Week
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Stories To Read From FNArena

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Why US Indices Could Be At Their Peak

By Kathleen Brooks, Research Director, Capital Index

The Fed may have raised its GDP projection for 2018, however, bad omens for US growth are starting to mount. The Markit PMI report for September saw a steep decline in the composite index, which fell to its lowest level since June 2017. As you can see in chart 1 below, the Markit PMI index has a strong positive correlation with US GDP. Thus, the decline in the PMI survey does not bode well for US growth.

The Fed's upward revision to the 2018 full year GDP report points to a sharp slowdown in growth in Q4, to the tune of 1.3%. Thus, investors should get ready for a slowdown in the US economy.

As you can see in chart 2, GDP matters for the performance of US stocks. Chart 2 shows the S&P 500 and year on year US GDP. The chart has been normalised to show how they move together. As you can see, US GDP and the S&P 500 tend to move in the same direction. As US GDP has jumped to some of the highest levels in the developed world in recent quarters, the S&P 500 has reached record highs. Likewise, as GDP dips it tends to lead to a period of weakness for the S&P 500. If this relationship holds, as we expect it to, then as GDP moderates the S&P 500 could come under pressure.

We could see the S&P 500 struggle as early as next week when we get the start-of-the-month data dump, including official PMI data and US payrolls. If this shows a moderation in US growth, then US stock performance could be at risk.

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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.

Property, Investments Underpin Brickworks

Market fundamentals remain strong for Brickworks but tighter credit has emerged to dent the housing outlook, particularly in NSW and Queensland.

-Fundamentals still supportive of new housing construction over the longer term -Relying on property and investments to cushion the housing downturn -Property development in FY19 centred on Oakdale South

By Eva Brocklehurst

Brickworks ((BKW)) is battling higher energy costs in its building products segment while property profits continue to exceed expectations. Strong contributions from investments as well as property drove a better than expected FY18 result, albeit buoyed by property sales. Building products benefited from demand on the east coast which was offset by a decline in sales in Western Australia.

Morgans notes an increased dividend continues the company's track record of raising dividends over the longer term. The balance sheet is robust, with gearing at 14.7%. Operating cash flow was up 48% in FY18 from increased earnings, distributions from the property trust and lower tax.

Energy costs are taking some of the cream off the top of building products while the housing market is becoming more challenging. Order books remain solid and east coast conditions are still supportive. Fundamentals such as population growth remain positive for new housing construction over the longer term but brokers note tighter credit conditions have resulted in patchy sales of late, despite a strong order book on the east coast.

Margin pressures from energy costs are building. Macquarie expects the initial guidance for a $20m step up in annual energy costs will be realised. Gas price increases will take effect in January and are expected to have a "significant adverse impact" on earnings, the company acknowledges.

Morgans notes the company's performance in WA has improved on the back of a range of restructuring initiatives. Furthermore, Brickworks has recently secured a new five-year wholesale gas agreement with Santos ((STO)), to start January 1, 2020. This flexible supply is a positive, the broker suggests, as contracted price increases taking affect from January 1, 2019 will have a significant adverse impact.

Meanwhile, Austral Bricks continues to emphasise margin growth through the sale of premium products and Brickworks is continuing to build in the Sydney CBD, with two projects on the drawing board. The cement import terminal is on track and expected to be in full production late in FY19. The next area of focus for further upgrades in NSW is Austral Bricks' Horsley Park plant.

Citi agrees that with FY18 marking the peak in the current housing cycle, the company will be relying on property and investments to cushion the downturn. Tighter bank lending has affected building activity, with the broker noting delays and cancellations and some projects. Brickworks first noticed this in August and envisages housing to fall -10% per annum over the next two years.

Bell Potter also observes conditions continue to vary across the states. The broker increases forecasts for property and investments while maintaining building product earnings estimates. The net result is upgrades of 20.4% and 13.2% for FY19 and FY20 respectively.

Investments

Investment earnings were up 20% and more earnings growth is expected, as thermal coal prices remain high and New Hope Corp ((NHC)) will purchase a further 40% of the Bengalla JV, taking its stake to 80% and boosting coal production across the next two years. Meanwhile, the market value of Brickwork's stake in Soul Pattinson grew to $2.2bn. Soul Pattinson is New Hope's largest shareholder, while Soul Pattinson and Brickworks have cross-shareholdings.

WH Soul Pattinson ((SOL)) now accounts for a large portion of Brickwork's value and, together with the asset base of the property trusts, brokers believe it should provide downside protection to valuations in the event of a housing downturn.

Reflecting on this emphasis, Bell Potter suggests a material decline in the Soul Pattinson share price is the biggest downside risk to the Brickworks valuation. The broker, not one of the eight stockbrokers monitored daily on the FNArena database, retains a Hold rating with a target of $16.

Morgans agrees the pressures on building products should be mitigated by the cross-holding in Soul Pattinson and increased activity in property, yet considers the stock fully valued. Citi also points to the TPG Telecom ((TPM)) merger with Vodafone Australia ((HTA)) as underpinning the company's investments.

Property

In property, development will be centred on Oakdale South (NSW), as three assets are completed during FY19. Property in FY18 was supported by profits from the completion of developments at Rochedale (QLD) and Oakdale Central amid a significant uplift in value following completion of infrastructure works. Property trust distributions increased by 20% while trust assets were up by 9%.

The sale of the Punchbowl (NSW) site along with strong development activity in the trust should support earnings. Significant development activity in the trusts produced strong redevelopment profits in FY18 and brokers expect another strong year as rental income rises. Bell Potter suggests the industrial property trust remains the undervalued part of the business and should deliver solid profits over the next 10 years.

FNArena's database shows four Hold ratings for Brickworks. The consensus target is $15.95, signalling -1.4% downside to the last share price.

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Confidence In Sims Metal Takes A Hit

Confidence in Sims Metal has taken a hit, brokers suggest, after the company downgraded guidance for first quarter earnings less than a month after reiterating it at investor briefings.

-Downgrade attributed to challenges for low-grade Zorba sales -Adds to volatility and uncertainty inherent in the scrap business -Turkey remains a key risk, being the company's largest scrap export market

By Eva Brocklehurst

Sims Metal Management ((SGM)) has sustained a deterioration in output and sales at its US-domiciled Sims Adams Recycling joint venture, causing a downgrade to first quarter earnings estimates. Based on current market conditions, management now expects underlying operating earnings (EBIT) of $58-63m in the first quarter versus guidance of around $76m previously, the drop wholly attributed to the JV earnings.

UBS believes the market set its expectations for FY19 earnings by simply annualising the September quarter guidance, and believes this simple modelling will continue for now because of the challenges facing scrap markets.The broker has low confidence in forecasts and reduces FY19 estimates for earnings by -17%.

Ord Minnett finds the announcement impinges on management's credibility, as guidance was only provided in the past month. In terms of overall quantity, the company has reported growth of 35% over the same period last year, despite a deterioration in the Turkish economy and US tariffs on Turkish steel.

The broker assumes the issues at the Sims Adams operations persist into the second quarter before being addressed through the installation of cleaning facilities. Heavy investment by Sims Metal in upgrading its own plants over recent years appears not to have extended to the JV.

Macquarie believes visibility may have been more opaque than management previously acknowledged but, all up, considers this downgrade more than discounted in the current valuation. Credit Suisse, nevertheless, finds the magnitude of the first quarter earnings slump hard to accept although acknowledges, as the 100%-owned and managed operations are unchanged, the issue is specific to the joint venture.

This could relate to the different geographic locations of the Sims Metal operations versus the JV, and a steep deterioration in Zorba [mixed non-ferrous scrap] material pricing. Based on the fall in the share price Credit Suisse upgrades to Outperform from Neutral.

The broker is most surprised that management was able to foresee a looming crisis in accepting low-quality Zorba material two years ago and implement technology upgrades across its US operations but not at (albeit not managed by Sims Metal) Sims Adams Recycling. Sims Metal is responsible for handling and selling the export volumes from the JV so knowledge of these challenges should have been well communicated and an abatement strategy implemented, the broker contends.

The issue demonstrates, again, brokers believe, that there is very limited visibility over volumes and earnings in the scrap business. Credit Suisse also points out, if guidance has a short shelf life, then modelling and forecasts are largely guesswork, heavily affected by global scrap prices, steel prices and non-ferrous prices as well as economic activity.

Zorba And Twitch

UBS notes Zorba and Twitch prices into the US midwest have been falling, affected by reduced Zorba demand from China and a re-allocation of supply from China to Southeast Asia. There is also low demand from US consumers of Twitch, affected by the large inventory positions held by these consumers.

Zorba non-ferrous processing specifications provide a grade that is not uniform and generally not ready for smelters. The destination for Zorba is usually further processing facilities, while Twitch involves a separation and upgrade on Zorba.

Sims Metal has advised that improvements to the Zorba processing have commenced at the Sims Adams JV and will be completed by December. If improving the Zorba quality entails expenditure of just $5-10m, then UBS asserts this is not a large sum of money for processors if it secures customers that have increasingly high product standards.

Credit Suisse agrees as, given this technological challenge can be overcome within three months, it undermines a strategic advantage the company has articulated regarding its capacity to undertake upgrades that others cannot afford.

Turkey

Meanwhile, the equity market has been concerned about the risk to the company's largest scrap export market, Turkey, and whether Sims Metal may need to find alternative markets for its US east coast production.

Ord Minnett notes tariff issues in Turkey do not appear to be having a negative impact on Sims Metal as yet and this is a key positive. The broker finds the stock cheap, although acknowledges sentiment around the company is overwhelmingly bearish.

FNArena's database shows three Buy ratings and three Hold. The consensus target is $14.48, signalling 22.5% upside to the last share price. Targets range from $12.50 (UBS) to $16.60 (Macquarie).

Where Are The Benefits Of Telco Mergers?

Where do the benefits of large-scale mergers in the telecommunications sector lie? The eventual outcome may not be as it appears at first glance.

-Incumbent carriers stand to benefit the most from consolidation -Consolidation of the mobile business in the UK did not lessen competitive intensity -Telstra will need to work hard to retain market share in mobile

By Eva Brocklehurst

Competition is unrelenting among telecommunications companies and the proposed merger of TPG Telecom ((TPM)) and Vodafone Australia ((HTA) is raising speculation as to which of the major players will be a winner in the longer term.

The Australian Competition and Consumer Commission (ACCC) will announce its decision regarding the merger of the two on December 13 and, on balance, most brokers expect the merger to be accepted. UBS envisages less regulatory risk if the ACCC narrowly defines the market in which the two operate as mobile, and greater risk if it is defined as converged, or fixed-mobile.

On a pro forma FY18 basis, the combined group is forecast to generate revenue of $6.1bn, operating earnings (EBITDA), pre-synergies of $1.8bn, and free cash flow, excluding spectrum purchases, of $900m. Synergies, particularly on costs, could be substantial, and Morgans estimates these in the region of $500m.

TPG Telecom and Vodafone Australia are expected to argue that the merger creates a robust third player that will compete with Telstra ((TLS)) and Optus and there are strong incentives to compete on price. UBS suggests undertakings may also be a solution to any ACCC concerns.

Research at JP Morgan concludes that incumbent carriers stand to benefit the most from consolidation, with an uptick in average revenue per user across the industry and incumbent share prices generally higher post the consolidation. Conversely, the benefits to the merger participants appear underwhelming, with market share losses and elevated expectations creating subsequent pressure on the shares.

The broker has studied the aftermath of five mobile-mobile and fixed-mobile mergers around the world to look for patterns that could potentially apply in Australia. The study supports a positive view on Telstra, which JPMorgan rates Overweight, and a negative view on TPG Telecom, which the broker rates Underweight.

The fixed-mobile merger of TPG Telecom and Vodafone Australia most resembles the Belgium experience, JP Morgan suggests, where the fixed carrier, Telenet, traded higher on the original announcement because of the large expected synergies. Yet, while the revenue per user was lifted industry-wide, Telenet actually lost market share after the acquisition and its share price declined by -25% from the peak a year earlier.

JPMorgan also notes the consolidation of the mobile business in the UK did not lessen competitive intensity. Despite the merger of Orange and T-Mobile in 2010 to form EE, the presence of the four remaining mobile operators meant competition remained intense. Revenue per user took several years to stabilise for both participants.

Whatever the benefit it may derive from consolidation in terms of its fixed line business, Telstra will still need to work hard to retain market share in mobile, Citi asserts. Competition in mobile has intensified as Vodafone Australia is matching the Optus 30GB $36 SIM-only plan with a $35 plan.

Having historically maintained a price premium of around 20%, that allowed Telstra to maintain a dominant market share, its offering is now at a 40% premium to peers for SIM-only plans. The broker considers this gap too large and Telstra will need to adjust pricing again if it wants to hold market share.

While Citi raises its valuation of Telstra by 15%, moving to a separate valuation for the infrastructure company, a Sell rating is maintained, amid doubts that the company will generate sufficient cash flow to keep its dividend at $0.22 per share in the long-term. The infrastructure company is valued at $21bn, including $8.4bn from recurring NBN.

Moreover, as earnings decline over the next three years Telstra will need to cut debt levels. If the company were to change its capital management framework and allow higher gearing on the infrastructure company, and borrow to pay the dividend, this would let it fund a $0.22 per share dividend for some several years more.

This would only be a temporary reprieve unless earnings can be increased. Citi calculates Telstra will need to find an additional $700m in free cash flow over and above forecasts in order to pay a $0.22 dividend in the long-term.

Citi increases its target for the fourth major telco, Vocus Communications ((VOC)), to reflect increased confidence in the long-term earnings recovery, as well as rising valuations for the telco sector locally. A Buy rating is maintained as Vocus is the only large-scale telco offering revenue growth.

The broker raises the multiple applied to the enterprise & wholesale business and brings it into line with the multiple applied to TPG Telecom's corporate business, reflecting increased confidence in the long-term growth profile. Citi also raises the multiples on the company's consumer division, reflecting relatively stable earnings versus Telstra's fixed line and TPG Telecom's consumer business.

The company's Australia-Singapore cable went live two weeks ago and Vocus has already sold 2.5Tbps of capacity which is expected to grow rapidly now the cable is operating. Citi expects FY19 to be the trough in earnings for Vocus while envisaging significant scope for cost reductions in the longer term.

See also, TPG Telecom Relying Heavily On Mobile on Sept 19, 2018.

Confidence In Santos Is Growing

An acquisition, lower costs and the rebound in oil prices have all provided increased confidence in the outlook for Santos, which has outlined a new production target for 2025.

-70% of the target involves the Quadrant acquisition -Further growth in the Cooper Basin requires more drilling -6mtpa expected from GLNG by 2021

By Eva Brocklehurst

Santos ((STO)) has outlined a path to a production target of over 100mmboe by 2025 and the acquisition of Quadrant is expected to deliver a significant portion of this growth. Incremental increases are also expected at GLNG, the Cooper Basin, Barossa and PNG LNG. The delivery of the Dorado oil project, acquired under the Quadrant deal, is expected to kick production along.

Morgan Stanley suggests the company has managed to lower costs significantly and improve well economics via drilling efficiencies. Santos has also been fortunate with a rebound in oil prices, reducing concerns regarding the balance sheet. The broker expects the trend to continue and, coupled with a new focus on costs and the large acreage, anticipates reserves and production will continue to grow across several assets.

Growth is largely within the company's control, UBS observes, given around 70% of the target is driven by the proposed acquisition of Quadrant and a further 10% related to the ramping up of Cooper Basin and GLNG equity fields.

UBS expects growth in the Cooper and GLNG to be driven by increased drilling activity, and the increase in well numbers across several assets means risk is spread more widely. Nevertheless, the Western Australian gas business is set to do the heavy lifting in terms of production growth, as Quadrant is set to add around 19mmboe (2018) plus 15mmboe from the development at Dorado.

Citi calculates that, in a scenario where the company can execute perfectly on all its assets, production could amount to around 140mmboe. This is not the broker's forecast but merely a reflection of existing guidance.

Morgan Stanley finds the target achievable and believes a further re-rating of the stock is likely, should oil prices stay near current levels. The acquisition of Quadrant also lowers the break-even point on free cash flow and arguably makes the business more defensive.

The broker suspects the market will focus on the de-leveraging profile and asserts Santos has articulated its growth plans well. Over time the growth plan should be incorporated in consensus valuations. The company has also made a well-timed acquisition in Quadrant although capital expenditure will start to increase and Morgan Stanley warns that the sector does not always perform in this environment.

Because the shares do not factor in the downside risk to operations UBS maintains a Sell rating. If the broker were to include projected production life then, all else remaining equal, valuation would lift to around $7 per share, suggesting the market is already incorporating the proposed 2025 target to some degree already. UBS bases its valuation on an implied oil price of US$70/bbl from the second half of 2018.

Cooper Basin

UBS acknowledges the continued decline in the cost base but suspects the market may not have factored in all of the risks associated with growth. UBS considers growth of 2-3mmboe in the Cooper is very likely, with a fourth rig being mobilised.

Additional wells will increase the resource base and production from the mature field. Yet, further out, growth in the Cooper Basin requires successful drilling to identify and develop 250-300mmboe of resources, given current 2P reserves imply less than 10 years of field life.

Citi points to capital expenditure guidance of US$300m for the next two calendar years in the Cooper and suspects the company is either being conservative in its guidance, productivity is declining, or there is simply a preference to grow resources and reserves via exploration and appraisal.

Management has guided towards 17-19mmboe by 2025 and Macquarie accepts that, in order to achieve the higher production, capital expenditure is likely to be above forecasts. The broker increases both gas and oil production forecasts, noting the focus will be on the performance of the Moomba South development where the company is targeting around 42mmboe of net 2C resources within the Patchawarra.

Morgan Stanley maintains an Overweight rating and confirms its conviction around the 2C resource conversion is increasing, suspecting it likely that consensus valuations for the asset will increase over time.

GLNG

Meanwhile, GLNG is ramping up the gas. By 2021 GLNG production is expected to reach 6.5mtpa of which equity gas will constitute 4.1mtpa. The company has indicated that gas has been re-directed to the domestic market from exports until the end of 2020.

The company is expected to spend around US $200m per annum over 2019/20 as production ramps up from Roma East, Scotia and Fairview. UBS considers 6mtpa challenging, albeit possible, given the availability at Fairview is lower than forecast and gas is being re-directed to the domestic market.

Management believes the Barossa will be the main back-fill opportunity for Darwin LNG. Santos expects to spend US$1-1.2bn over four years prior to first gas, well above broker expectations. Meanwhile, the company's expectations for PNG LNG are in line with its partners. The project is now producing above pre-earthquake levels at 9mtpa.

FNArena's database shows two Sell ratings, two Hold and one Buy (Morgan Stanley). The consensus target is $6.63, suggesting -9.8% downside to the last share price. Targets range from $5.59 (Morgans, yet to comment on the new target) to $8.30 (Morgan Stanley).

More Capital, But Risks Still Pervade For Nufarm

A multitude of risks beset Nufarm and, in downgrading forecasts, several brokers suggest it may take time for the stock to re-rate.

-A return to growth expected as recent initiatives are progressed -Europe projected to reach 45% of group operating earnings in FY19 -Glyphosate regulatory issues may linger

By Eva Brocklehurst

Besides Australia's severe east-coast drought, agricultural chemical producer/distributor Nufarm ((NUF)) was plagued with problems over FY18 and the usual benefits from geographic diversity were lacking. Consequently, the earnings outlook is downgraded and, as the balance sheet appears stretched, a capital raising has ensued.

Guidance for FY19 operating earnings (EBITDA) of $500-530m suggests no contribution from Australasia in the first half and around a $30m contribution in the second half. Normal rainfall conditions are assumed to return in the autumn. Deutsche Bank suggests a host of risks will weigh on the stock in the year ahead, including ongoing drought in Australia, volatility in Brazil, US tariffs, consolidation in Europe, Brexit and higher raw material costs.

Bell Potter envisages the primary drivers of earnings over FY18-21 include achieving a reduction in working capital towards a target of 35-37% of revenue, delivering on the Omega 3 initiative, integrating recent European acquisitions and the potential impact of any regulatory change around core products.

The company reported a statutory after-tax loss of -$16m in FY18 including -$70.6m in impairments in the Australian business. On a positive note, North and Latin American earnings were ahead of expectations and Credit Suisse notes any fears regarding drought in Argentina or transport/currency issues in Brazil came to nought. Citi also points out market share gains in both regions.

While Europe was weaker than expected, some of the factors are controllable, such as plant outages, while weather continues to be the wildcard. Following the acquisition of the Century and FMC portfolios, Europe is projected to reach around 45% of group operating earnings in FY19.

Climatic conditions, particularly in Germany, France, Poland and the UK are potentially the largest drivers of near-term earnings and drought, as northern Europe enters the planting window in March-April, is a risk.

The company made no changes to guidance for Omega 3 canola. Regulatory approvals for Omega 3 appear to be proceeding as planned, with guidance for first revenue from commercial contracts expected by the end of FY19.

Credit Suisse points out a failure to date to reach a commercial agreement with BASF and competing patent claims means there is some litigation risk in the near term. Investment in the Omega 3 project should begin to tail off from FY19 and Bell Potter calculates the return on invested capital hurdle of 16% requires only a fairly modest capturing of market share.

Capital Raising

The company announced a $303m fully underwritten 3-for-19 accelerated renounceable entitlement offer at $5.85 a share, an -11.9% discount to the dividend-adjusted prior close.

Sumitomo, the company's largest shareholder, has elected not to participate in the rights issue. Bell Potter suspects this may cause the market to shift its view, to Sumitomo being a seller rather than a suitor for the business, and result in a potential stock overhang. Deutsche Bank agrees the fact Sumitomo did not take up its entitlement could create a dampener for the stock.

Credit Suisse calculates the equity raising is around -6% dilutive and reduces net debt to a more comfortable 1.8x FY19 operating earnings. Morgans recommends shareholders take up the entitlement offer, given the 17% upside and suggests any re-rating of the stock is likely to take time. The broker downgrades to Hold from Add.

The valuation remains compelling, in Citi's view, and the capital raising could be a catalyst for re-rating as it removes a shadow hanging over the balance sheet. Morgan Stanley agrees a risk has been removed, although did not ascertain any need to raise capital in the first place.

Glyphosate

Glyphosate regulatory issues may linger but Credit Suisse suggests the safety aspect is supported by scientific evidence while the disclosure of a 12% contribution to gross profit provides a basis for quantifying the downside risks.

The biggest unknown is the recent ruling against Bayer (Monsanto) by a grounds keeper who contracted cancer after using glyphosate and, Bell Potter asserts, whether this paves the way for similar lawsuits in other jurisdictions, as well as the potential for a tail of liability to develop in a similar fashion to the asbestos liabilities recognised by building material companies.

While the industry has downplayed the risks, the broker believes that the hurdle rate required for investment will now rise to reflect the heightened risk profile. Bell Potter, not one of the eight stockbrokers monitored daily on the FNArena database, has a Hold rating and $7.15 target.

The database shows four Buy ratings, one Hold (Morgans) and one Sell (Deutsche Bank). The consensus target is $7.69, suggesting 14.7% upside to the last share price. This compares with $8.04 ahead of the results.

See also Drought Casts A Pall Over Nufarm Earnings on July 24, 2018.

Oil Market Facing New Dilemma

Having balanced the oil market since deciding to withhold barrels in January 2017, OPEC and its cohorts are now faced with an opposing dilemma, increasing output enough to cover expected shortages over the next few months.

-Are there sufficient barrels in the market to make up for lost Iran supply? -Under-investment in oil supply a growing concern -Yet Russian investment increasing at a significant rate

By Eva Brocklehurst

Ahead of the joint meeting of OPEC and non-OPEC countries to consider the current declaration of co-operation, analysts reviewed the outlook for the oil market. The questions centred on spare capacity, as Iran's production starts to decline, as well as plans for conforming to production constraints, if required, going forward.

CIBC Capital Markets believes the OPEC alliance has successfully balanced global oil markets since agreeing to withhold 1.8m bpd since January 2017. This time, OPEC and cohorts are faced with a diametrically opposite decision, obtaining consensus for an increase in output enough to cover shortages from Iran and Venezuela over the next few months.

CIBC suspects, based on analysis of August supply data, that there are sufficient barrels in the market to make up for losses of supply. The question now is whether the alliance has both the capacity and desire to continue balancing the market.

ANZ analysts point out, despite an increase in production agreed on in June, the market continues to tighten. The falls in Iranian crude exports are larger and arriving earlier than expected, already showing signs of being affected by the reimposition of US sanctions.

Spare capacity is also falling sharply and the analysts suggest the market is exposed to supply-induced price shocks. Iran appears to be storing increasing amounts of crude on tankers in the Persian Gulf, according to Bloomberg ship tracking data. The ANZ analysts suggest this comes at a sensitive time for the market.

While Saudi Arabia and Russia would have been across the potential for a fall in Iranian exports, the analysts suspect that their ability to balance the market is becoming even harder. The drop in exports from Iran appears to be stemming from a lack of interest from key purchasers, namely China and India. China has just endured its longest period without receiving Iran crude in three years and the reason for the hiatus remains unclear.

In the short term, Morgan Stanley suspects supply risks will outweigh concerns regarding demand. Low inventory, falling spare capacity, constrained US production and the Iranian sanctions are skewing the price risk to the upside.

The broker also observes the northern summer was characterised by several OPEC members raising output aggressively ahead of the expected losses from Iran. This coincided with a period of weak Chinese imports. However, these factors have been reversing in recent weeks.

Morgan Stanley reiterates a call for Brent to reach US$85/bbl in coming months. Minimal spare capacity and low inventory are supporting prices. Inventory in July, expressed in days-of-demand, reached the lowest levels since the start of 2011.

Meanwhile, spare capacity is low by historical standards and the majority is in Saudi Arabia, where realising this capacity likely requires additional drilling. Morgan Stanley believes under-investment is a growing concern, which will eventually impact on the balance of supply/demand.

A reduced rate of project sanctions in recent years is emerging as a critical issue and a fall in the oil price now would exacerbate supply challenges in the future. The broker notes, expressed in a trade weighted basket of emerging market currencies, crude prices are near 2013/14 highs while gasoil has already surpassed previous records. Yet global growth in demand for gasoline and middle distillates is yet to deviate from the trend rate.

Morgan Stanley believes, while exports from Iran have already fallen sharply, the risks remain to the downside. The broker argues that consensus overstates production growth from the US, while challenges in Venezuela and Angola are significant.

Russia

On the other hand, Citi continues to envisage substantial upside to Russian liquids production. The broker estimates Russian producers still have around 240,000 bpd of idle capacity available from the 410,000 bpd estimated back in May. In terms of drilling, Russian producers did not ease up during the period when OPEC was restraining its production.

The broker suspects that the US, Russia and Saudi Arabia combined are able to supply enough oil during the last quarter of 2018 to limit a spike in the price above US$80/bbl. Russia appears to be at the head of the advance. Citi envisages Russian output headed to 12m bpd by 2020, as greenfield activity remains unusually high and fields are being ramped up at an impressive rate.

Going forward, Morgan Stanley believes demand represents the main risk to oil prices. Emerging markets are driving growth but higher US interest rates and concerns over trade have weakened their currencies in recent months relative to the US dollar. This is particularly the case of Brazil, Mexico, Argentina, Russia, South Africa and India. Nevertheless, the broker considers the risks to demand at this stage are not strong enough to revise its global oil figures materially.

Stock Performance

Morgan Stanley expects returns in the Australian energy sector to be supported by strong oil prices as the sector has outperformed the ASX 200 in the year to date, with returns of 11.3% versus 5.2% in local currency terms.

The broker's oil strategist retains a long-term positive outlook for oil prices, which should support stocks. A renewed capital expenditure cycle could also extend returns. The analysts consider it likely that upstream capital expenditure will increase, improving capacity and potentially extending the sector's performance further into the future.

Material Matters: Metals, Aluminium & Coal

A glance through the latest expert views and predictions about commodities. Base, precious metals; aluminium; and thermal coal.

-Opportunities seen forming in base and precious metals -Aluminium likely to remain in surplus, curbing price rises -Buoyant pricing continues for high-grade thermal coal

By Eva Brocklehurst

Base, Precious Metals

2018 was expected to be a good year for metals but JPMorgan notes an escalating trade war between the US and China became reality and the base metal segment, in particular, took a beating. Barring a macro move into recession, the broker believes base metal prices are bottoming and a rebound should ensue in coming quarters. Metals appear quite cheap on both an absolute and relative basis to other asset classes.

The broker screens zinc and copper as particularly cheap. Moreover, JPMorgan expects China's fiscal easing to provide a material lift to metal demand over the next two quarters, offsetting reduced demand in the rest of the world.

Citi agrees copper appears oversold, particularly with inventories approaching a two-year low. The broker notes equity prices are being driven by negative sentiment towards base metals and also upgrades nickel player Western Areas ((WSA)) to Buy after a pull-back in the share price.

Morgan Stanley observes, over the September quarter, selling across base and precious metals occurred as markets priced in US dollar strength and the potential threat of tariffs. Only bulk commodities held up, supported by a lack of speculative selling and strong demand.

The price deck now carries a bullish tilt versus the spot price for base metals and the broker believes negative moves in both gold and base metals have created opportunities from a commodity perspective. Morgan Stanley also considers a weakening US dollar and eventual pullback in US equity markets supports a constructive outlook for precious metals. A long-standing bullish view on palladium is retained.

The move lower in gold and copper prices brings these two metals to the top of the broker's commodity ranking. Morgan Stanley expects copper, gold and silver prices to recover in 2019, with steady demand fuelling a recovery in copper and capital flowing back to precious metals.

JPMorgan also keeps a bullish bias in place for gold for the second half of FY19, believing the inversion of the yield curve will likely attract increased interest in the yellow metal.

UBS has Buy ratings on Northern Star Resources ((NST)), OceanaGold ((OGC)) and Alacer Gold ((AQG)). The broker likes Northern Star for its momentum and potential to turn around the recently-acquired Pogo mine. OceanaGold is expected to produce solid results from its operations, while Alacer Gold offers the largest potential return, albeit contingent on a successful ramp up of the sulphide project.

In aggregate, the broker believes Australian stocks are trading at similar forward enterprise value/operating earnings ratios versus their North American peers. Moreover, free cash flow yields for the ASX peers are generally higher and debt is lower.

Gold bellwether Newcrest Mining ((NCM)) is rated Sell as, while the UBS forecasts strong production growth in FY19, this is modelled as a near-term peak. Nevertheless, the stock screens well against the global majors, having the longest mine life at its major producing assets.

Morgan Stanley also notes lithium stocks have fallen significantly on the back of Chinese prices dropping to US$10,120/t from US$16,000/t during the September quarter. The broker upgrades Orocobre ((ORE)) to Equal-weight from Underweight and maintains an Equal-weight rating for Galaxy Resources ((GXY)), albeit with modest upside envisaged.

Morgan Stanley also envisages significant upside for graphite stock Syrah Resources ((SYR)), although it remains not without risk given the Balama project is yet to be declared commercial.

Aluminium

China will be implementing cuts to alumina production over the winter but leaving aluminium relatively unchanged. The reason is that aluminium smelters are designed to run continuously and it takes three months to power down and re-start, so winter curtailments would theoretically mean full production for only two months in a year.

The final quarter of the year is usually a period of restocking for aluminium smelters in China and the domestic alumina price is already 22% of the Shanghai aluminium price, a peak level.

Credit Suisse doubts a push from a cost perspective will lift aluminium prices as demand is softening. Hence, aluminium is expected to remain in surplus and circumvent any attempt by smelters to raise their prices. Meanwhile, global alumina supply is likely to tighten but the broker is uncertain whether the price will rise further, as aluminium smelters cannot afford to pay any more.

Credit Suisse's best guess for the fourth quarter alumina price is that Australia may settle its prices at $550/t and the price differential to China would be insufficient to incentivise Chinese alumina exports.

Citi agrees the alumina market is structurally tight and likes the strong dividend yield from Alumina Ltd ((AWC)) as cash is returned to shareholders. The main risk for the stock is how long the AWAC strike persists in Western Australia as the risk of a material loss of production is growing.

Thermal Coal

Shipments of Australian thermal coal to China have increased by almost 30% at the expense of other east Asian nations, which have turned to Russia as a result. Macquarie observes, faced with domestic shortages, Chinese buyers are importing Indonesian lignite and Australian top grade thermal coal to create a substitute product.

Mid-range seaborne coal is being avoided, despite favourable economics, because of its high sulphur content. This has led to a dislocation in prices, with premium high-grade thermal coal rising to levels not previously seen. Emerging economies that are more price sensitive, such as the Philippines and Malaysia, are sourcing most of their additional coal from nearby Indonesia. Meanwhile, faced with higher competition for Indonesian coal, India has turned to South Africa and the US.

Macquarie remains bearish on the outlook for all internationally-traded coal products based on an expected recovery in China's domestic production, which in turn should reduce demand for imports. The broker notes most of the increase in international production has come from Indonesia and the US, traditionally high-cost operators, which have stepped in to fill the gap as seaborne miners in Australia, South Africa and Colombia have failed to deliver meaningful growth.

Citi has revised up fourth quarter thermal coal prices, expecting the high-quality market to stay tight in the run-up to annual contract negotiations. After the winter in the northern hemisphere, utilities in Japan and Korea are expected to start switching to mid-level coal because of the current price differential.

The broker also expects more coal to shift to the Pacific Basin from the Atlantic as physical premiums are expected to remain significantly higher. The broker suspects a possible convergence between coal and gas pricing, if coal demand in Europe comes under pressure as utilities burn more gas and less coal on the back of an anticipated fall in local gas prices. Citi also upgrades Whitehaven Coal ((WHC)) to Buy from Neutral on the back of earnings upgrades and lower share prices.

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 September 17 to Friday September 21, 2018 Total Upgrades: 6 Total Downgrades: 6 Net Ratings Breakdown: Buy 41.77%; Hold 42.64%; Sell 15.59%

At face value, downgrades and upgrades in stockbroker recommendations for ASX-listed entities kept each other in perfect balance during the third week of September, but one has to take into consideration that retailer Premier Investments alone was responsible for three downgrades prior to and after it released FY18 financial numbers.

For the week ending Friday, 21st September 2018, FNArena registered a total of six upgrades and downgrades. Apart from Premier Investments, aged care operators are also represented among the downgrades, as is yield-infrastructure play Sydney Airport. The positive side doesn't reveal one dominating theme other than most upgrades going towards share market laggards, including Rio Tinto, Reliance Worldwide and Primary Healthcare.

Positive amendments to valuations/price targets were plenty, which is no doubt share market supportive, as is the observation that many of such supportive moves stem from companies reporting financial results post the August reporting season. TPG Telecom enjoyed the largest gain during the week (+15.7%), followed by Beach Energy, Premier Investments, WorleyParsons, Charter Hall and Woodside Petroleum.

There were equally some large reductions taking place, but such amendments have come out in noticeably smaller numbers. Little surprise, aged care provider Estia Health suffered the most (-12.2%), followed by Automotive Holdings, Telstra and another aged care provide, Japara Healthcare.

Positive earnings estimates adjustments were hefty with New Hope Corp commanding the week's lead, handsomely beating Perseus Mining, Synlait Milk and Premier Investments. Not so lucky were NextDC, TPG Telecom, Ardent Leisure, Telstra and oOh!media were earnings estimates took a large step backwards.

The share market overall continues to be dominated by international tensions and portfolio rotation into value laggards.

Upgrade

COSTA GROUP HOLDINGS LIMITED ((CGC)) Upgrade to Buy from Neutral by UBS .B/H/S: 1/3/0

The share price has underperformed since the August results and UBS upgrades to Buy from Neutral. Supporting the upgrade is the stronger wholesale produce pricing and the growth projects.

Upside is expected to FY19 guidance for low double-digit net profit growth, albeit limited, and the broker suggests there is a risk of a large skew to the second half.

Still, the outlook is considered priced in as expectations have been re-based post the FY18 result. Target is steady at $8.20.

FONTERRA SHAREHOLDERS' FUND ((FSF)) Upgrade to Neutral from Underperform by Credit Suisse .B/H/S: 0/2/1

The disappointing FY18 results were well flagged with two downgrades in the second half. The FY19 guidance of 25-35c per share is disappointing but Credit Suisse views management's more conservative intentions as a positive.

The broker believes the company's ability to forecast earnings is challenged by the complexity of the business and limited control over input costs.

Credit Suisse upgrades to Neutral from Underperform and lowers the target price to NZ$5.09 from NZ$5.12.

PRIMARY HEALTH CARE LIMITED ((PRY)) Upgrade to Accumulate from Hold by Ord Minnett .B/H/S: 2/2/3

The Fair Work Commission has intervened in a dispute relating to the Dorevitch pathology business, ordering Primary Health Care to offer pay increases of up to 20% to around 1800 workers. The company has confirmed the impact on underlying net profit in FY19 would be -$4.5m and plans to take measures to mitigate the impact.

Clarification on the long-delayed ruling removes an overhang, Ord Minnett suggests. The broker reduces FY19 earnings estimates by -2%. Rating is upgraded to Accumulate from Hold and the target increases to $3.30 from $3.10. The broker expects attention can now turn to improving the business under the new management team, with the potential for a boost to Medicare funding ahead of the next federal election.

RIO TINTO LIMITED ((RIO)) Upgrade to Add from Hold by Morgans .B/H/S: 6/1/0

Rio Tinto plans to return the $3.2bn in net proceeds from the sale of its remaining coal assets through a new off-market share buyback which will be carried out over the remainder of 2018. While the buyback is a positive, Morgans struggles with the move to divest coal, as it has further concentrated the business.

The broker considers the recent weakness in the share price has uncovered attractive value, and healthy metal prices could mean additional capital management and growth is added. Morgans upgrades to Add from Hold. Target is raised to $81.32 from $80.67.

RELIANCE WORLDWIDE CORPORATION LIMITED ((RWC)) Upgrade to Hold from Sell by Deutsche Bank .B/H/S: 3/2/0

The company has hosted an investor briefing. Deutsche Bank is pleased that John Guest is on track as it is the near-term catalyst for the business. The broker remains concerned that adequate US sales margin growth can be achieved, nonetheless, as the opportunities are largely in lower margin segments.

While forecasts remain unchanged, given the recent underperformance in the share price, the broker upgrades to Hold from Sell. Target is $4.80.

WOODSIDE PETROLEUM LIMITED ((WPL)) Upgrade to Outperform from Underperform by Credit Suisse .B/H/S: 3/4/0

Credit Suisse upgrades to Outperform from Underperform and believes Scarborough's time has come. The broker, with a new analyst assuming coverage, considers Scarborough makes up for the aspects of the business it does not like, presenting a more de-risked project than is widely credited.

The broker considers Woodside's unique industry position and appetite for greater LNG market exposure is the differentiator. Positive announcements regarding Browse are also expected and major downside risks, aside from the oil price, are believed unlikely to materialise in the near term. The broker raises the target to $40.50 from $27.20.

Downgrade

ESTIA HEALTH LIMITED ((EHE)) Downgrade to Neutral from Outperform by Macquarie .B/H/S: 1/3/0

The Australian government has announced a royal commission into the aged care industry. Macquarie suggests negative media coverage and scrutiny from a royal commission will increase the likelihood of falling occupancy.

Despite having a cautious view on the aged care sector, the company's balance sheet and consistent conservative growth made Estia Health the broker's preference among listed operators.

However, given the negative coverage Macquarie considers the stock unlikely to outperform and the rating is downgraded to Neutral. Target is reduced to $2.70 from $3.60.

JAPARA HEALTHCARE LIMITED ((JHC)) Downgrade to Underperform from Neutral by Macquarie .B/H/S: 0/2/1

The Australian government has announced a royal commission into the aged care industry. Given the increased scrutiny and attention operators will receive in FY19, Macquarie believes there is increased risk from the company's strategy of reducing staff costs.

Consistent with the broker's view of the industry, there is a risk of falling occupancy throughout FY19. The earnings impact from a change in occupancy is greater for Japara Healthcare than its listed peers and the broker downgrades to Underperform from Neutral. Target is reduced to $1.33 from $1.77.

PREMIER INVESTMENTS LIMITED ((PMV)) Downgrade to Sell from Neutral by Citi and Downgrade to Hold from Buy by Deutsche Bank and Downgrade to Neutral from Buy by UBS .B/H/S: 1/4/1

Citi observes Smiggle is shifting to a less capital intensive model including concessions, wholesale agreements and third-party online partners. Nevertheless, the broker remains cautious and suspects rising labour costs and digital investment will carry over into FY19.

The broker downgrades the stock to Sell from Neutral on valuation grounds. Target is raised to $17.00 from $16.40. While earnings growth remains strong, the broker reduces retail operating earnings forecast by -9% in FY19 and -7% in FY20 because of elevated growth in operating costs.

FY18 results highlight the growing contribution of Smiggle as well as good cost control, and Deutsche Bank is encouraged by the sales trend in the apparel brands. Smiggle and Peter Alexander, the highest margin and highest growth brands, now account for 43% of retail sales.

The broker believes management has done a good job of steadying the core brands and executing on its growth strategy, however, the stock is nearing the revised valuation and the rating is downgraded to Hold from Buy. Target is raised to $18.50 from $16.70.

UBS has analysed Australian shopping habits and brand positions across the fashion sector. The data is broadly supportive of Premier Investments in terms of brand awareness and online strength, particularly at Peter Alexander.

The survey suggests some weakness in fashion expenditure early in 2018 but recent data from the ABS indicates trends have improved since April. The broker expects a solid FY18 result on September 20 but downgrades the rating to Neutral from Buy on valuation grounds. Target is raised to $20.30 from $17.30.

SYDNEY AIRPORT HOLDINGS LIMITED ((SYD)) Downgrade to Underperform from Neutral by Macquarie .B/H/S: 3/3/2

The Productivity Commission review in the next nine months resets the focus to the threat around regulatory intervention, Macquarie observes. Submissions are taking a similar approach to previous reviews, with the airports supporting the current regime and airlines arguing for a more credible threat of "final offer" arbitration.

However, Macquarie doubts that regulatory intervention would make an impact on end-users versus lifting airline profitability. The broker takes a conservative approach, suggesting the pace of dividend growth will likely need to slow to ensure a smooth path for re-pricing and a shift to tax being paid.

Rating is downgraded to Underperform from Neutral. Target is raised to $7.13 from $7.05.

Total Recommendations Recommendation Changes

Broker Recommendation Breakup

Broker Rating Order Company New Rating Old Rating Broker Upgrade 1 COSTA GROUP HOLDINGS LIMITED Buy Neutral UBS 2 FONTERRA SHAREHOLDERS' FUND Neutral N/A Credit Suisse 3 PRIMARY HEALTH CARE LIMITED Buy Neutral Ord Minnett 4 RELIANCE WORLDWIDE CORPORATION LIMITED Neutral Sell Deutsche Bank 5 RIO TINTO LIMITED Buy Neutral Morgans 6 WOODSIDE PETROLEUM LIMITED Buy Sell Credit Suisse Downgrade 7 ESTIA HEALTH LIMITED Neutral Buy Macquarie 8 JAPARA HEALTHCARE LIMITED Sell Neutral Macquarie 9 PREMIER INVESTMENTS LIMITED Sell Neutral Citi 10 PREMIER INVESTMENTS LIMITED Neutral Buy UBS 11 PREMIER INVESTMENTS LIMITED Neutral Buy Deutsche Bank 12 SYDNEY AIRPORT HOLDINGS LIMITED Sell Neutral Macquarie Recommendation Positive Change Covered by > 2 Brokers Order Symbol Company New Rating Previous Rating Change Recs 1 WPL WOODSIDE PETROLEUM LIMITED 43.0% 13.0% 30.0% 7 2 CHC CHARTER HALL GROUP 50.0% 20.0% 30.0% 4 3 WOR WORLEYPARSONS LIMITED 50.0% 29.0% 21.0% 6 4 RWC RELIANCE WORLDWIDE CORPORATION LIMITED 50.0% 30.0% 20.0% 5 5 OML OOH!MEDIA LIMITED 83.0% 63.0% 20.0% 3 6 DXS DEXUS PROPERTY GROUP 33.0% 14.0% 19.0% 6 7 PRY PRIMARY HEALTH CARE LIMITED -21.0% -38.0% 17.0% 7 8 MMS MCMILLAN SHAKESPEARE LIMITED 40.0% 25.0% 15.0% 5 9 AWC ALUMINA LIMITED 70.0% 58.0% 12.0% 5 10 TPM TPG TELECOM LIMITED -10.0% -21.0% 11.0% 5 Negative Change Covered by > 2 Brokers Order Symbol Company New Rating Previous Rating Change Recs 1 NSR NATIONAL STORAGE REIT -50.0% -13.0% -37.0% 3 2 PMV PREMIER INVESTMENTS LIMITED 17.0% 50.0% -33.0% 6 3 TLS TELSTRA CORPORATION LIMITED -25.0% 6.0% -31.0% 6 4 EHE ESTIA HEALTH LIMITED 25.0% 50.0% -25.0% 4 5 HT1 HT&E LIMITED 40.0% 60.0% -20.0% 5 6 IGO INDEPENDENCE GROUP NL -25.0% -7.0% -18.0% 6 7 NEC NINE ENTERTAINMENT CO. HOLDINGS LIMITED 25.0% 40.0% -15.0% 4 8 FXJ FAIRFAX MEDIA LIMITED 25.0% 40.0% -15.0% 4 9 AOG AVEO GROUP 50.0% 63.0% -13.0% 3 10 AAD ARDENT LEISURE GROUP 13.0% 25.0% -12.0% 4 Target Price Positive Change Covered by > 2 Brokers Order Symbol Company New Target Previous Target Change Recs 1 TPM TPG TELECOM LIMITED 7.810 6.750 15.70% 5 2 BPT BEACH ENERGY LIMITED 1.793 1.628 10.14% 4 3 PMV PREMIER INVESTMENTS LIMITED 17.157 15.963 7.48% 6 4 WOR WORLEYPARSONS LIMITED 19.758 18.436 7.17% 6 5 CHC CHARTER HALL GROUP 7.138 6.694 6.63% 4 6 WPL WOODSIDE PETROLEUM LIMITED 36.611 34.711 5.47% 7 7 OML OOH!MEDIA LIMITED 5.517 5.250 5.09% 3 8 HT1 HT&E LIMITED 2.700 2.570 5.06% 5 9 AWC ALUMINA LIMITED 3.100 2.958 4.80% 5 10 NEC NINE ENTERTAINMENT CO. HOLDINGS LIMITED 2.300 2.220 3.60% 4 Negative Change Covered by > 2 Brokers Order Symbol Company New Target Previous Target Change Recs 1 EHE

ESTIA HEALTH LIMITED 3.083 3.513 -12.24% 4 2 AHG AUTOMOTIVE HOLDINGS GROUP LIMITED 2.624 2.874 -8.70% 5 3 TLS TELSTRA CORPORATION LIMITED 2.950 3.194 -7.64% 6 4 JHC JAPARA HEALTHCARE LIMITED 1.618 1.702 -4.94% 4 5 NSR NATIONAL STORAGE REIT 1.463 1.535 -4.69% 3 6 IGO INDEPENDENCE GROUP NL 4.483 4.614 -2.84% 6 7 AAD ARDENT LEISURE GROUP 1.975 1.992 -0.85% 4 8 PRY PRIMARY HEALTH CARE LIMITED 3.021 3.028 -0.23% 7 9 NXT NEXTDC LIMITED 7.912 7.924 -0.15% 6 Earning Forecast Positive Change Covered by > 2 Brokers Order Symbol Company New EF Previous EF Change Recs 1 NHC NEW HOPE CORPORATION LIMITED 39.633 28.800 37.61% 3 2 PRU PERSEUS MINING LIMITED 2.500 2.125 17.65% 3 3 SM1 SYNLAIT MILK LIMITED 45.397 38.735 17.20% 3 4 PMV PREMIER INVESTMENTS LIMITED 83.784 75.270 11.31% 6 5 AWC ALUMINA LIMITED 31.690 28.756 10.20% 5 6 KMD KATHMANDU HOLDINGS LIMITED 23.862 21.653 10.20% 4 7 BPT BEACH ENERGY LIMITED 22.450 20.533 9.34% 4 8 RIO RIO TINTO LIMITED 681.818 656.768 3.81% 7 9 NEC NINE ENTERTAINMENT CO. HOLDINGS LIMITED 20.398 19.665 3.73% 4 10 SVW SEVEN GROUP HOLDINGS LIMITED 127.200 122.650 3.71% 4 Negative Change Covered by > 2 Brokers Order Symbol Company New EF Previous EF Change Recs 1 NXT NEXTDC LIMITED 0.700 1.933 -63.79% 6 2 TPM TPG TELECOM LIMITED 36.667 43.940 -16.55% 5 3 AAD ARDENT LEISURE GROUP 3.850 4.588 -16.09% 4 4 TLS TELSTRA CORPORATION LIMITED 19.417 22.783 -14.77% 6 5 OML OOH!MEDIA LIMITED 22.550 25.578 -11.84% 3 6 QAN QANTAS AIRWAYS LIMITED 60.930 66.130 -7.86% 6 7 JHC JAPARA HEALTHCARE LIMITED 7.850 8.280 -5.19% 4 8 AHG AUTOMOTIVE HOLDINGS GROUP LIMITED 20.275 21.352 -5.04% 5 9 OSH OIL SEARCH LIMITED 29.865 31.349 -4.73% 6 10 PRY PRIMARY HEALTH CARE LIMITED 14.372 15.061 -4.57% 7 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: Another One Bites The Dust

America's oldest nuclear reactor shut down last week. Meanwhile, the spot uranium price continues to rise.

-Oyster Creek shuts down -IAEA has a warning for governments -Uranium spot price marches ever onward

By Greg Peel

In December 1964, construction began on the Oyster Creek nuclear power plant in New Jersey. In 1969, the reactor was connected to the grid. Last week, Oyster Creek – America's oldest operating reactor -- was shut down. It wasn't just a matter of old age, as the reactor was licensed to operate for yet another ten years.

The reactor is the sixth to be closed down in the US in the last five years. Twelve more are slated for decommissioning by 2025. In most cases, a lack of commercial viability in today's energy market, dominated by cheap gas, has been the deciding factor. At Oyster Creek, it was a case of the New Jersey state government changing water usage rules that would have required operator Exelon to build new cooling towers at an estimated cost of US$800m.

The US uranium production and nuclear power industries remain in a state of flux, beholden to both state government policy – supportive or otherwise – and to federal government policy, which is currently being reviewed.

Foresight Required

There are thirty countries in the world currently operating nuclear reactors. Of those thirty, several are looking to expand their fleet and/or upgrade existing reactors to increase operating life. Several others are aiming to downsize or retire their fleets. A further thirty countries are currently considering plans to introduce nuclear energy.

It's a long process. Had Oyster Creek seen out its license, it would have marked 65 years from construction to decommissioning, and that's assuming the license wasn't extended or the plant refurbished in the interim. As industry consultant TradeTech reports, last week the International Atomic Energy Agency noted that "strong and consistent government support is vital to the success of nuclear power. From inception through decommissioning, at least a century of vigilance is required for nuclear power plants, and necessary oversight as well as research and development can be carried out only under consistent national policies regarding nuclear power".

Over the last several years, a change in stripe of the government in the electoral cycle of a democratic nation has brought about a change to vital energy policy approach. In Australia, it doesn't even take a full electoral cycle nor a change of stripe of government. The country has had seven prime ministers in ten years and in most cases, downfalls have been brought about due to energy policy disagreement either between political parties or within them.

The country currently driving global nuclear reactor builds is China. There's a lot to be said for a communist dictatorship run by a president for life when it comes to energy policy. At the very least it provides for foresight – something completely lacking in today's democracies that live simply from election to election and change policies at will to ensure survival.

Perhaps it requires a country to near choke itself to death with pollution to provide the necessary wake-up call. (See: The World Needs Nuclear Energy For EVs)

The Smart Money

The shift towards electric vehicles is arguably one reason why uranium has become popular as an investment in recent months. Weekly volumes in the global spot uranium market continue to rise. Last week saw no less than 2mlbs U_3O_8 changes hands in ten transactions, TradeTech reports, yet not one featured an actual end-user on the buy-side.

Rather, the buyers included intermediaries, producers buying in to cover delivery contracts rather than actually mine the stuff at a loss, and "financial entities", as TradeTech dubs them. Typically this would be code for hedge funds playing speculator, but now it is listed investment funds that are in on the act, pooling investor funds to simply buy and store yellow cake.

TradeTech's weekly spot price indicator rose another US45c to US$27.65/lb last week.

There were no transactions reported in uranium term markets. TradeTech's indicators remain at US$29.50/lb (mid) and US$31.00/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 UIKeyInputLeftArrowamounts 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 September 20, 2018

Last week saw the ASX200 continue a choppy graft back from the 6100 recent low.

A lot of the stocks highlighted in green below were red last week and green the week before. As this trend persists, I can only make the assumption it is coincidental that each week's move just happens to take those stocks up or down a percentage bracket, but it seems overly coincidental they all would also do so in unison, every week.

So take it as you want.

Otherwise, takeovers continued to be a driver of short position movements last week, we might assume.

Last week Centuria Industrial REIT ((CIP)) leapt into the table from oblivion to 9.8% shorted, which can be explained by a takeover offer made for the fund by Propertylink Group ((PLG)). Now Asian platform ESR Real Estate has made a bid for Propertylink, so it's unclear where that leaves Centuria.

Suffice to say Centuria's share price has since lost half of the 11% jump it enjoyed on the day of the bid announcement, and in terms of the short position which likely was a takeover play, well, it's vanished.

In its place is BWX Ltd ((BWX)), which has jumped to 10.7% shorted from 7.7% shorted after two senior executives resigned when a private equity takeover they attempted to orchestrate fell over.

On the other side of the ledger, Bingo Industries ((BIN)) has successfully completed a capital raising to fund the acquisition of Dial-a-Dump for $577.5m. Bingo shorts have fallen to 5.7% from 7.2%, which suggests a standard takeover arbitrage in which a hedge fund shorts the stock and then picks up the rights issue at a discount, locking in a profit.

Beyond that, we welcome to the 5% plus shorted table Speedcast International ((SDA)). See below.

Weekly short positions as a percentage of market cap:

10%+

JBH 19.5 SYR 16.7 GXY 16.7 ORE 16.2 DMP 13.0 ING 12.3 MTS 11.8 GXL 11.6 BWX 10.7 MYR 10.5 HVN 10.3 GEM 10.3

In: BWX

9.0-9.9

IFL, NWS

Out: CIP, VOC, IGO, NUF, IVC 8.0-8.9%

CSR, NEC, VOC, IGO, IVC, AAC, NUF, SUL

In: VOC, IGO, IVC, NUF, SUL Out: NAN

7.0-7.9%

GMA, NAN, NXT, MLX, BIN, PLS

In: NAN, NXT Out: BWX, SUL, BIN, PLS

6.0-6.9%

PLS, MYO, RSG, KAR, SEK, HT1, SIG, MND, GNC, FLT, MOC

In: PLS Out: NXT, NWL, BGA

5.0-5.9%

NWL, BIN, CAB, BLA, KDR, BEN, BAL, MSB, SDA, CQR, CLQ, PPT, AMP

In: BIN, NWL, SDA, PPT

Movers & Shakers

Satellite services provider Speedcast International ((SDA)) can be included among the list of “new world” growth stocks that have been very popular with investors this past year. More than often we have seen these new world stocks become overly hyped by the market ahead of a spectacular fall from grace.

The stock was up 25% year to date in late August when the company posted a big miss on both FY18 earnings and FY19 guidance and sorely disappointed analysts. The stock fell -40% on the day and has not since recovered.

Speedcast appeared in the 5% plus shorted table last week at 5.3%.

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: Dentists, Aged Care, Outdoor Media

Weekly Broker Wrap: Housing; dentistry; Commonwealth budget; aged care; insurance; and outdoor media.

-Negative aspects of the housing market are increasing -Corporatisation of Australia's dental market is growing -Upside from a better budget position likely to be returned to households -Royal Commission likely to focus on deteriorating standards in aged care -Recent consolidation should improve profitability in the outdoor media sector

By Eva Brocklehurst

Housing

The Australian Prudential Regulatory Authority has instructed lenders to develop internal risk limits for the share of loans that have debt-to-income ratios at very high levels. UBS believes APRA may want first loans that have ratios over 6x down to a 10% share of business, far below current estimates of 33%.

The broker has polled clients and is surprised most were unaware that borrowing capacity for anyone with existing debt can be reduced sharply. Major banks are expected to start sharing over 65% of lending data in coming weeks ahead of comprehensive credit reporting the system that is required from July 2019.

In addition, the Labor Party proposes to limit negative gearing to new housing if it wins the upcoming federal election. UBS points out, when negative gearing was limited in 1985, investor home loans fell -30-40%.

The impact on the broader housing market could be magnified this time around, the broker asserts, as the investor share of loans has tripled since 1985. Several negative aspects are playing out in the broker's credit tightening thesis which could weaken housing sentiment and demand and raise the risk of a credit crunch.

Dentistry

Wilsons suggests the corporatisation of Australia's dental market could extend to 40-50% from the current 15%. There remains a large pool of targets for consolidation as well as alternative avenues for growth.

Dental services organisations dominate in terms of building greenfield sites and bringing new practices to the industry, while the growth of independent practices is marginal and sub-scale. Expanding the market and patient access depends on improving awareness of oral health and overcoming the perception of higher costs.

The analysts note digital marketing in the sector is becoming more sophisticated as it seeks to attract new patients and optimise service levels. Investment in technology is key to differentiating from the small independent competitors. Elements of specialty practice such as orthodontics, periodontics and aesthetics are becoming increasingly accessible to general dentistry.

Commonwealth Budget

The Commonwealth government's final budget outcome for 2017/18 was better than UBS expected, with a -$10.1bn deficit, or 0.6% of GDP, a significant improvement versus the May budget estimate. Along with the recent strength in jobs and commodity prices UBS expects a better starting point for 2018/19.

The government has indicated a mini budget may be prepared ahead of the election that is due by May 2019. Hence, UBS suspects upside from the better budget position will be returned to households via an additional income tax reduction from July 2019.

However, in terms of household cash flow, this expected tax cut is already offset by the recent re-pricing of mortgage rates and surging petrol prices. UBS believes the tax cuts are not enough to lift the consumer outlook or change its view that the Reserve Bank of Australia will maintain official rates on hold until 2020.

Aged Care

While the terms of reference for the Royal Commission into Aged Care are yet to be decided, UBS expects a focus on what the government perceives to be a deteriorating standard of resident care. Similar to the 2016 reductions to the aged care funding instrument, the Royal Commission was announced with minimal prior consultation, which the broker reminds investors emphasises the level of political risk the sector bears.

UBS notes deteriorating financial health in the sector as the main for-profit operators now account for around 60% of pre-tax profit. The number of operators in the sector declined between FY14-17 by 152 and the staff cost/revenue ratio has increased to 66.4%.

The broker's analysis suggests that, if the nursing union's staffing ratios are adopted, the cost imposition on the sector could approach over $3.6bn and this policy looms as a focal point for the Royal Commission. UBS envisages the potential financial impact on the listed operators is limited.

The ongoing need to attract private capital to the sector signals any material cost imposition would need to be met with additional government funding and/or deregulation of basic daily resident fees. The broker also does not envisage material headwinds to sector occupancy rates and potential 'flight to quality' may actually benefit listed operators.

Insurance

Macquarie suggests cash settlement, customer communication and mis-selling are likely to be the focus of recommendations from the Hayne Royal Commission. The broker does not believe changes will have a material impact on insurance industry profitability.

Should the Commission seek to limit full cash settlement of home claims, the broker estimates this could add around $150-350m in additional claims to the industry. To address customer communication the broker expects internal audit and compliance costs to be added.

Limits to incentives for agents could make distribution via certain channels uneconomical and change the mix in the industry. The broker's analysis suggests this is already happening in the motor dealer channel.

Macquarie understands the interim report will not cover insurance but the final report, due in February, is likely to include recommendations for the industry. Now the Royal Commission is behind the insurance industry the broker believes the focus will return to fundamentals.

As lower margins roll through the NSW CTP portfolio and commercial lines take longer to improve incumbents are likely to struggle to hold market share. Macquarie maintains Underperform ratings for Insurance Australia Group ((IAG)) and Suncorp ((SUN)).

Outdoor Media

Citi expects, after recent consolidation, there will be a long-term improvement in profitability for the outdoor media industry. The broker believes both QMS Media ((QMS)) and oOh!media ((OML)) are attractive ways to play the structural growth in the sector.

The broker updates forecasts for oOh!media to account for the Adshel acquisition, raising the target to $5.75 and maintaining a Buy rating. The tender for Adshel's largest contract, Brisbane City Council, is currently underway and the outcome is expected to be a key catalyst for the stock.

The share price of QMS Media has fallen -6% since the ACCC approved the recent oOh!media mergers, despite the FY18 results coming in at the top end of guidance. While the weakness could be explained by some takeover premium departing the share price and reports of a possible acquisition of Val Morgan, Citi suggests negative sentiment surrounding the company's prospects as a smaller third player in the industry is also playing a part.

Meanwhile, the broker adjusts its forecasts for HT&E ((HT1)) to account for the sale of Adshel. The company will undertake a strategic review of its corporate structure and the broker envisages significant scope for cost reductions.

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GWA Group Emphasising Renovations

GWA Group is targeting growth in market share, moving its emphasis to the renovations segment in both residential and commercial.

-Market share expected to rise to 35%, resulting in additional revenue -FY20 earnings growth expected as divestment costs roll off -Opportunities for a buyback or special dividend

By Eva Brocklehurst

GWA Group ((GWA)) has cut costs, sold non-core assets and is now positioned to invest in growth, targeting renovations and extensions in the residential building industry. The company is also targeting opportunities in the commercial renovation segment, such as in aged care.

The company's direct exposure to new residential construction will decline as it aspires to expand in repairs and remodelling. This should remove earnings volatility. As a result, Wilsons expects the company's market exposure to be similar to DuluxGroup ((DLX)) in the longer term.

The direct exposure to new residential housing construction is minimal and Wilsons estimates revenue from the new residential sector is $67m and, as a result, a -5% decline in volumes is unlikely to have a material impact on earnings.

Historically, the company's market share growth has not been that impressive but Wilsons is encouraged by the fact that the bathroom & kitchens share increased to 20.8% in FY18. The company believes that over time its market share will reflect the move into renovations and rise to 35%, resulting in additional revenue.

The stock may be trading largely in line with its five-year historical average price/earnings ratio but Wilsons believes it has never before offered such realistic and achievable options or margin resilience, which stems from the market share strategy and investment in cost reductions.

The broker believes the growth targets in commercial and residential renovation are achievable over the long-term and should deliver additional revenue of $150m and operating earnings of $38.1m. Growth in these two segments will result in the company reflecting an attractive renovation exposure of around 70%, similar to Dulux and one of the reasons Dulux trades on high multiples.

The stock is trading at around a discount of -26.8% versus its peers on FY19 price/earnings estimates. Wilsons, not one of the eight stockbrokers monitored daily on the FNArena database, upgrades to Buy with a target of $3.72, given the earnings growth, dividend yield and valuation.

The broker does forecast a decline of -12.2% in FY19 for earnings because of the divestment of the doors & access systems and a step-up in stranded costs previously allocated to this business. FY20 earnings growth of 9.5% is forecast, largely because these costs will roll off.

Macquarie considers the stock fairly valued, although acknowledges upside if new products in development such as Smart Command can provide further sales growth. Options exist on capital management and provide valuation support along with the dividend yield.

The broker notes the success of the CleanFlush range was evident in the recent results, with sales a 73% and now accounting for around 25% of all toilet sales. Renovations and repair generated 53% of bathroom and kitchen revenue. Management is taking a measured approach to acquisitions, which need to fit in with the water solution strategy and be capable of achieving similar margins to its base business.

Morgans agrees the stock appears fully valued given the growth outlook and has noted a trading update is expected at the AGM in October. The broker forecasts FY19 earnings (EBIT) to be down -10% because of the loss of earnings from the doors & access business as well as higher corporate costs.

Still, the company is estimated to have net cash of $50m at the end of FY19 which would provide plenty of capacity for further investments in growth. In the absence of a compelling M&A deal the broker believes there are opportunities for a buyback or a special dividend.

FNArena's database shows one Buy rating (Credit Suisse) and four Hold for GWA Group. The consensus target is $3.66, signalling 24.1% upside to the last share price. The dividend yield on FY19 and FY20 forecasts is 5.9% and

5.8% respectively.

See also, GWA Expanding Market Opportunity on April 13, 2018.

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Quality vs Value, Bond Yields vs Global Growth

In this week's Weekly Insights:

-Quality vs Value, Bond Yields vs Global Growth -Aged Care: A Royal Disaster Foretold -Rudi Talks -Rudi On TV -Rudi On Tour

Quality vs Value, Bond Yields vs Global Growth

By Rudi Filapek-Vandyck, Editor FNArena

On Monday, AXA Investment Managers held its annual media round table in Sydney which includes open floor conversations with a number of in-house experts who usually operate offshore.

The Global CEO of Rosenberg Equities, essentially the in-house stockbrokerage for the asset manager who thinks and operates globally, Heidi Khashabi Ridley, suggested the house view has now shifted in that increasing exposure to higher quality equities at still reasonable prices seems but the most logical/prudent strategy given the cycle is getting long in the tooth.

Admitting "defensive" today may not necessarily equal "defensive" ten years ago when Fed tightening and an end to the economic cycle triggered an extremely harsh global bear market, the view at Rosenberg Equities is that quality growth at a reasonable price pretty much resembles the best defensive asset in today's context.

Before you ask, Rosenberg Equities' definition of quality is exactly the same as the one key factor that dominates my own research into All-Weather Performers in the Australian share market: it's about the ability, as a corporate organisation, to sustainably grow revenues and profits with relatively little volatility in the uptrend.

One interesting element that rose to the surface during the open conversation between journalists and AXA experts is that research supports the perception that companies of high quality provide lots of numbers and details when issuing guidance and discussing their latest performance with analysts. Companies of lesser quality need to hide behind rather vague statements; or they cannot provide any forward guidance at all.

An equally intriguing piece of research was presented by Kathryn Mohan McDonald, Head of Sustainable Investing at said Rosenberg Equities. According to her latest paper, companies that excel in diversity are better investments than companies with a mere homogenous mono-culture characterised by less diversity.

Findings were based upon extensive data research for the top 1000 companies in the USA, with "diversity" not limited to age or gender, but including cultural backgrounds, levels of education and geographical origin. The AXA research found there is compelling evidence to make the case that more diversity is "economically correct"; it leads to positive outcomes for companies and for their shareholders.

One of the suggestions made is that more diversity in a corporate organisation acts like an "economic moat" in that it might allow the company to engender brand loyalty and encourage innovation. Is this just me, or do I see yet another direct connection to my All-Weather Stocks?

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Asset managers at Morgan Stanley highlight just how tough the overall investment climate has become in 2018. Very few assets have produced a positive return since January 1st, an observation that might have escaped investors in Australia given Australian equities are among the happy few this year.

The picture darkens a whole lot if one adopts the angle of a global investment manager based in the USA. Morgan Stanley keeps track of 17 different assets, ranging from US two-year Treasuries to global high yield bonds, to commodities, the S&P500 and MSCI China, Europe and Emerging Markets.

When measured in US dollars, only three out of the 17 assets (Australia is not included), are in positive return territory as September, calendar month number nine, draws to a close. This balance is not only the worst since the GFC, it is worse than in 2008 in the midst of the GFC!

Back then the basket of assets generating positive return consisted of US 10 year Treasuries, US 2 year Treasuries, the US Aggregate Bond Index and Emerging Markets local debt. Today, the list of assets includes the Russell 2000, the S&P500 and Real Estate Investment Trusts (REITs).

Note Morgan Stanley does not separately include the Dow Jones Industrial Average (DJIA) while the S&P US Aggregate Bond Index is designed to measure the performance of publicly issued US dollar denominated investment-grade debt.

At the very bottom of this year's table of investment returns sit (in order of worsening performance year-to-date) Emerging Market equities (MSCI EM), Emerging Markets local debt and MSCI China. The strategists do not think the timing is right to start buying Emerging Markets equities, but are warming towards local debt in Emerging Markets.

Also, the irony hasn't escaped the strategists the best performing asset class thus far in 2018 -US equities- is also the most historically expensive asset class on the board.

The strategists like the fact that gold has relatively held its own given circumstances and suggest this might bode well for the precious metal moving forward. They note the seasonally challenging period for crude oil ths year coincides with predictions of more tightness in global energy markets.

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One relationship equity investors might want to keep an eye on is the gap between investment grade corporate debt in the USA and 10 year US government bonds ("Treasuries").

Assuming historical patterns apply in today's context, the above mentioned strategists at Morgan Stanley point out since the late 1980s, yields on 10 year Treasuries have tended to peak some eight months after the spread with investment grade credit bottomed. Morgan Stanley suggests the trough in the spread between the two occurred in February this year, and few would argue with that.

Eight months later is about... now. History also suggests US equities subsequently peak around three months later, which takes the timeline to December. There are no iron clad certainties with these historic patterns, but the strategists at Morgan Stanley are certainly keeping their eyes focused on further developments from here onwards.

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The world's focus is on a flattening yield curve in the USA and, in more recent times, on how the yield on 10 year Treasuries has again risen above 3%.

At what point will financial markets genuinely start caring about higher US bond rates? Morgan Stanley strategists point out it's not so much the level in the US bond market that influences other asset classes, as is the level over and above US inflation that matters most.

As such, the strategists make the case that real rates in the US have remained remarkably stable since 2014 and the uptrend since mid-2016 has simply pushed US real yield from the bottom of the range to the top. What happens if there is a real rate break-out?

Morgan Stanley strategists would prefer if the range remained in place with a break-out to the upside suggesting a new regime has started.

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Strategists at Citi seem pretty relaxed about the US bond market (more about this further below) but they are equally not confident there is now opportunity in Emerging Markets equities.

"The question now facing EM is whether the outlook for capital flows is so weak that it requires further increases in interest rates", say the strategists. Their gut feel suggests real interest rates in Emerging Markets need to rise more as the rate differential between EMs and developed countries still remains low by historical standards.

As capital continues to flow out of Emerging Markets, the pressure builds for local central banks to raise official cash rates.

Ultimately, point out the strategists, this means a different form of vulnerability might become evident at some point: growth risks are now pointing to the downside and this might expose growing risks attached to the payability of public debt.

Right now, argues Citi, financial markets are demanding emerging countries shrink their external financing needs. This raises the obvious question of how efficiently countries can meet the new demand?

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Citi strategists remain rather sanguine about the immediate outlook for US equities. Sure, they share the concerns about capex intentions and overall business sentiment, in particular if the Democrats win the mid-term elections, and then there is downward pressure on margins and corporate profitability on the back of rising input costs, including wages, but it has to be pointed out US economic data remain robust and healthy.

It is difficult to see a major correction for US equities when earnings growth is as strong as the current numbers suggest it is, say the strategists.

Having said so, the risks for global growth are to the downside, that much the Citi strategists acknowledge, on a 18 months horizon. And while the risk for inflation is now a little higher, Citi does not see substantial higher inflation ahead. Irrespective, Citi strategists believe investors should keep a close watch on US corporate margins.

Since 2000, point out the strategists, US firms have struggled to pass through higher input costs onto consumers due to structural changes in technology and global online marketplaces.

On Citi's house view, European equities will become the next outperformers until mid-2019, followed by copper and gold, but the forecast remains for ongoing positive return for US equities. The outlook for oil is believed to be negative with Citi's total return projections putting Brent at the bottom of the table.

Citi's relaxed attitude towards growth, risks, inflation and rising bond yields is probably best illustrated by its projection the yield on US ten year Treasuries should revert back to 2.85% with the Federal Reserve to stop tightening at 2.75%-3% which means four more rate hikes, including this month.

In Australia, Citi strategists see more upside from "value" stocks than from "growth" stocks.

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Global assset allocation strategists at JP Morgan are equally of the view that US equities' outperformance is about to end. Investors should prefer non-USD assets instead.

The strategy is conditional though: on the assumption there will be no full-blown escalation in the trade war between the USA and China, and neither will political risks in Washington reach hyper levels, and neither shall the Federal Reserve fail to recognise any of such developments may they arise.

For good measure: JP Morgan is still Overweight US equities but the strategy from here onwards is to gradually start building larger exposure in Emerging Markets equities. If trade tensions ease, as the strategists expect it will, this will also give "value" stocks the opportunity to catch up with secular growth stocks.

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For good measure, I also have to add the recommendation by Malcolm Wood, chief investment officer at Baillieu Holst who seems convinced there is enough evidence to suggest growth in the Australian economy is about to slow down considerably as weaker business confidence, slower consumption from households and the drought will take some -0.6%-0.8% directly off GDP growth.

Wood recently reiterated the view investors should look for Australian Global Leaders; companies that benefit from strong global growth and a weaker Aussie dollar.

Aged Care: A Royal Disaster Foretold

I was asked by another medium to share my thoughts on the local aged care sector in light of the next Royal Commission, as suggested by the new Prime Minister. Below are my contributions.

Question: Aged Care stocks have taken a hammering - do you see this as a buying opportunity?

I do think the recent announcement of a Royal Commission and subsequent sharp share price weakness for ASX-listed providers of aged care facilities and services have exposed one major flaw in share market strategies adhered to by many a value investor; by solely focusing on apparent "undervaluation" and not taking into account this sector was clearly positioned for more public scandals, even without yet another Four Corners expose and the subsequent knee-jerk response by the fresh Prime Minister in Canberra, investors had effectively traded in "corporate quality" for hope that more bad news would remain limited, and thus the impact on the share price would too.

A "cheap" looking share price says nothing about why that might be the case. While it is not always easy to determine why a certain share price is not getting any traction or keeps falling while others are not, I'd argue any investor (or his/her stockbroker or advisor) who at the very least had done some research into this sector should have spotted the risks for investing in this sector. It really should have been obvious.

As per always though, the attractiveness of a "cheap" looking share price always draws in a herd of investors who think "business quality" is but a subjective factor and a low Price-Earnings (PE) ratio and high dividend yield are "hard facts". Well, those investors have once again been proven wrong. Just like they have with plenty of prior examples, ranging from Telstra to iSentia and many others.

If the old adage still applies that value investing knows nothing about timing, then the timing of any sustainable recovery for this sector has now been pushed out, potentially for a considerable time. Those hoping it will ultimately still come good must be patient, possibly for a prolonged time.

Investors holding these stocks for prospective income should be prepared for potential dividend cuts.

Question: What affect do you think the commission could have on the aged care sector from an investor's point of view?

If we take any guidance from what other Royal Commissions have brought to the surface, including the revelations from banks and insurers, we can only assume a Royal investigation into aged care, potentially including retirement homes, can get very, very ugly. Anecdotal stories from adult children whose parents have not or are not been treated well suggests there is abundance in sad stories including rorting the system, understaffing, subpar services, unfair contracts, personal abuse and systemic neglect. This list is by no means exhausted.

Some might claim a Royal Commission will separate the better quality operators from the lower quality peers, and expose the fact the sector is essentially underfunded by belt-tightening governments. Those arguments are valid, but they are merely long-term and do not hide the fact that, short term, there is so much potential for scandal and public outrage, any investor in the sector better have a fortified stomach; all indicators available point towards a situation most likely to get worse before it can get better for the sector overall.

Question: Do you think other analysts will follow Macquarie's lead and downgrade aged care stocks?

Stockbroker ratings are usually very much "value" oriented so the fact share prices already are down a lot since the announcement of a pending Royal Commission, plus the fact this sector was already "cheaply" priced prior because of more regulatory scrutiny and changes in government funding, might prevent more downgrades from following Macquarie's move.

I observe that Macquarie's sharply lowered price targets for listed operators remain well above where share prices are trading. Thus other brokers might be more inclined to equally reduce their short to medium term valuations and price targets, while retaining their Hold or Buy ratings, possibly with an extra tag of Elevated Risk.

Question: Do you think a commission was warranted?

Two things need to be taken into consideration here. Firstly, the Royal Commission into banks and financial services has surprised by revealing many more examples of corporate mischief and unacceptable behaviour than the majority of clients and onlookers had expected. Secondly, we now live in a political era that increasingly favours plain populism.

If we consider the first a "success", then it should not surprise the Federal Government is applying the formula elsewhere. The real surprise will be if there are no more Royal Commissions being called after aged care, which seems poised to be "successful" in the same vein as is the current Royal Commission into banks and financial services. I suggest the local power industry looks like the next easy target.

Rudi Talks

Audio interview from last week Tuesday about the share market in September and the August reporting season:

http://boardroom.media/broadcast/?eid=5ba090ff5bd1e20d13cb7199

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, midday-2pm -Friday, 11.15am, Skype-link to discuss broker calls

Rudi On Tour

-Presentation to AIA members and guests Chatswood, on October 10 -Presentation to ATAA members and guests Sydney, on 18 October -AIA Celebrity Lunch, Brisbane, on November 3

(This story was written on Monday 24th September 2018. It was published on the Monday 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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