not changed is the tenure of contracts being offered and the broker notes these are still one-year terms.

Credit Suisse also questions the huge proportion of CSG reserves that are in lower quality areas, as fields start to be drilled out. The broker acknowledges that CSG projects do not know what well productivity will look like a year so ahead, making it hard to predict the supply picture.

In terms of equity markets, the broker suggests there are relatively few direct beneficiaries that have meaningful leverage to the east coast gas price. The purest plays include Senex Energy ((SXY)) and Beach Energy ((BPT)), while Santos ((STO)) has potential but requires both organic reserve additions or acquisitions.

For APA Group ((APA)) the broker believes there is potentially negative consequences from imports circumventing the need for its pipelines.

#### Elixinol Global

Elixinol Global ((EXL)) operates in the industrial hemp and emerging medical cannabis sectors with three business units in Australia and the US. The category is currently experiencing strong revenue growth following recent regulatory changes to legalise the cultivation of hemp in the US, amid a growing acceptance of the clinical benefit from the products in controlling symptoms of numerous chronic medical conditions.

Bell Potter notes, while Elixinol Australia is yet to commence operations, the legal framework is now established for the medicinal cannabis industry in this country. Following IPO, chief executive Paul Benhaim retains 53% of the listed entity. Bell Potter commences coverage with a Buy rating and \$2.12 valuation.

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## Gateway Pays Up For Expansion

Gateway Lifestyle has ventured into the South Australian market, acquiring two established estates central to its long-term strategy to grow rental income.

-Brokers suggest full price paid for the sites -Acquisition should improve overall asset quality -Further asset recycling expected

By Eva Brocklehurst

Gateway Lifestyle ((GTY)), a provider of retirement communities, has acquired two established manufactured home estates (MHE) for \$45m, to be funded by debt as well as the issue of \$3m in shares to the vendors.

The location is in South Australia and the company's rationale is to improve its overall portfolio quality, expanding from its core east coast location. Settlement is late in FY18 and the company expects no material impact on earnings in FY18.

In aggregate the sites have 555 long-term lots, of which 488 are occupied and 67 are approved development lots. Development sales remain active.

CLSA acknowledges the company is providing a platform for further growth, which is consistent with a long-term strategy to grow rental income. Yet, the broker believes the company has paid a full price for a new market, with an implied price of \$81,000 per lot.

CLSA estimates an initial and stabilised yield of 5.8% and 7.0% respectively. The broker forecasts FY19 accretion of 1.4% and maintains an Outperform rating and \$2.24 target on the stock.

In theory, Shaw and Partners, which maintains a Hold rating and \$2.21 target, expects the transaction will be accretive to earnings in FY19, given the yield spread over the company's 3.9% cost of debt. Yet, management has plans for further asset sales so the broker does not assume there will be a meaningful upgrade to the FY19 outlook.

### Asset Recycling

UBS agrees further asset recycling may offset the earnings benefit, although the acquisition should improve overall asset quality. The broker has a Buy rating and \$2.30 target. Gearing is expected to remain within the target range of 25-35%.

Based on a rental rate in line with the company's average, as details are not been provided, UBS estimates incremental rental income of \$3.7m from the asset.

The broker considers the price paid is full, assuming \$50,000 per vacant lot and a 70% operating margin that implies a cap rate around 6.3% on the operating assets. UBS also expects these assets will be able to achieve rental growth of 3-5% per annum.

On a built-out basis, which converts the development sites to rent paying sites, Macquarie suggests the cap rate improves to 6.55%. The broker notes this is below the 7-7.5% rate of the current mature portfolio, which reflects a combination of several factors such as tight pricing in direct markets, conservatism in the stock's valuation and the better attributes of these sites versus average assets.

The broker agrees the transaction is further evidence of the company's intention to acquire either mature sites or development sites, as opposed to converting sites, noting in February the company divested two non-core conversion assets for \$18m and acquired a greenfield site for around \$38,000 per lot.

Macquarie does not factor this transaction into forecasts, anticipating further non-core asset sales that will limit accretion and maintains a Outperform rating and \$2.14 target.

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## What Chance Of A Big Correction?

In this week's Weekly Insights (published in one single edition this week):

-What Chance Of A Big Correction? -No Weekly Insights Next Two Weeks -Conviction Calls -An Evening With Rudi - Sold Out -Finance Ruled By Self-Interest & Bias

What Chances Of A Big Correction?

By Rudi Filapek-Vandyck, Editor FNArena

Two things happened last week. I had quite an elaborate telephone conversation with a worried investor, let's call her K, after she'd read about a prediction that global equities might be poised for a -43% sell-down, and she since felt very uncomfortable with having her money in the share market.

Then another subscriber, Martin, who's a professional working in the local finance industry, sent me a message in which he confided to be "very confused".

The world economy is growing, Martin observed, with the USA a standout. More people are working, less tax is being paid by corporations in the USA, and some of the tax savings will flow into workers pay. The majority of companies in the USA and locally have been reporting improving returns. Interest rates are rising, but only gently, Central Banks are easing QE while inflation seems under control. Et cetera

Yet market commentators continue to predict a major correction to equities in 2018.

Martin asks: Why does improving economic conditions equal a correction? Is this more about the length of time that the bull run has been going that makes all these voices say it can't go on forever? Your truly a confused Martin.

Both events combined have inspired me to write the response below.

\*\*\*\*

The share market is, above anything else, a mix of conflicting emotions, in particular when assessed on a short term scale. Sometimes even a hint of potential risk on the horizon can set off a stampede of money fleeing onto the sidelines, as has happened on many an occasion, but that's simply the emotional side that makes anything involving human sentiment transitory and unstable by definition.

For temporary share market weakness to morph into something much more sinister we need a lot more ammunition than simply human emotion. There needs to be a genuine prospect of economies facing a recession, or for corporate profits to wither, or for a military conflict to break out, or something of equally severe negative impact.

The global economy is experiencing a rare synchronised move upwards with all major economic regions improving, for the first time since pre-GFC, supporting global GDP at a level not seen for a long while. This is reflected in corporate profits and margins which, around the world, are in the healthiest shape for a long while. But asset prices are far from cheap, while the era of exceptional, abundant liquidity is coming to a close.

Already, the Federal Reserve is reducing its balance sheet and lifting the official cash rate with other central banks expected to follow.

Arguably, risks have been rising all throughout 2017, but sometimes investors simply don't want to pay attention. I think it was the prospect of the corporate tax cut in the USA that outweighed just about everything else. Now that those tax cuts are in place, and we all come to the conclusion that any infrastructure program will be long-winded and medium-term at best, while geopolitical tensions are rising, as well as political risk inside and outside the White House, we are left with many reasons to feel less confident about the outlook, and maybe pay more attention to potential booby traps.

Many a share market commentator tends to refer to healthy economies when asked about the direction of share markets, but history shows there is not a strong relationship between the two. One reason as to why is because financial markets try to look forward, into the future. So it matters a lot less about what is now, or even tomorrow, and a lot more about what we, collectively, think/hope/fear might be on the horizon.

Back in early 2008 global markets were selling off and Goldman Sachs came out with the bold prediction the US economy was descending into recession. At that time, global growth seemed solid, corporate margins and profits were on a high, but three quarters down the track Lehman Bros folded and the US and the global economy were staring into the abyss.

This time around the Federal Reserve is intent on removing the excess policy stimulus that has supported financial markets post-GFC, and a lot has changed since the last tightening cycle. From demographics to technology, from ultra-low interest rates for an extended period of time to populist, strong-man politics overpowering democracy, and so many new elements in between. Typically, equity investors are not used to having to spend a lot of time wondering what global bond yields might do, and what the potential implications might be, and they feel uncomfortable about it.

Look no further than the many predictions that inflation is about to break-out; that bond yields are on their way to 4% (from below 2.9% now); that elevated asset prices will de-rate (if not deflate); that gold is back as a safe haven, together with cash; that government bonds are now in a bear market and the only way forward is down in price, and up in yield; that the technical picture is deteriorating for equity markets; that the sell-off in crypto currencies is a harbinger of what is about to happen to other risk assets; we have yet to see the global debt bubble burst, et cetera, et cetera.

Two certainties we have, apart from the usual ones about death and taxes: most of these predictions will be proven wrong. This, however, won't prevent investors to be less sanguine about the outlook this year because even the most ardent bull will have to acknowledge that, overall, risk is on the rise.

Asset prices are not cheap. But we need a major change in the landscape to pull equity markets down by -20% or more. What can it be?

The biggest fear among investors is that inflation is making a come-back and thus more central bank tightening will be necessary; this pushes up bond yields, creating ever stronger headwinds for equity valuations. It also brings forward the idea that at some point the Fed Funds rate will reach its neutral level, meaning the next hike will be the one step too far.

History shows us central bankers always move one step too far. Firstly because monetary policy works at great delay, it's not an exact day-to-day framework with immediate impact. Secondly, economies are fluid. All we know today is the neutral rate setting is a lot below what it used to be. But we don't know exactly what it means, neither where exactly the new neutral is located.

It cannot be denied inflation in the USA is rising and bond yields have risen in response. But equally important: this does not imply the next step is a break-out with the Federal Reserve scrambling to stay in control. The best description I have come across, and I believe it's from economists at Citi, is that financial markets have been pricing out the death of inflation.

Previously, financial markets were focused on deflation, with central bankers putting in their might to retain some sort of price inflation into the global system. Financial markets have now accepted that inflation is not completely dead and buried. This is all that has changed over the past six months or so.

It doesn't mean one-way traffic for bonds. It doesn't mean inflation is about to explode. It doesn't mean, by default, equity markets are poised for a big correction. There is a lot more impacting on and inside today's economies to make the present sufficiently different from the past. But fear is an important driver, it can be all-consuming under the wrong circumstances and with so many market participants unsure about what exactly is the trajectory of inflation in the US, nobody should be surprised market volatility has made a come-back with a vengeance.

My view is too many commentators and experts too eagerly predict inflation will only move higher from here. Note global bond markets are not reflecting any such scenarios. This even to the dismay of central bankers like RBA Deputy Governor Guy Debelle who likes to think the battle against deflation has been won, and bond markets should be more reflective of potential upside risk.

Bond markets can be wrong, just like equities. A popular saying is that bonds have successfully predicted the last few recessions more than 15 times. They might be proven wrong tomorrow. After all, it wasn't that long ago economists in Australia were tripping over each other to predict the next RBA rate hike and local bonds were reflecting just that.

Those same economists have gone eerily quiet. Forecasts about Melbourne Cup day 2017 rate hikes, or February-May 2018, have proved to be unquestionably wrong. Most forecasts are shifting into 2019, sometimes into late 2019. In financial markets, just like in daily life, the speed and timing of events is of crucial importance. Australian bonds today are suggesting the RBA is in no hurry, with plenty of time on its hands, and no disaster scenarios, like a return to the high yielding eighties, should be on the agenda.

Equally important, the opposite scenario remains just as valid. There is an argument to be made global economic momentum peaked late in 2017, and there's now an underlying shift towards a decelerating pace. Look no further than, for instance, to the recent changes in predictions for Q1 GDP growth in the USA by the Atlanta Fed.

Between last week and February 1st, that forecast for Q1 USA GDP has declined to 1.9% from 5.4%. This is a widely followed economic indicator by many a professional investor.

Under a not so favourable scenario, global growth is now decelerating, also because China is putting more focus on quality. Were this slowing to extend, and to become front of mind for investors, while the Federal Reserve staunchly sticks to its tightening agenda, one can see how this combination can easily unsettle investors nerves.

Maybe today's bond market is balancing out the probabilities between these two opposing outlooks?

Finally, the world is swimming in debt and we now have a President in the White House who is likely to increase government debt and future liabilities even further. Plenty of worrisome analyses around also about what potentially can go wrong with highly indebted consumers in countries like Australia and Canada. Analysts at Deutsche Bank recently published a study into zombie companies. These are companies which cannot service its debt and only continue to operate with government support, and for as long as interest rates stay low.

After so many years of ultra-low interest rates, cheap money if you like, there is bound to be some unknown, hidden vulnerability inside the global financial system. Very few were aware in early 2008 there was excess in subprime loans and related derivatives originating from a fraudulent Wall Street, yet once the system tightened, weaknesses simply opened up more weaknesses.

It would be quite naive to think this time the transition will be nothing short of smooth. In this context, anti-volatility investment products blowing up in late January might as well serve as a canary in the coal mine. As the economic cycle matures and global liquidity tightens, there will be more of such sudden hiccups. That's almost a guarantee.

Yet, none of all this means equities cannot possibly climb the wall of worry for another year, though I am quietly confident 2018 won't be a repeat of 2016, nor of 2017. The best we can do is accept that risk is on the rise, and so will be market volatility and uncertainty.

It remains far too early to predict which of the scenarios will gain the upper hand in the months ahead. It may yet turn out the answer is: none of the above. That wouldn't be the first time either.

### No Weekly Insights Next Two Weeks

Due to travel arrangements, there won't be a Weekly Insights next week. The following week turns Monday into a public holiday due to Easter, hence Weekly Insights shall resume in three weeks, on Monday April 9th.

It is my intention to write a Rudi's View in early April to break this rather long interruption.

### Conviction Calls

Citi's US equities strategist Tobias Levkovich has put forward the idea that while the S&P500 might not necessarily have peaked for this cycle already, it's going to be tougher nevertheless for equity investors to avoid "performance frustration".

The strategist's suggestion is that sector rotation and shorter term trading strategies will be the panacea that heals all ills at a time when US equities can potentially throw up a lot more volatility for the remainder of 2018, though not necessarily also with a lot of gains to compensate for it.

In Australia, Morgans continues to provide its army of stockbrokers with plenty of ideas to keep the clientele happy. Morgans has selected three standouts which it believes offer exceptional value with share prices thought to be too cheap in the order of -20-25%. These three are (don't laugh) Telstra ((TLS)), Macquarie Atlas Roads ((MQA)) and Australian Finance Group ((AFG)).

Actually, Morgans refers to AFG Group but there is no such company listed on the ASX, and yes, we did check with both the ASX website as well as afgonline.com.au

The three standouts are part of the stockbroker selecting Key Buys post the February reporting season, further including: Sydney Airport ((SYD)), BHP ((BHP)), Kina Securities ((KSL)), Orora ((ORA)), CML Group ((CGR)), Wagners Holdings ((WGN)), Motorcycle Holdings ((MTO)), Noni B ((NBL)), PWR Holdings ((PWR)), Aventus Retail Property ((AVN)), Webjet ((WEB)), Lindsay Australia ((LAU)) and Emeco Holdings ((EHL)).

Morgans also selected Key Sells, motivated as companies having reported underwhelming results and where the stockbroker sees better opportunities elsewhere: Woolworths ((WOW)), QBE Insurance ((QBE)), Brambles ((BXB)),

Santos ((STO)), Blackmores ((BKL)), Accent Group ((AX1)), Monash IVF ((MVF)), Virtus Health ((VRT)), National Storage REIT ((NSR)), Bega Cheese ((BGA)), Infigen Energy ((IFN)), and Range International ((RAN)).

### An Evening With Rudi - Sold Out

No use in sending in any more inquiries, next month's An Evening With Rudi in Paddington has sold out. This has become quite the popular event. FNArena didn't have to address the full database to get all bums on seats.

We might inquire with a number of investors in the FNArena database to see whether there is sufficient interest elsewhere to possibly take this initiative beyond the boundaries of Sydney's eastern suburbs, but amidst tight schedules and plenty of things on my personal To Do list, this is one promise I simply cannot make.

But I'll try.

### Finance Ruled By Self-Interest & Bias

Even the Romans knew it: if you lay down with dogs, you are likely to get up with fleas.

In the Australian financial sector this means it is extremely difficult to find intelligent, reasoned opinion that is not tied by vested interests. Cue the ALP's proposal to scrap the cash back component of the dividend imputation policy introduced by the Howard government in 2000, which has since become an integral part of the survival tactics employed by many a struggling retiree.

What is not on the agenda is that the Australian tax system should be updated, renewed and structurally reformed as many of current benefits and payouts, including the ATO's cash payback, are unlikely to remain sustainable longer term.

What is never touched upon, amid the loud and biased pamphlets and protests, is that generous and skewed tax benefits have lured retiree investors into sub-optimal investment strategies, effectively tying them up with ball and chain into capital loss generators such as Telstra in the share market, just like they once upon a time got caught up in dud investments in the agricultural sector, which were also supported and motivated by tax benefits.

The tax man should never engage in financial advice, but that's essentially what such unsustainable benefits amount to.

Anyone looking for a dividend oriented strategy today should take on board the knowledge that yield plus growth is, has been, and shall remain the superior investment strategy in the share market, but not one without the other. This has been a constant returning statement in my own analysis and observations stretching over many years, and there is plenty of third party research supporting the same conclusion.

I hereby submit evidence exhibit A from the recent investor presentations given by Janus Henderson. All one needs to know is both performance lines on the chart below show global equities and higher dividend global equities backed by growth. The latter (in red) wins the race hands down, even after falling substantially more during the GFC.

The same observation also stretches to a general consensus throughout the Australian financial sector, including journalists, throughout 2017 that a Royal Commission into the banking sector was an utter waste of taxpayer's money. What more could it possibly dig up than what was already public knowledge?

Well, this year, the Royal Commission has only just started and already it is clear the sector smells on many accounts. Once this Royal Commission releases its final findings it is but likely the sector will be covered in shame and the government and regulators forced to put in practice a much more stringent regime for the sector.

Consumers will be better off, one presumes, but for shareholders low expectations and being prepared for a lot more disappointment seems but the logical thing to do at this stage.

### Rudi Talks

Last week's audio interview on changed dynamics for the Australian share market:

<https://boardroom.media/broadcast/?eid=5aa73eb1271b41638bdc6e3b>

### Rudi On TV

This week my appearances on the Sky Business channel are scheduled as follows:

-Tuesday, 11.15am Skype-link to discuss broker calls -Thursday, noon-2pm -Friday, 11am Skype-link to discuss broker calls

## Rudi On Tour

-An Evening With Rudi, Paddington, 11 April (sold out) -Presentations to ASA members and guests Gold Coast and Brisbane (2x), on 12 & 13 June -ATAA members presentation Newcastle, 14 July -AIA National Conference, Gold Coast QLD, late June-August 1 -Presentation to ASA members and guests Wollongong, in September

(This story was written on Monday 19th March and it was published on the day in the form of an email to paying subscribers at FNArena, 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: [info@fnarena.com](mailto:info@fnarena.com) or via the direct messaging system on the website).

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- The AUD and the Australian Share Market (which stocks benefit from a weaker AUD, and which ones don't?) - Make Risk Your Friend. Finding All-Weather Performers, January 2013 (The rationale behind investing in stocks that perform irrespective of the overall investment climate) - Make Risk Your Friend. Finding All-Weather Performers, December 2014 (The follow-up that accounts for an ever changing world and updated stock selection) - Change. Investing in a Low Growth World. eBook that sells through Amazon and other channels. Tackles the main issues impacting on investment strategies today and the world of tomorrow. - Who's Afraid Of The Big Bad Bear? eBook and Book (print) available through Amazon and other channels. Your chance to relive 2016, and become a wiser investor along the way.

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

P.S. II - If you are reading this story through a third party distribution channel and you cannot see charts included, we apologise, but technical limitations are to blame.

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