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Stories To Read From FNArena

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FNArena
Financial News, Data & Analysis

GPO Box 3145
Sydney NSW 2001

info@fnarena.com

Your editor
Rudi Filapek-Vandyck

Your dedicated team of journo's
Greg Peel
Eva Brocklehurst

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Banks Under Intense Scrutiny As Rates Dive

As a record low cash rate prevails, amid weak consumer and business sentiment and only muted improvements in housing activity, Australia's major banks are being squeezed mercilessly.

-Banks more cautious about offsetting lost income from rate reductions -Rise in mortgages does not mitigate the challenges for banks -Major banks may need to change approaches to capital management

By Eva Brocklehurst

As the Reserve Bank of Australia sends the cash rate to a record low of 0.75%, and the market prices in at least one more cut, the banking sector is increasingly in the spotlight. All the major banks responded to the cut to official rates in October by announcing changes to residential mortgage rates, and all have re-priced investor interest-only loans by more than other lending rates.

Standard variable rates have been reduced in a range of -13-30 basis points in response to the RBA's latest reduction of 25 basis points. Shaw and Partners compares this with cuts in standard variable rates ranging from -43-45 basis points in response to the prior two 25-point reductions to the cash rate.

The banks have clearly become more concerned about their ability to achieve reductions in funding costs in order to offset the lost income. If the RBA continues to cut the cash rate then banks will be confronted with paying less on transaction deposits and that's something they do not want to face, the broker asserts.

If current trends persist, Macquarie deduces there is downside risk to credit growth forecasts. In theory, interest-rate reductions should lift borrowing capacity which, in turn, should be positive for property prices and credit growth.

However, the broker believes APRA's (Australian Prudential Regulatory Authority) requirement to incorporate debt-to-income serviceability limits will become a severe constraint on the banks. The Reserve Bank of New Zealand capital proposals also remain an overhang for the major banks and Macquarie suspects APRA will look to limit capital outflow to New Zealand.

Moreover, the valuation discount in the bank sector of -10%, relative to the long-term average versus the all industrials, only partially incorporates the headwinds, the broker adds.

Weakness Continues

Weakness is expected in the near term, and without a surge in credit supply Morgan Stanley agrees it is unlikely the banks can fully offset margin headwinds. The broker's earnings model for the financial sector continues to deteriorate as rate reductions occur alongside declines in business and consumer sentiment.

Brokers are on the lookout for any unconventional policy given, Morgan Stanley suggests, that to be effective the RBA is likely to focus on bank funding costs. The broker puts the bank sector at Equal-weight, believing the headwinds from the interest-rate cycle are finely balanced by overall dividend yield attraction. Furthermore, the credit pulse is the swing factor in the bank scenario.

Investor approvals have fallen considerably over the past couple of years, JPMorgan notes, tracking the decline in house prices. This would suggest that lowering investor interest-only rates in isolation would be unlikely to produce a response in demand. However, given the recent uplift in house prices, the changes to mortgage rates (the gap between investor interest-only rates and other products has reduced) could provide some support for investor growth in the future.

UBS counters this argument by noting that a lot of good news has already been priced into the banking sector. A pick-up in housing lending may be positive, as industry data indicates mortgage approvals have risen 10% from the lows, but this does not mitigate the increasing challenges faced by banks.

Even if mortgage approvals re-accelerate to levels experienced at the height of the housing bubble, which UBS considers unlikely, housing credit growth will only grow to around 5.5%.

Moreover, the benefit to bank revenues would be offset by interest margin pressure given the rate reductions required to re-stimulate the housing market to these levels. With ongoing revenue pressure, UBS expects further dividend reductions and banks to re-base their target returns on equity to more realistic levels.

JPMorgan also points out the changes in bank mortgage rates reflect increasingly large inflexible deposit balances, noting Commonwealth Bank ((CBA)) referenced $160bn of deposits for which the full rate reduction could not be passed on.

Which Bank?

Morgan Stanley asserts the major banks will need to go further and change their approach to capital management, targeting higher capital levels and lower pay-out ratios. This stems from more onerous capital requirements from both APRA and the RBNZ. Moreover, each of the four are likely to respond differently in terms of dividends, reinvestment plans and buybacks.

For ANZ Bank ((ANZ)), the broker expects a -10% reduction in dividend in FY20 and no buybacks. ANZ appears the most affected by the RBNZ proposals. Morgan Stanley has upgraded its rating to Equal-weight, noting the bank has underperformed other major banks by -5-10% over the past six months. Investor expectations may be low but the challenges are understood and the broker suggests the relative PE (price/earnings) multiple provide some support.

Shaw and Partners points out ANZ's performance in terms of investor loans has been particularly poor and the bank still has the highest investor interest-only mortgage rates, signalling market share in these loans is likely to continue to slide.

Westpac Bank ((WBC)) is likely to cut the dividend by -15% in the second half of FY19 and underwrite the dividend reinvestment plan to raise $2bn in capital, Morgan Stanley asserts, as it has the highest pay-out ratio and a pro forma CET1 ratio of less than 10.5%.

A flat dividend and $2bn in future buybacks (down from $3bn) is forecast for Commonwealth Bank and Morgan Stanley expects the board will look to hold the dividend steady, given a relatively strong capital position.

Morgan Stanley has downgraded its rating for National Australia Bank ((NAB)) to Underweight becomes number four in the order of preference, as the outlook for revenue is deteriorating and further reinvestment is probably required. The broker suspects the bank will continue to use the dividend reinvestment plan to build capital and there is a risk of another dividend reduction in FY20.

NAB has recently announced additional remediation charges of $1.19bn, bringing its overall remediation provision in FY19 to $2bn. Macquarie considers these charges are low-quality items and, while not incorporating them directly in valuation, acknowledges prior conservative estimates have proven to be consistently low. Hence there is the risk of more remediation beyond FY19.

Recognising the capital implications, and the pending impost from RBNZ, the broker increasingly envisages a need for National Australia Bank to lift its CET1 capital, likely via underwritten dividend reinvestment plans. This will make it difficult to grow earnings.

Morgans forecasts a discounted dividend reinvestment plan in respect of the bank's 2019 final dividend and has always suspected that the rally in the share price since the reduction in the dividend in May was unjustified.

UBS assesses it will take some time for National Australia Bank to rebuild confidence but remains encouraged by the new executive team, agreeing nonetheless the outlook is increasingly challenged in an ultra-low interest rate environment, and the earnings risk appears heavily skewed to the downside.

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Cash Squeeze Looms For Specialist Platforms

Specialist fund platforms continue to benefit from disruption, taking business from the majors, but brokers point out a squeeze on cash accounts looms large amid further cuts to official interest rates.

-Large platforms carry uncertainties around remediation and regulatory actions -Yet small platforms face elevated margin pressure -And downside risk to pricing as cash rates head lower

By Eva Brocklehurst

Trends in flows on specialty fund platforms remain highly divergent and June 2019 represented the fourth consecutive quarter of outflows for the industry. Previously, inflows occurred in every quarter for the past 15 years. with one small quarterly exception in 2012.

However, Credit Suisse points out June quarter outflows were less severe than in the prior quarter, which was the lowest in the 15-year time series. All funds experienced growth in funds under administration, with the slowest being assets in retail funds. Industry funds received around 90% of total net flows.

Recent themes continue, including major banks and AMP ((AMP)) losing share to industry funds and specialists. Retail funds lost -1.1% in market share over the quarter, the biggest market share loss in the broker's time series since 2005.

Specialist platforms such as Netwealth Group ((NWL)), HUB24 ((HUB)), Praemium ((PPS)), OneVue ((OVH)) and Xplore Wealth ((XPL)), have increased total market share to 5.5% as of June. Netwealth and HUB24, which have wider broker coverage, gained 0.18% and 0.11% market share, respectively.

Those large cap platforms that retreated include AMP, down -0.19%, and National Australia Bank ((NAB)), down -0.11%. Flows into personal superannuation products also now exceed those into investment products.

Another contributor to net flows is the benefit payments from pension phase accounts. Retail funds are experiencing benefit payments, Credit Suisse observes, at levels 75% above industry funds. Around 34% of retail funds under administration are in the pension, or drawdown, phase, while only 10% of industry funds are at the same stage.

Meanwhile, in 2019 to date there has been a -12% decline in total financial advisers. HUB24 and Netwealth continue to benefit from disruption in the market and industry funds remain beneficiaries of the bulk of money, as retail platforms compete over fees and the small residual flow.

Large-capitalised platforms, such as IOOF Holdings ((IFL)) and AMP offer valuation appeal, Credit Suisse suggests, but also carry uncertainties around remediation costs and the impact of regulatory actions. On the other hand, small-cap platforms, such as HUB24 and Netwealth, face elevated revenue margin pressure. Hence, the broker prefers the large caps.

UBS expects Netwealth, as a percentage of assets under management, and Magellan Financial Group ((MFG)) will lead the way in terms of net flows among fund managers, while IOOF will also experience positive flows. Assets under management for both Netwealth and IOOF are likely to be boosted by stronger equity markets, in the broker's view.

Netwealth and HUB24 net flows should continue growing, Citi asserts, driven by market share gains as well as an improvement in adviser activity. Both remain beneficiaries of the structural shift to specialty platforms, but there is downside risk to overall pricing as cash rates head lower.

Rate Cuts

Citi points out interest rates on platform cash accounts have been lowered by -25 basis points in line with the cut to the Reserve Bank of Australia's official rates. Netwealth, HUB24 and BT Panorama have all lowered rates, and margins remain at risk from any further reduction to the cash rate.

Citi economists expect the RBA to cut by another -25 basis points in February 2020 and, technically, Netwealth and HUB24 could maintain the cash margins by lowering the rate on cash accounts to zero. Forecasts assume a -15 basis points impact on cash administration margins from the fourth quarter of 2020 onwards.

The reduction in the official cash rate leaves a majority of account holders on HUB24 and Netwealth platforms with negative cash returns, net of administration fees. Macquarie envisages little ability to offset the impact, and calculates sensitivities for an annualised -25 basis points squeeze on cash FY20 earnings per share of -14% for HUB24 and -9% for Netwealth.

Classifying pooled capital as retail deposits also represents additional downside risk for the specialty platform providers. HUB24 and Netwealth offer higher risk in this regard relative to other industry platforms. The broker reminds investors that Netwealth in FY19 generated operating earnings margins of 52.6% for a 2.5% market share.

Macquarie remains concerned about the sustainability of cash spreads and associated fees and also believes macro conditions present unprecedented pressure for platforms.

Credit Suisse points out cash administration fees are significant contributors to Netwealth and HUB24 earnings. This makes them very sensitive to cash allocations. The broker expects cash administration fees will face pressure over the long-term as allocations decline and advisers look to use cash alternatives, such as term deposits and cash ETFs (exchange traded funds), that have a similar risk profile but better returns.

On the FNArena database Morgans covers Praemium, with an Add rating and $0.59 target. Netwealth Group has one Buy, for capital and one Sell rating. The consensus target is $7.68 signalling -13.9% downside to the last share price. HUB24 has one Buy rating, three Hold and one Sell. The consensus target is $12.44, suggesting 4.7% upside to the last share price.

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Headwinds Prevail For Flight Centre

While corporate travel and online growth underpin Flight Centre, the leisure business is mired in several uncertainties and profit is expected to decline in the first half.

-Corporate earnings growth stable, online leisure sales double -Is the potential in Europe underappreciated? -Scaling up of corporate, home-based and online offering in Australia to provide most upside

By Eva Brocklehurst

The earnings trough has deepened for Flight Centre ((FLT)), amid increased volatility in offshore markets and lower interest earnings. There have also been increased costs from the implementation of the enterprise bargaining agreement. On the bright side, corporate travel has continued to deliver stable earnings growth and online leisure sales have doubled during the September quarter, despite relatively challenging trading.

Flight Centre has provided a trading update, indicating first half pre-tax profit will decline. UBS, having already factored in a decline, trims forecasts further to allow for a -5% reduction. Management expects a strong rebound in the second half, given the usual skew. UBS now forecasts 8% FY20 pre-tax profit growth and a three-year compound growth rate for FY20-23 of around 10%.

Citi continues to envisage a return to growth in the second half as several one-off factors disappear. Pre-tax profit is forecast to decline by -6% in the first half which is the fourth consecutive half of declines. Flight Centre has not yet shared in the boost from tax stimulus and interest-rate reductions but brokers acknowledge the visibility into the second quarter earnings is quite limited at this stage.

Citi downgrades FY20 and FY21 pre-tax profit expectations by -8% and -7%, respectively, to factor in a slower recovery in Australian leisure and a moderation of growth in the offshore business. Costs associated with the collapse of Thomas Cook are also factored in. Citi does not expect Flight Centre to reach its 2% pre-tax profit margin until FY25, given a slower-than-expected recovery in Australian leisure.

Morgan Stanley also anticipates the second half will be assisted by easier comparisons and, beyond this, the company will benefit as overseas markets improve and from any upside associated with recent rate reductions and tax refunds domestically. The broker points out the critical booking period, which commences late January, will be important for shedding further light on the full year outlook.

Offshore

Offshore business, which has been a major source of growth previously, is likely to moderate in FY20 in the absence of acquisitions, Credit Suisse assesses. The year is also likely to be affected by Brexit, the unrest in Hong Kong and uncertainty in the US (safety concerns in the Dominican Republic have affected travel to a key destination for the US leisure business).

Corporate upside is partially supported by the acquisition of 3 Mundi in France and its inclusion contributes nearly half of the pre-tax profit improvement the broker assumes for the corporate channel. The remainder of assumed growth is achieved in the Americas.

Credit Suisse also believes the company's position in Europe is not widely appreciated. To date very little corporate travel has been originated by Flight Centre in Europe but the experience in North America is considered a helpful indicator of the potential.

Australia

Trading conditions deteriorated significantly in Australia in the first four months and Credit Suisse suspects debate around the sustainability of the company's shop network is likely to intensify. Home-based consulting and strong online growth are believed by many to be impacting on the shop network. Yet Credit Suisse disagrees, and asserts that while there will be a need to accelerate the transition in channels, the shop cost base can be reduced with a manageable impact on profit.

Upside stems from the fact Flight Centre operates one of the largest online travel booking businesses in Australia, surprising Credit Suisse with the speed of growth, and the home-based and corporate channels are also growing rapidly. Moreover, the broker points out the latter two channels have a significantly higher pre-tax margin versus the leisure business.

Credit Suisse upgrades to Outperform from Neutral, estimating a wide potential guidance range for pre-tax profit of $332-382m in FY20 and assuming no transaction growth from the shops but a benefit from the stabilisation of the net revenue margin.

Nevertheless, online sales represent a relatively small percentage of the company's leisure travel transactions, Shaw and Partners notes. The broker, not one of the seven stockbrokers monitored daily on the FNArena database, goes the other way and downgrades to Hold from Buy, ahead of the expected FY20 guidance at the AGM on November 7.

The business is diversified and strong, UBS concludes. Moreover, the market is not paying for the penetration and scaling up of the online offer in Australia. The broker does not consider the update overly negative in the context of strong top-line online growth and the undemanding multiple implied for Australasian leisure.

There are six Buy ratings and two Hold on FNArena's database. The consensus target is $49.07, signalling 20.2% upside to the last share price. Targets range from $43.50 (Morgans, yet to comment on the trading update) to $54.10 (UBS). The dividend yield on FY20 and FY21 forecasts is 4.0% and 4.6% respectively.

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Orora Increases Exposure To North America

Most brokers believe Orora has made the right decision to sell its Australasian fibre business to Nippon Paper, although this increases its exposure to North America.

-Could private equity take a look or further asset sales ensue? -Canned beverage business is growing versus glass -Capital return expected upon completion of transaction

By Eva Brocklehurst

Packaging business Orora ((ORA)) has found the right buyer and the right price for its Australasian fibre business, assessing the offer is at a premium to comparable transactions and in the best interests of shareholders.

The sale to Nippon Paper for $1.72bn exits a mature business and removes a lower-margin/return operation from the portfolio. The deal also reduces the company's footprint in Australasia to beverage packaging, which accounted for around $170m in earnings in FY19.

Citi considers this move strategically and financially positive, with the low likelihood of another offer probably why management considered Nippon Paper made a compelling proposition. Brokers await the company's AGM on October 14 for further details on the outlook for the remaining business.

The sale of the business means private equity, and others, could be taking a look at Orora's remaining assets, Credit Suisse asserts. The company will be left with a higher-quality beverage operation, which principally operates in glass and cans.

These are two areas where private equity could scrape a pre-tax free cash yield of 6%, which the broker calculates is "not bad" given Australian bonds are at sub-1% levels.

The broker assesses the stock in the light of this potential, and upgrades to Outperform from Neutral. Nevertheless,earnings estimates are reduced, with Credit Suisse suspecting weakness on the back of a soft US manufacturing survey and questioning whether the company's statement that "initiatives were being implemented to deliver earnings growth" means that earnings are not growing.

The operating environment is making it difficult to integrate the Pollock and Bronco acquisitions, in the broker's opinion. That said, Credit Suisse acknowledges management does not want to break up the company and will not run an asset sale program, although investors may price further asset sales into the stock.

The Australasian beverage business is growing as the company's major beer customer, Carlton United Brewery, has been migrating customers to cans from glass. There is also growth in non-alcoholic canned beverages.

Citi believes the company will be well-placed to benefit from potential substrate switching to metal cans or glass from plastic. Glass is constrained by capacity and Australian wine export growth is flat, although Credit Suisse notes a cost reduction program should provide growth into FY21. Moreover, the broker ascertains the company's rival would need to put in substantial new capacity to win over any of its glass customers.

Capital Return

The company intends to return $1.2bn to shareholders through the most efficient capital management initiatives. The transaction, netting $1.55bn, is expected to complete early in 2020, following customary conditions such as regulatory approvals, with returns envisaged likely in the first half of FY21.

Ord Minnett assumes the transaction closes in January 2020 and $1.2bn is returned to shareholders via special dividend while UBS considers the most likely option is a combination of a special dividend and share buyback

The company has also signalled an intention to maintain an investment grade credit rating with a leverage ratio of between 2.0x and 2.5x.

North America

Morgan Stanley believes the sale provide significant scope for capital management but also increases the exposure to North American earnings risk. Assuming the transaction is completed, North America would make up 40% of the company's earnings (EBIT) an increase from 32% in FY19, the broker calculates.

North America remains of concern as earnings margins fell -90 basis points in the FY19 results, to 4.5%. Morgan Stanley expects margins to remain subdued at around 4.6% in FY20 before increasing to 5.0% in FY21.

Ord Minnett takes a similar view, notinging the quality of the portfolio has been diluted by the fact North American business now represents close to half of group earnings. Hence, the broker's rating is downgraded to Hold from Accumulate. Ord Minnett assumes the transaction closes in January 2020 and $1.2bn is returned to shareholders via special dividend.

FNArena's database has two Buy ratings and four Hold. The consensus target is $3.15, suggesting 3.5% upside to the last share price. Targets range from $2.97 (Morgans, yet to comment on the transaction) to $3.40 (Credit Suisse).

Disclaimer: The writer has shares in the company.

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The Later United States Empire

By Richard (Rick) Mills Ahead of the Herd

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

The Later United States Empire

In 1917, the United States created the federal debt limit (or ceiling) to make it easier to finance World War One, essentially allowing Congress to borrow money to pay for the war effort by issuing bonds.

By 1939 with World War Two looming, Congress passed the first aggregate debt limit, but it meant little. For nearly 60 more years the debt ceiling caused nary a ripple, until 2011 when Congress delayed approval of the annual budget, nearly causing a government shutdown. Then a minority in the House of Representatives, Republicans balked at the [US]$1.3 trillion deficit, the third largest in history, so Democrats suggested a $1.7 billion cut in defense spending, since the war in Iraq was winding down. The GOP wouldn't agree to that, instead offering $61 billion in non-defense cuts including Obamacare. Finally the two sides agreed on $81 billion worth of cuts.

But that wasn't the end of it. When Standard & Poor's lowered its outlook on whether the US would pay back its debt to "negative", all hell broke loose. Suddenly there was the prospect of the Treasury Department being unable to borrow to pay ongoing expenses, like issuing Social Security checks to vulnerable seniors. Worse, if the Treasury couldn't borrow to pay interest on the debt, the US might have to default, which would crash financial markets and plummet the dollar, the world's reserve currency.

While Standard & Poor's did lower the US credit rating from AAA to AA+, sending a shock through stock markets, Congress managed to agree to raise the debt ceiling to $16.694 trillion. An expected drop in demand for US Treasuries didn't happen, nor did interest rates spike, in fact they fell to 200-year lows in 2012.

Since then there have been repeated, and dramatic, clashes over raising the debt ceiling, which is now being used regularly as a political tool to exact budgetary concessions, rather than its intended purpose, to keep a lid on government spending.

2019 was no exception. At the end of December, 2017, Congress hit an impasse over President Trump's demand for $5.7 billion in federal funds, for a US-Mexico border wall. Trump and the Congress disagreed on an appropriations bill to fund the government for the 2019 fiscal year, or even a resolution to extend passage of the bill. Without appropriations legislation in place, nine executive departments totaling around 800,000 employees were shut down partially or in full. This affected about one-quarter of all government activities. Employees were either furloughed or required to work without pay. The 35-day shutdown was the longest in US history.

The impasse was broken in January 2019 by Trump who finally agreed to a temporary spending deal that did not include $5.7 billion for a wall. In July the House Speaker, Nancy Pelosi, and Senate Minority Leader Chuck Schumer announced a budget deal that raised US discretionary spending to $1.37 trillion in the fiscal year 2020, from $1.32 trillion in 2019, thus avoiding a debt default.

I thought the debt ceiling drama was behind us but the subject surfaced again while checking Wolf Street earlier this week. An article pointed to a report by the US Treasury saying that the US gross national debt jumped by $110 billion in the last two business days of fiscal 2019, and increased $1.2 trillion for the whole year. "This ballooned the US gross national debt to a vertigo-inducing $22.72 trillion," the article states.

We also learn the debt grew by 5.6% in 2019 and now amounts to 106.5% of GDP, an increase from the 105.4% debt-to-GDP at the end of fiscal 2018.

US Gross National Debt Jumps $1.2T in Fiscal 2019, to $22.7T

This is graphically - literally and figuratively - displayed in Wolf Street's US gross national debt chart, showing the debt climbing steadily from around $15.4 trillion to its current $22 trillion in just seven years. Every year is marked by a new "stair", indicating permission granted to raise the debt ceiling to pay for expenditures from money the US will have to borrow. It is the epitome of an unsustainable business model - the equivalent of losing money every year, and repeatedly asking the bank to fund your failing enterprise. Eventually the bank is going to say no.

From 2012, the end of the Great Recession, to 2016, the gross national debt climbed, on average, by $947 billion a year. Between 2018 and 2019 the increases averaged $1.23 trillion per year.

The only reason the US has gotten away with it so far is because the US dollar is the reserve currency. Everyone knows if America were to default on its debt, the entire financial system that is based on the US dollar would collapse. The US national debt really is “too big to fail.”

Doomed empires

How did we get here? Well, history is marked by empire after empire that has over-extended itself, militarily; the US is no different.

When the Romans gobbled up Egypt, Judea, Britain and Gaul, the Roman Empire became stretched, with long supply lines requiring more money to maintain. At the beginning of the empire the denarius currency was of high purity, containing about 4.5 grams of silver. However the amount of gold and silver available was limited. When it started to get mined out, the Treasury could no longer meet its expenses. Roman officials though found a way to work around this: by decreasing the purity of the coinage, they could make more coins with the same face value, allowing the government to spend more. But not indefinitely.

At the time of Emperor Marcus Aurelius, the denarius dropped to about 75% silver. Sixty years later, it had been significantly debased, with barely 5% silver, the rest bronze. By 265 AD, during the reign of Gallienus, coins only had 0.5% silver in them, meaning it took many more coins to purchase the same amount of goods.

The lower-valued currency also hit the Treasury hard. Its response was to levy steep taxes on the population, leading to political chaos; during the 3rd century there were over 50 emperors, with most murdered, killed in battle or assassinated. With prices inflated by 1,000%, trade ground to a halt, replaced by a primitive barter system. From there the Roman Empire split into three states, weakening it. For the next 200 years barbarians invaded from all directions, killing many Romans in battles or through transmission of plagues. By 476 AD the Roman Empire was dead.

Great Britain also found currency devaluation coincided with the end of its dominion, despite the saying “The sun never sets on the British Empire.”

During the 19th century the importance of the British pound, the world’s oldest currency still in use, grew in relation to Britain’s status in the world. In fact the pound, then the world’s reserve currency, occupied the same place in the global economy as the US dollar does today - even more considering de-dollarization.

As explained by NPR:

During the reign of Queen Victoria, Britain became a major commercial and industrial center. British capital financed railroads in India and Australia, shipping ports in Asia and cotton plantations in the United States. The pound could be used to buy and sell anywhere on Earth.

However the need to maintain far-flung colonies in Africa, India, Southeast Asia, Australia and Canada, drained the government’s purse. After two world wars, especially the extremely costly World War One, Britain’s status in the world declined, along with the value of the pound, symbolized by most of its colonies gaining independence in the early to mid-20th century.

A warring nation

The Roman and British empires were underpinned by strong militaries that both expanded territories and defended them. The same can be said for other empires throughout history - the Akkadians, Vikings, Greeks, Gauls, Spanish, Portuguese and Soviets, to name a few, all seized power by conquering or seizing other lands.

The United States since World War Two has been the bully on the global block - challenged but not yet surpassed in economic nor military power.

World domination however comes at a heavy price to the national budget. Military spending is the main reason for the spiraling debt over the past few years; as a line item, it is second only to Social Security.

Last year President Trump signed off on a huge increase in defense spending. The 2019 National Defense Spending Authorization Act, with a budget of $717 billion, raises America’s troop levels to the highest in a decade. The NDSAA allocated $616.9 billion for the Pentagon, $69 billion for overseas operations and $21.9 billion for nuclear weapons programs.

Among the big-ticket items set out in the act are 77 F-35 Joint Strike Fighters, of which Turkey will receive two of the new jets, $85 billion for the Black Hawk helicopter program, $1.5 billion for littoral combat ships and funding for the Air Force’s new long-range stealth B-21 bomber.

At the time Trump called it the “most significant investment in our military and our war fighters in modern history.”

Big spender

According to the Stockholm International Peace Research Institute (Sipri), as the largest military in the world by far, the US has spent an average $650 billion every year since 2010. It spends more on defense than the next nine countries combined.

Of this amount, $400 billion is earmarked for nuclear weapons between 2017 and 2026, which is an increase of $52 billion from the previous 10-year estimate of $348 billion, according to a Congressional Budget Office report.

This year estimated US military spending is $892 billion. However a number of items are not in the actual Department of Defense budget, which can be misleading. For example the DoD budget does not include nuclear weapons spending, black ops, interest on the defense portion of the debt and ongoing spending obligations to veterans. The budget for nuclear weapons falls under the Department of Energy. Other military expenses - care for veterans, health care, military training, military aid and secret operations – are put under other departments or are accounted for separately.

Adding all these items together, actual defense spending is more like $1.2 trillion - around the same amount of new debt that was heaped onto the national debt this year.

Military-industrial complex

Not only does the US have easily the most powerful military with enough weapons to destroy the world many times over - about 6,550 at last count, compared to Russia's approximate 6,800 - it is also the biggest arms dealer.

The US now exports 34% of global arms sales. US arms sales are rising as Russia's, the next largest arms dealer, are falling.

Indeed military spending is big business - the "military-industrial complex", a term coined by President Eisenhower, is thriving.

Democrats may call for a shift in priorities away from defense, but cuts are unlikely to happen due to the inertia of military spending that US defense contractors and the United States' allies have grown used to.

The Washington Post recently published an article that examined this long-running nexus between defense and industry. It found that networks have expanded well beyond traditional "corporate giants bending metal for the Pentagon." For example since 9/11, more agencies are involved in national security, stemming from the Department of Homeland Security's creation in 2002-03. Large defense contractors like Lockheed Martin and General Dynamics now deliver a wider range of goods and services to the federal government. WAPO summarizes:

Since 9/11, an increasingly diverse array of firms have a significant stake in federal national security spending. Those funds now flow from a large portion of the federal government and into many sectors of the U.S. economy. If anything, Eisenhower's complex has become more complex and potentially influential.

Winter is coming

Of course, the United States isn't the only nation sitting under an immense pile of debt. As debtor nations go, it's actually around the middle of the pack, in terms of debt-to-GDP ratio. Economists frequently refer to two metrics that reflect a country's ability to pay for its liabilities: the gross national debt and the debt-to-GDP ratio.

Debt to GDP is the ratio comparing what a country owes to what it produces, on an annual basis. A country that is able to continually pay the interest on its debt without refinancing or hindering its economic growth is generally considered stable. The problem with highly-indebted nations is that creditors (ie. banks and sovereign bond holders) are apt to seek higher interest rates for loaning to countries deemed to be at higher risk of meeting interest payments.

A country with exceedingly high debt may be refused loans altogether.

According to a World Bank study, countries whose debt-to-GDP ratios are above 77% for long periods (remember the US's is at 106.5%) experience significant slowdowns in economic growth. Every percentage point above 77% knocks 1.7% off GDP, according to the study, via Investopedia.

Conclusion

Everybody these days has a credit card, and most people have more than one. Over-doing it on "the plastic" is curtailed by outrageously high interest rates. Failure to pay the balance each month results in mounting interest charges.

If the US government were to operate like a household, any harmony that existed would abruptly turn into a domestic upon receipt of the Visa bill. You can't spend more than you make. Ok maybe for a while, but eventually, the bank will restrict your right to borrow. The United States doesn't have to adhere to this basic financial rule because it runs on the world's reserve currency. If expenses exceed revenues, all the central bank has to do is print more money – inflation be damned. Even in 2011, when the country came within a whisker of declaring bankruptcy, investors still rushed out and bought Treasuries, ironically, as a safe haven against a US default.

Washington needs to stop kicking the can down the road and take a hard look at its expenditures. Does the military really need to maintain 700 bases? How many more nuclear weapons are needed to destroy the world? There are already enough to nuke every living thing several times over. Or at least, be honest with the public as to how much is actually being spent on the military. Break it down for us, instead of hiding it.

The US could learn a lot from what happened to Rome; debasement of its currency spelt the beginning of the end of the Roman Empire.

Since the US Federal Reserve was created in 1913, the dollar has lost 95% of its value. Over a hundred years ago a buck was worth a buck; in 2013 it was valued at 5 cents – its worth eroded by inflation - just like the Roman denarius.

Some wise words were written by Huffington Post columnist William Astore, a history professor and retired US Air Force lieutenant colonel. He quotes classicist Steven Willett who sounded a warning to "US militarists and imperialists," stating:

My personal concern is the misallocation of our resources in futile wars and global military hegemony. We are acting under the false belief that the military can and should be used as a foreign policy tool. The end of US militarism is bankruptcy. I agree with [Andrew] Bacevich's recommendation that the US cut military spending 6% a year for 10 years. The result would be a robust defensive military with more freed-up resources for infrastructure, education, research and alternative energy. Our so-called defense budget is a massive example of what economists call an opportunity cost.

The US is now about where Rome was in the third to fourth centuries. In his magisterial study The Later Roman Empire, 284-602: A Social, Economic, and Administrative Survey," A. H. M. Jones shows what a drain the army was on the [economy of Rome]. By the third to fifth centuries, the army numbered about 650,000 scattered along the limes and stationed at central strategic locations. It took most of the state's revenues, which had long been declining as the economy in the west declined. And even that 650,000 was far too small for adequate defense of the [Roman] empire.

Military spending feeds into the debt "death spiral" the US finds itself in. But while some fret over the unsustainably high level of indebtedness, others look for opportunity; one obvious beneficiary has been gold.

Investors love gold because it tends to hold its value through time. They see gold as a way to preserve their wealth, unlike paper or "fiat" currencies which are subject to inflationary pressures and over time, lose their value.

And they observe rising levels of US debt as a major deterrent in raising interest rates; the Fed has lowered rates by a total of 0.5% at its last two meetings - a low-rate environment is likely to continue for the foreseeable future, considering the economic uncertainty both globally and domestically.

Naturally I follow the usual factors that influence gold prices: the US dollar, bond yields, interest rates, inflation, ETF inflows/ outflows, central bank bullion purchases, safe haven demand, etc. A lower gold price before and during China's Golden Week is an established trend going back seven years, as is the upward price acceleration just after the week ends.

An environment tailor-made for gold investments is being created.

Richard (Rick) Mills

rick@aheadoftheherd.com

Richard is the owner of Aheadoftheherd.com and invests in the junior resource/bio-tech sectors. His articles have been published on over 400 websites, including:

WallStreetJournal, USAToday, NationalPost, Lewrockwell, MontrealGazette, VancouverSun, CBSnews, HuffingtonPost, Londonthenews, Wealthwire, CalgaryHerald, Forbes, Dallasnews, SGTReport, Vantagewire, Indiatimes, ninemsn, ibtimes and the Association of Mining Analysts.

If you're interested in learning more about the junior resource and bio-med sectors, and quality individual company's within these sectors, please come and visit us at www.aheadoftheherd.com

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

Weekly Ratings, Targets, Forecast Changes - 04-10-19

By Rudi Filapek-Vandyck, Editor FNArena

Guide:

The FNArena database tabulates the views of seven major Australian and international stock brokers: Citi, Credit Suisse, 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 30 to Friday October 4, 2019 Total Upgrades: 4 Total Downgrades: 10 Net Ratings Breakdown: Buy 37.91%; Hold 45.60%; Sell 16.48%

The Australian share market continues to be hit by macro threats and challenges, and by stockbroking analysts issuing more downgrades than upgrades for individual ASX-listed entities.

For the week ending Friday, 4th October 2019, FNArena registered four upgrades and ten downgrades. Only two upgrades went up to Buy (CSL and Nufarm), while six downgrades moved to Sell.

Among the stocks receiving fresh Sell ratings are Alumina ltd, Fortescue Metals (2x) and Western Areas. There is a theme in here that has been in place for several weeks now. Ahead of the banking reporting season, National Australia Bank was downgraded to Sell as well.

Not much is happening in the week's overview for positive revisions to target prices, with Nufarm sitting on top, well ahead of the few others. The flipside equally shows little action with Webjet and South32 the only ones worth mentioning.

Very few companies are enjoying upgrades to analysts' earnings forecasts, but Fonterra and Nufarm are two of the week's lucky ones. Unfortunately, there is a lot more happening on the negative side, where forecasts are slipping lower. The week's biggest reduction is for Sims Metal Management, followed by National Australia Bank, Coronado Global Resources, Orocobre, Whitehaven Coal, and New Hope Corp.

I am sure readers don't need my assistance to detect the underlying theme. Global growth worries are now front and centre of investors' attention.

Upgrade

AUSTRALIA & NEW ZEALAND BANKING GROUP ((ANZ)) Upgrade to Equal-weight from Underweight by Morgan Stanley .B/H/S: 1/5/1

ANZ Bank has underperformed other major banks over the past six months and Morgan Stanley observes investor expectations are low while key challenges are understood. The broker raises the stock to number two in order of preference and upgrades to Equal-weight from Underweight.

The broker still envisages revenue and earnings risk amid execution challenges following three years of cost cutting. Target is raised to $26.00 from $25.80. Industry view: In-Line.

CSL LIMITED ((CSL)) Upgrade to Overweight from Equal-weight by Morgan Stanley .B/H/S: 4/3/0

Morgan Stanley observes tight immunoglobulin market conditions have absorbed the company's accelerating supply, leaving upside risk to FY20 guidance.

Given low inventory and strong patient demand, the broker expects immunoglobulin volume to accelerate 16% in FY20 as the collection strategy evolves.

Longer-term, the broker is even more convinced about disruption but considers this is unlikely until FY22. Rating is upgraded to Overweight from Equal-weight and the target raised to $251 from $220. Industry view: In-Line.

MAYNE PHARMA GROUP LIMITED ((MYX)) Upgrade to Neutral from Underperform by Macquarie .B/H/S: 0/4/0

The company has announced a supply and license agreement with Mithra for the commercialisation of a combined oral contraceptive. Macquarie assesses the agreement provides an opportunity for both growth and diversification of earnings over the medium to longer term.

Management estimates potential peak sales of the contraceptive of US$200m and the expected launch is in the first half of 2021, subject to US FDA approval.

With an implied shareholder return of 5% based on a revised target price, the broker upgrades to Neutral from Underperform. Target is raised to $0.66 from $0.51.

NUFARM LIMITED ((NUF)) Upgrade to Outperform from Neutral by Macquarie .B/H/S: 3/2/0

No surprises from the Nufarm FY19 result given the company kept the market well-informed. The surprise came with the sale of the LatAm business, which had been soaking up 33% of working capital while representing 28% of earnings, suffering negative cash flow for the last five years and exposed currency risk, at what Macquarie describes as a "good price".

Significantly, the sale reduces debt to a comfortable level at this difficult time. The broker has subtracted LatAm earnings forecasts but lifted its target to $6.56 from $5.30, noting the stock trades at an enterprise value discount to global peers and the market is ascribing no value to Omega-3. The sale also increases Nufarm's leverage to improved seasonal conditions in Australia. Upgrade to Outperform.

Downgrade

ALUMINA LIMITED ((AWC)) Downgrade to Sell from Neutral by UBS .B/H/S: 2/2/2

A general update on the mining sector, including re-adjusting forecasts for metals and minerals, has led to a downgrade for Alumina ltd to Sell from Neutral. UBS is anticipating a subdued environment leading into 2020 with gold the sole exception.

UBS analysts are not expecting any recovery in prices in the absence of better demand an/or producers curtailing output. Target price remains unchanged at $2.10.

FAR LIMITED ((FAR)) Downgrade to Equal-weight from Overweight by Morgan Stanley .B/H/S: 1/1/0

Morgan Stanley observes the stock price continues to drift, amid uncertainty around project timing, funding and arbitration hearings. Rating is downgraded to Equal-weight from Overweight.

The quality of the project in Senegal remains high and there is significant upside envisaged by the broker over time, depending on how the company finances its share of the asset.

The broker sets the target to $0.06 from $0.10 to reflect the risks around funding. Industry view is In-Line.

FORTESCUE METALS GROUP LTD ((FMG)) Downgrade to Underperform from Neutral by Credit Suisse and Downgrade to Sell from Neutral by UBS .B/H/S: 2/1/4

Credit Suisse has downgraded iron ore forecasts for the second half of 2020 by -12% and for 2021 by -13%. The broker downgrades to Underperform from Neutral, given the recent share price strength.

However, this is largely a call on the commodity outlook, as it will be difficult for the stock to outperform in a falling price environment.

That said, the company has shown a willingness to return funds to shareholders and there are two projects driving organic growth, Credit Suisse acknowledges. Target is reduced to $7.50 from $8.00.

A general update on the mining sector, including re-adjusting forecasts for metals and minerals, has led to a downgrade for Fortescue Metals to Sell from Neutral. UBS is anticipating a subdued environment leading into 2020 with gold the sole exception.

UBS analysts are not expecting any recovery in prices in the absence of better demand an/or producers curtailing output. Price target for Fortescue has improved to $7.50 from $6.40.

LENDLEASE GROUP ((LLC)) Downgrade to Neutral from Buy by UBS .B/H/S: 4/1/0

UBS downgrades to Neutral from Buy, believing risks are now more balanced. The broker assesses the market is pricing in a solid outcome for the sale of the engineering & services business.

However, net sale proceeds could be materially lower than the market expects, in the broker's opinion, given the higher-than-expected negative working capital balance in that division. Target is raised to $17.50 from $16.30.

NATIONAL AUSTRALIA BANK LIMITED ((NAB)) Downgrade to Underweight from Equal-weight by Morgan Stanley .B/H/S: 2/3/2

Additional remediation announced by National Australia Bank, all else being equal, will reduce Morgan Stanley's cash profit forecasts by -24% for the second half of FY19 and by -12% for FY19 overall.

Morgan Stanley moves National Australia Bank to number four in its major bank order of preference, believing the outlook for revenue is deteriorating. Rating is downgraded to Underweight from Equal-weight.

The stock has outperformed other major banks by an average of 5-10% over the past six months and is now trading at a premium to both ANZ Bank ((ANZ)) and Westpac Bank ((WBC)). Target is reduced to $25.60 from $26.00. Industry view: In-line.

PUSHPAY HOLDINGS LIMITED ((PPH)) Downgrade to Lighten from Hold by Ord Minnett .B/H/S: 1/0/0

Slower acquisition of new customers has affected revenue expectations, Ord Minnett observes. The broker suggests this highlights the growth challenge in a maturing market.

FY21 revenue forecasts are lowered and the rating is downgraded to Lighten from Hold. Target is reduced to $2.80 from $3.08.

SOUTH32 LIMITED ((S32)) Downgrade to Neutral from Buy by UBS .B/H/S: 4/2/1

A general update on the mining sector, including re-adjusting forecasts for metals and minerals, has led to a downgrade for South32 to Neutral from Buy. UBS is anticipating a subdued environment leading into 2020 with gold the sole exception.

UBS analysts are not expecting any recovery in prices in the absence of better demand an/or producers curtailing output. Price target drops to $2.80 from $3.30.

WEBJET LIMITED ((WEB)) Downgrade to Neutral from Outperform by Credit Suisse .B/H/S: 2/3/0

Credit Suisse is concerned about the worrying trend of earnings downgrades. The Thomas Cook receivables exposure is two thirds of B2B FY19 earnings and a reminder of the credit risk in B2B.

The broker reduces underlying earnings estimates by -10% and -11% for FY20 and FY21 respectively, because of the removal of Thomas Cook earnings and an increasingly conservative view across B2B forecasts.

Rating is downgraded to Neutral from Outperform. The broker will await indications that earnings are stabilising before becoming more positive. Target is reduced to $11 from $14.

WESTERN AREAS NL ((WSA)) Downgrade to Sell from Neutral by UBS .B/H/S: 3/2/1

Having conducted a general sector update, UBS has downgraded Western Areas to Sell from Neutral. While forecasts for the price of nickel have been adjusted upwards, the analysts suggest this has already been priced into the share price.

In addition, while working on the Odysseus project, UBS makes it clear this company carries execution and capex risk. Target price has risen to $2.90 from $2.50. Estimates have been increased.

Total Recommendations Recommendation Changes

Broker Recommendation Breakup

Broker Rating Order Company New Rating Old Rating Broker Upgrade 1 AUSTRALIA & NEW ZEALAND BANKING GROUP Neutral Sell Morgan Stanley 2 CSL LIMITED Buy Neutral Morgan Stanley 3 MAYNE PHARMA GROUP LIMITED Neutral Sell Macquarie 4 NUFARM LIMITED Buy Neutral Macquarie Downgrade 5 ALUMINA LIMITED Sell Neutral UBS 6 FAR LIMITED Neutral Buy Morgan Stanley 7 FORTESCUE METALS GROUP LTD Sell Neutral UBS 8 FORTESCUE METALS GROUP LTD Sell Neutral Credit Suisse 9 LENDLEASE GROUP Neutral Buy UBS 10 NATIONAL AUSTRALIA BANK LIMITED Sell Neutral Morgan Stanley 11 PUSHPAY HOLDINGS LIMITED Sell Neutral Ord Minnett 12 SOUTH32 LIMITED Neutral Buy UBS 13 WEBJET LIMITED Neutral Buy Credit Suisse 14 WESTERN AREAS NL Sell Neutral UBS Recommendation Positive Change Covered by > 2 Brokers Order Symbol Company New Rating Previous Rating Change Recs 1 FSF FONTERRA SHAREHOLDERS' FUND -33.0% -50.0% 17.0% 3 2 CSL CSL LIMITED 50.0% 36.0% 14.0% 7 3 NUF NUFARM LIMITED 60.0% 50.0% 10.0% 5 Negative Change Covered by > 2 Brokers Order Symbol Company New Rating Previous Rating Change Recs 1 LLC LENDLEASE GROUP 70.0% 90.0% -20.0% 5 2 WEB WEBJET LIMITED 40.0% 60.0% -20.0% 5 3 WSA WESTERN

AREAS NL 33.0% 50.0% -17.0% 6 4 NAB NATIONAL AUSTRALIA BANK LIMITED -7.0% 7.0% -14.0% 7 5 S32 SOUTH32 LIMITED 43.0% 57.0% -14.0% 7 6 REA REA GROUP LIMITED 8.0% 17.0% -9.0% 6 Target Price Positive Change Covered by > 2 Brokers Order Symbol Company New Target Previous Target Change Recs 1 NUF NUFARM LIMITED 6.578 6.082 8.16% 5 2 WSA WESTERN AREAS NL 3.133 3.067 2.15% 6 3 CSL CSL LIMITED 246.986 241.986 2.07% 7 4 LLC LENDLEASE GROUP 17.508 17.268 1.39% 5 Negative Change Covered by > 2 Brokers Order Symbol Company New Target Previous Target Change Recs 1 WEB WEBJET LIMITED 14.200 15.080 -5.84% 5 2 S32 SOUTH32 LIMITED 3.104 3.204 -3.12% 7 3 NAB NATIONAL AUSTRALIA BANK LIMITED 27.000 27.214 -0.79% 7 Earning Forecast Positive Change Covered by > 2 Brokers Order Symbol Company New EF Previous EF Change Recs 1 FSF FONTERRA SHAREHOLDERS' FUND 22.447 12.907 73.91% 3 2 NUF NUFARM LIMITED 27.984 23.387 19.66% 5 3 WSA WESTERN AREAS NL 31.040 29.540 5.08% 6 4 SUN SUNCORP GROUP LIMITED 88.829 86.257 2.98% 7 5 CSL CSL LIMITED 648.872 643.424 0.85% 7 6 LLC LENDLEASE GROUP 133.300 132.600 0.53% 5 7 IAG INSURANCE AUSTRALIA GROUP LIMITED 37.871 37.729 0.38% 7 8 AGL AGL ENERGY LIMITED 129.271 128.843 0.33% 7 9 A2M THE A2 MILK COMPANY LIMITED 43.766 43.628 0.32% 6 10 ASX ASX LIMITED 258.343 257.600 0.29% 7 Negative Change Covered by > 2 Brokers Order Symbol Company New EF Previous EF Change Recs 1 SGM SIMS METAL MANAGEMENT LIMITED 53.227 66.560 -20.03% 6 2 NAB NATIONAL AUSTRALIA BANK LIMITED 178.267 204.771 -12.94% 7 3 CRN CORONADO GLOBAL RESOURCES 48.010 54.194 -11.41% 3 4 ORE OROCOBRE LIMITED 1.348 1.516 -11.08% 6 5 WHC WHITEHAVEN COAL LIMITED 21.233 23.763 -10.65% 7 6 NHC NEW HOPE CORPORATION LIMITED 20.083 21.845 -8.07% 4 7 S32 SOUTH32 LIMITED 20.037 21.274 -5.81% 7 8 WEB WEBJET LIMITED 64.564 67.124 -3.81% 5 9 BHP BHP GROUP 310.310 321.666 -3.53% 7 10 RIO RIO TINTO LIMITED 968.780 985.317 -1.68% 7 Technical limitations

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Uranium Week: Paddling Fast

Going nowhere. Uranium prices continue to rise and fall but it remains a case of failure to launch.

-Anticipated demand still absent -Spot prices remain range-bound -Australia ponders nuclear energy

By Greg Peel

Expectations that sustained uranium demand from utilities and producers would materialise in 2019 are yet to be proven accurate, with several potential buyers pre-occupied with trade issues in the US. The year began as a waiting game with regard the section 232 petition and that game continues on pending the release of Trump's Working Group recommendations and any developments with regard sanctions on Iran and Russia.

The month of September saw a little more activity than prior months, but nothing spectacular. The spot market saw 30 transactions concluded totalling 6mlbs U3O8 equivalent, industry consultant TradeTech reports. Price volatility remains exceedingly low.

TradeTech's spot price indicator closed the month at US$25.70/lb, up US40c from the August close and up 7% over four months. But the US$26.00/lb price level continues to prove a bridge too far.

The spot market stalled once more in the first days of October, with only five transactions concluded up to last Friday. TradeTech's weekly spot price indicator fell back -US30c to US$25.40/lb.

Several utilities concluded transactions in the mid- and long-term term market sectors in September, including a number of off-market transactions. TradeTech's mid-term price indicator has fallen to US$27.00/lb from US$28.00/lb in August, while the long-term price indicator has risen to US$31.00/lb from US$30.00/lb.

Australia in Focus

Australia continues to grapple with the concept of nuclear energy. While the federal government is happy to sell uranium to nuclear weapons-capable nations, it has long dismissed the notion of a home-grown nuclear power industry. Parties of both stripe have for decades seen the prospect as politically unpopular, and thus a no-go area.

As for uranium mining, the federal government has capped the number of permissible mines at four, located in the federal jurisdiction of the Northern Territory and state-government controlled South Australia. Of the four, one is shut down pending better uranium prices and another is only processing stockpiled ore.

While the federal government controls the cap on uranium mines, state governments determine whether uranium mining is allowed or not. Currently it is only allowed in South Australia, with the exception of projects which were underway in Western Australia prior to a change in government which rescinded the lifting of a ban by the previous government.

Investment in uranium in Australia is politically fraught. Most opposed to uranium is Queensland, which boasts Australia's highest concentration of coal mines, and thus coal mine workers.

Which is why it is of some surprise the Australian Workers Union – the country's largest union -- is supporting the lifting of the federal ban on nuclear energy. Facing an upcoming significant energy deficit as Australia's legacy coal-fired power stations reach their use-by dates, the conservative federal government, beholden to the powerful coal lobby, is triumphing coal-fired over anything else (despite Australia being one of the world's largest exporters of LNG), particularly renewables. But bowing to internal pressure, the government has recently set up a round table to discuss the possibility of nuclear power.

The majority of Australians, net of coal industry workers, support renewable energy over coal-fired power and the development of new thermal coal mines. Would they support nuclear power? This is the conundrum for the government, which admits there is a certain lack of logic in one of the world's largest sources and producers of uranium itself shying away from nuclear energy.

Meanwhile, Australia's prospective uranium miners plug on. Vimy Resources ((VMY)) last week revealed "excellent geochemical results" at its 78/22% joint venture project with Rio Tinto ((RIO)) in the Northern Territory.

Paladin Energy ((PDN)) is continuing to move towards the restart of its Langer Heinrich mine in Namibia, confident uranium prices will eventually recover, while Deep Yellow ((DYL)) has advanced additional funds towards a

feasibility study for its Reptile Project, also in Namibia.

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

The Short Report - 10 Oct 2019

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

Summary:

Week ending October 3, 2019

Last week ended with a major sell-off for the ASX200, in line with Wall Street's response to a slew of weak US data and the re-emergence of the R-word.

Such a sell-off would be reason enough to assume an opportunity for shorters to take profits, and the sea of green below would be testament. But…

I'm just a little bit sceptical because I've been here before often enough to know that when shorts appeared to be covered in such numbers, it could be a case of misleading ASIC data. It may all revert next week. For now, we'll take it as read, but with a grain of salt until then

What does definitely make sense is a drop in shorts in Nufarm ((NUF)) to 12.7% from a table-topping 17.4%, leaving a familiar scene of the top three shorted stocks all being battery-related miners. See below.

Otherwise, JB Hi-Fi ((JBH)) shorts fell to 11.5% from 13.1% and GWA Group ((GWA)) to 10.8% from 12.3%. See below.

Weekly short positions as a percentage of market cap:

10%+ GXY 16.9 SYR 16.3 ORE 16.0 ING 14.9 NXT 13.2 NUF 12.7 HUB 11.7 JBH 11.5 GWA 11.8 BKL 10.5 BIN 10.4 SDA 10.2

In: SDA Out: DMP

9.0-9.9

BOQ, CGC, MTS, IVC, BGA

Out: SDA, IVC 8.0-8.9%

IVC, DMP, HVN, DCN, OML, BWX, RWC, SUL

In: DMP, IVC Out: PPT, IFL, SGM, CGF

7.0-7.9%

CGF, SGM, CLH, IFL, PPT, A2M, PLS

In: CGF, SGM , IFL, PPT, A2M Out: NEA, CSR, MYR

6.0-6.9%

MYR, CSR, NCZ, AMP, MIN, SFR

In: MYR CSR, MIN Out: A2M, SAR, CUV

5.0-5.9%

CTD, COE, CLQ, RSG, NEC, NWL, SAR, FMG, GMA, MSB, LNG, GUD, SEK, AWC,

In: SAR, AWC Out: PGH, GEM, WEB, ADH, KGN, MIN, BAP, RFF, CMW, EHL Movers & Shakers

It's been a tough year for agri-chemicals supplier Nufarm. The relentless drought has led to profit warning after profit warning. Such running disclosure meant there were no surprises in the company's earnings result released last week. What did catch the market by surprise was the announced sale of Nufarm's LatAm business.

Prior to that announcement, Nufarm's biggest concern was its debt position, which threatened to become a major problem were the drought to linger on and on. Not only did the price paid for the LatAm business exceed all broker

expectations, the subsequent debt reduction opportunity means Nufarm is now well out of the woods.

Which was enough to have the stocks rallying 32% on the day, and another 14% subsequently, clearly aided by a short-covering scramble as shorts dropped to 12.7% from 17.4%.

As for both electronics retailer JB Hi-Fi and kitchen & bathroom supplier GWA Group, there's been no new news out of either company. But when Wall Street turned around and rebounded after the October 3 sell-off, JB HiFi's share price took off to a new all-time high. GWA's bounce was rather less spectacular.

But it was prior to the bounce that JB shorts fell to 11.5% from 13.1%, and GWA's to 10.8% from 12.3%. Serendipity? Or a decision to cover shorts in the wake of yet another RBA rate cut, which should by rights provide a boost to consumer spending (it hasn't)?

Whatever the case, shorters have been self-flagellating for years in keeping JB Hi-Fi almost perennially near the top of the most shorted table, while rarely ever being provided with a chance to cash in, except maybe during the GFC and the arrival of Amazon, the latter proving an unfounded fear.

ASX20 Short Positions (%)

Code Last Week Week Before Code Last Week Week Before AMC 0.7 0.6 RIO 4.8 4.8 ANZ 0.6 0.7 S32 1.4 1.4 BHP 3.4 3.3 SCP 1.1 1.0 BXB 0.1 0.1 SUN 0.1 0.5 CBA 0.8 0.8 TCL 0.3 0.3 COL 1.0 1.1 TLS 0.2 0.2 CSL 0.2 0.2 WBC 0.8 0.8 IAG 0.5 0.4 WES 0.7 0.8 MQG 0.5 0.6 WOW 0.8 0.8 NAB 0.6 0.7 WPL 0.7 0.7 To see the full Short Report, please go to this link

Guide:

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

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

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

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: Dwellings, Currency & A-REITs

Weekly Broker Wrap: dwelling starts; building materials; currency; grocery; and A-REITs.

-Latest dwelling starts imply downturn going forward -JPMorgan suggests sales for CSR likely to slump -Little support envisaged ahead for Australian dollar -Foreign direct investment flows head back to Europe -Deflationary pressures ease across the grocery market -Pressure on A-REITs amid softening outlook for rental growth

By Eva Brocklehurst

Dwelling Starts

Second quarter dwelling commencements rose 1.1% but are still down -20.3% over the year. While private homes went backwards, down -16% year-on-year, the multi-unit and other dwelling category rebounded, albeit still down -26% year-on-year.

UBS notes, reflecting the prior boom, residential work under construction remains high but activity will fall sharply as annual completions drop to around 180,000 in 2020 from the current 217,000. This will also be a drag on consumption going forward.

Non-residential building commencements, meanwhile, were flat, down -18% year-on-year. The numbers imply a construction downturn going forward and UBS asserts, given sentiment has deteriorated, the Reserve Bank of Australia is likely to cut official rates by -25 basis points in November and again in the first half of 2020, taking the cash rate to 0.25%.

Building Materials

JPMorgan believes the latest building activity data, particularly residential commencements and completions, signals sales for CSR ((CSR)) will fall sharply in FY20. The broker forecasts CSR's building products revenue to decline -10%. Depressed spot aluminium prices will also impact on the profitability of the Tomago smelter, with JPMorgan noting the ingot premium for Japan has been trending lower.

The broker retains an Underweight rating on CSR and estimates for earnings per share in FY20 are -12% below consensus. JPMorgan expects dwelling commencements to continue moderating, presenting a tough back drop for Adelaide Brighton ((ABC)) as well.

Australian Dollar

UBS is bearish about the outlook for the Australian dollar, expecting it at US$0.66 by the end of 2019. Several factors are likely to apply the pressure, including lingering support for the US dollar. UBS doubts US dollar can weaken very much despite the fact US yields are fallen significantly.

Global growth is now in the 10th lowest percentile for the last 20 years and this backdrop tends to be supportive of the US dollar, not the least because US investors maintain a strong home bias in global downturns.

Weak global growth will also bring about risk aversion and the broker expects no significant de-escalation in the trade war. Moreover, UBS doubts lower interest rates will be bullish for equities over the more medium term, as eventually equities will have to adjust and catch up with weaker macro fundamentals.

As the RBA cuts rates further and the discussions centring on quantitative easing intensify, the broker expects the Australian dollar will retain a bearish tone. Finally, commodity prices are unlikely to offer much support for the currency. High iron ore prices are considered unsustainable and commodities are unlikely to cushion the impact of lower domestic rates and increased risk aversion.

Morgan Stanley points out the Australian dollar has not reacted to the drop in consumer sentiment, as indicated by the latest survey, implying markets are closely tuned to the US/China trade negotiations.

The broker suspects the US Federal Reserve has opened the way for balance sheets to expand and cope with the increasing liquidity being hoarded by the big banks. Importantly, net foreign direct investment has turned in Europe, flowing inwards as a weakening global investment climate makes corporates scale back from international activities. This recent shift in flows has not been reflected in the euro versus the US dollar.

Morgan Stanley is not surprised that investors are waiting to read between the lines of the US/China meeting, given global trade tensions have been blamed for the slowdown in growth. Moreover, the size and structure of cross-border capital flows as well as global trade provide indications on the health of the global economy.

This is where an alarm is being sounded by the foreign direct investment flows into Europe, which has been a net provider of foreign direct investment to the world.

The swings have been so significant that the scaling back of activity by international corporate investors is consistent with the global economy moving into recession and, as a result, Morgan Stanley suspects this could push the Fed into considering additional easing measures that will weaken the US dollar.

Grocery

Deflationary pressures across the grocery market continue to ease in the first quarter, UBS notes. The broker's study reveals this stemmed from fresh inflation and weakening dry goods deflation.

Both Coles ((COL)) and Woolworths ((WOW)) appear to have experienced inflation in food in the September quarter. UBS concludes an improving inflation backdrop is positive for the sector and there is scope for stocks to re-rate further if these trends continue.

Metcash ((MTS)) is expected to be the biggest beneficiary of a return to dry goods inflation and remains the broker's preferred pick in the sector. Coles is the least preferred, given an expected risk to near-term earnings. UBS assesses the grocery market is rational and pricing is improving while ranges are not being reduced as retailers focus on differentiation.

A-REITs

JPMorgan suggests Australian Real Estate Investment Trusts (A-REITs) will experience pressure on rates of return amid a softening outlook for rental growth. Based on lower assumed 10-year rental growth of 3.5% per annum in Melbourne and 3.0% per annum in Sydney, the broker believes current acquisition yields are in the high 5% range and rates of return are likely to expand 30-60 basis points over the medium term before falling back to a 6-6.5%, deemed fair value.

The Sydney and Melbourne office markets have been global outperformers, delivering capital growth of around 110% since 2013. However, the broker believes the cycle is maturing, with Sydney's net effective rental growth slowing to 1.4% in the year to September versus 12.5% a year earlier. Melbourne growth has been more resilient at 6.2% in the year to September.

Demand has also tapered off, particularly when technology and flexible workspace providers are excluded, while sub-lease space has increased in Sydney. Historically, JPMorgan notes, this has been a strong leading indicator of future capital growth and if sub-lease space continues to grow this could lead to a correction in rents, yields and capital values. While supply remains significant it is balanced by low vacancy rates and high pre-commitments.

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Waxing Interest In EclipX

EclipX Group is reverting to focus on its core fleet and novated leasing businesses, and interest in the company is only expected to grow.

-Right2Drive, CarLoans remain the key non-core divestment opportunities -Reduced likelihood of breaching debt covenants -Takeover attraction likely to gain momentum

By Eva Brocklehurst

EclipX Group ((ECX)) is progressing with a simplification strategy, making the business more attractive as a stand-alone operation. As a result, brokers increasingly emphasise sector consolidation as a theme. The company's focus will revert to the fleet and novated lease businesses and Right2Drive has been set aside, with the company exploring all options for both the front and back books.

EclipX Group divested its commercial equipment finance business in the last month, leaving just Right2Drive and its CarLoans businesses as non-core. UBS expects an exit of Right2Drive and CarLoans will occur in FY20 and now assumes $40m as a base case from the sale, versus $25m in previous estimates.

Citi has removed losses from the commercial equipment finance operation from estimates, upgrading FY20 forecasts for earnings per share by 15% as the model is rolled forward, with divestment of the remaining businesses contributing half of its target of $1.96.

The company has announced a $15m cost optimisation plan for its core business over FY19-21. UBS calculates an implied pro forma FY20 net profit of $58m and envisages upside risk for core income growth as earnings are positively affected by divestments and cost optimisation.

The cost base is expected to reduce to $83m by FY22 from $141m in FY19. Growth should also come via increased novated leasing penetration and leasing to small-medium business as well as operating leverage.

UBS reduces FY19-20 estimates by -16-18% to take into account the underperformance of the non-core businesses as well as stranded costs and does not anticipate the company will breach its corporate debt covenants, given the now higher estimate for the monetisation of non-core operations.

Macquarie anticipates the company will be a target in the consolidation of the fleet and novated lease sector in Australasia and Citi agrees the core leasing operation could prove attractive to suitors, which will only garner momentum as the underperforming operations are discarded.

There are four Buy ratings and one Hold (Morgan Stanley) on FNArena's database. The consensus target is $1.81, signalling 4.7% upside to the last share price. Targets range from $1.35 (Morgan Stanley) to $2.20 (UBS).

See also, Divestment Lauded As EclipX Reduces Risk on July 9, 2019

Disclaimer: The writer has shares in the company.

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Baby Bunting Running Strongly

Baby Bunting has confidently reiterated earnings assumptions for FY20, with an expanded gross margin being the main surprise in a detailed trading update at the AGM.

-Strong outlook as unusual trading conditions now cycled through -Opportunities in shopping centres still exist -Strongest earnings outlook among discretionary peers, Macquarie asserts

By Eva Brocklehurst

Baby goods retailer Baby Bunting ((BBN)) is confident, outlining strong earnings momentum and planning 5-6 new stores in FY20. The company's trading update for the first 14 weeks of FY20 revealed a slowdown in like-for-like sales growth to 3.1%, implying 1.6% in the final eight weeks of the period. Technical issues with the website, now fixed, also affected sales conversion and customer experience.

While like-for-like sales imply a deceleration versus the first six weeks, brokers point out this reflected the cycling of unusual trading conditions in September 2018, including the Babies "R" Us closure and heavy clearance activity.

At its AGM, the company reiterated FY20 operating earnings (EBITDA) guidance of $34-37m and net profit of $20-22m. A gross margin of 36.6% was obtained to date, up 270 basis points and ahead of most broker expectations.

Management expects this level of gross margin performance to persist through FY20. Seasonally, the first quarter is usually a lighter period for sales but Macquarie suggests, given the strength in margins, the mid to upper end of guidance is achievable.

With competitor closures and clearance activities now cycled Citi expects gross margin improvement to continue in FY21 and FY22, as the penetration of private-label and exclusive products increases towards the long-term target of 50%.

The company opened one new store and expects to open another two in the first half of FY20. As the competitive landscape has improved there are new growth opportunities in shopping centres. More shopping centre stores, which have a greater proportion of higher gross margin consumables and soft goods sales, are being rolled out.

Morgan Stanley asserts Baby Bunting is under-penetrated in shopping centres. The store network plan is currently under review and could be a positive catalyst in the next few months. Citi envisages upside to the long-term roll-out target of 80 or more stores given the success of the shopping centre format, on the back of the fact four of the company's largest competitors have closed down.

Baby Bunting possesses the strongest earnings outlook among discretionary retail peers, in Macquarie's view, with visible growth drivers and a relatively defensive category, amid lower online threats. Morgans, too, considers the business well-placed for growth, being the only national baby goods retailer, and now forecasts FY20 operating earnings of $36.9m and net profit of $21.2m.

Baby Bunting appears more in control of its growth compared with most other retailers, the broker adds. The main risks include Amazon, a falling Australian dollar and weaker consumer sentiment as well as higher than expected rates of store cannibalisation. Guidance does exclude significant project-related costs, Morgans points out, which will be taken below the line and not affect the dividend.

FNArena's database has four Buy ratings for Baby Bunting. The consensus target is $3.72, suggesting 3.9% upside to the last share price. This compares with $3.17 ahead of the update.

See also, Baby Bunting's Growth Spurt To Continue on August 19 2019.

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SMSFundamentals: Finding Yield In A Low Rate World

SMSFundamentals is an ongoing feature series dedicated to providing SMSF trustees with valuable news, investment ideas and services, in line with SMSF requirements and obligations.

For an introduction and story archive please visit FNArena's SMSFundamentals on the website.

Finding Yield In A Low Rate World

With term deposit rates around 1.5%, the ten-year bond rate at 0.9%, inflation at 1.6% and stock market volatility ever present, where can one invest for both safety and income in today's interest rate environment?

By Greg Peel

As Australian banks evoke the usual howls of disgrace by not fully passing on RBA interest rates cuts to mortgage holders, persistently ignored are the retirees who seek to rely on "risk-free" investments to both preserve capital and provide a reasonable income. Gone are the days of surviving happily on bank term deposits (guaranteed by the government) or government bonds.

Both are currently offering negative real yields (after inflation).

The stock market offers attractive yields, such as ~6% (fully franked) yields on bank shares, and real estate investment and other investment trusts can offer even better yields (albeit not necessarily franked). But the stock market cannot offer any form of safety in terms of capital preservation. While some stocks are more defensive than others, the GFC showed sometimes this just doesn't make a difference.

Are there alternatives?

Yes there are, and we're not talking gold. Gold is supposedly the ultimate capital preservation investment but pays no income, and the GFC sparked an initial sell-off in gold as stock market investors desperately tried to cover their margin calls.

There are several active fund managers who specialise in debt as an investment, with a view to providing a risk/reward balance amenable to the retiree or any other investor seeking a comfortable balance of capital preservation and income, or risk/reward. Increasingly such investments are packaged into trusts that are listed on the stock exchange.

Research house Independent Investment Research (IIR) has analysed several recent listings and selected a handful it sees worthy of recommendation. The following outlines those recommendations.

MCP Master Income Trust ((MXT))

Manager: Metrics Credit Partners

Listed: October 2017

Founded: 2011

Loan Type: corporate, diversified by borrower, industry and credit quality

Credit quality: A to BB

Targeted annual return: RBA cash rate plus 3.25% (4.00% currently) net of fees

Distributions: monthly

IRR's view:

MCP Master Income Trust provides retail investors an alternative to the majority of accessible fixed income funds, which are largely engaged in secondary market bond trading. In contrast, the Manager's investment strategy is very hands-on transactional, with the focus on originating transactions, conducting detailed bottom-up due-diligence, structuring the loan and managing the loan life-cycle thereafter. As such, the Manager's ability to successfully

structure and manage transactions that meet the investment objectives and avoid credit defaults is critical. In this regard, the analysts note a strong track record of providing a stability of capital and predictability of income.

IRR notes this track record has been established during a period of relatively benign economic conditions, although the investment team boasts substantial experience over the full economic cycle, including through the GFC. Historically the Manager's underlying wholesale funds have consistently and, generally, materially exceeded the respective funds' target returns. Furthermore, the monthly returns profile has been characterised by a high degree of stability.

IIR ascribes the MCP Master Income Trust a Recommended Plus rating. MXT represents something of a unique investment proposition for Australian retail clients, providing exposure to a diversified portfolio of direct-lending corporate loans and by way of a liquid LIT (listed investment trust) structure. It does so through a portfolio created and actively managed by a team with a deep skill set and a track-record of delivering a risk-return outcome in excess of target levels and without a single negative month or credit loss (albeit during a period of benign credit markets).

Gryphon Capital Income Trust ((GCI))

Manager: Gryphon Capital Investments

Listed: May 2018

Founded: 2014

Loan Type: floating rate asset-backed securities (ABS) with a particular focus on residential mortgage-backed securities (RMBS)

Credit quality: Up to 50% of the portfolio may be invested in non-investment grade securities

Targeted annual return: RBA cash rate plus 3.50% (currently 4.25%) net management fee of 0.72%

Distributions: monthly

IRR view:

The Trust is suitable for those seeking an investment with a regular income stream. The Trust will provide access to ABS and RMBS, which is typically only available to the institutional market and will be the only listed vehicle on the ASX that provides access to a portfolio of ABS and RMBS. ABS and RMBS are tradable securities and therefore the Trust may experience capital gains or losses, however IIR expects returns to be largely income. While the Trust provides an alternative fixed income investment, investors should be aware of and comfortable with the risks associated with ABS and RMBS. Up to 50% of the portfolio may be invested in non-investment grade securities which carry a higher level of risk than investment grade securities.

Residential mortgages have historically had low levels of defaults and delinquency rates have remained low throughout previous crises. This combined with the credit enhancements of RMBS has resulted in no defaults historically on Australian issued RMBS. A significant shock to the residential housing market may nevertheless negatively impact the performance of the Trust and may result in capital loss.

IIR has assigned the Trust a Recommended rating. The Manager has a robust investment process with strict investment criteria. Prior to the establishment of the Trust, the Manager only managed portfolios on behalf of institutional investors. The Manager has a focus on capital preservation and will only invest in RMBS that pass the 1 in 200 year event as defined by APRA's Probable Maximum Loss (PML), which imply a national house price decline of over 40%. To be eligible for investment, securities must not be expected to incur a capital loss when the 1 in 200 year event is applied.

NB Global Corporate Income Trust ((NBI))

Manager: Neuberger Berman (Australia)

Listed: August 2018

Founded: 1997 (in the US)

Loan Type: corporate (US 60%, Europe 20%, Emerging markets 20%), diversified by individual, industry, geography and credit quality

Credit quality: B and BB, occasionally suitable BBB and CCC

Targeted annual return: 5.25% plus moderately growing net asset value

Distributions: monthly

IRR's view:

Neuberger Berman is an independent, 100% employee-owned investment management firm headquartered in New York, and which has approximately US$300 billion in assets under management. Neuberger Berman's non-investment grade team has a 20+ year track record managing high yield corporate bonds, beginning with the U.S. high yield market in 1997 and subsequently expanding into Emerging Market high yield corporate bonds and European high yield corporate bonds, as those markets developed in size and sophistication.

The Manager seeks to provide its target return with a strong emphasis on capital preservation and downside risk mitigation and, historically, has delivered on this performance objective. More broadly, the Trust has the ability to fill a gap in many domestic retail investor portfolios. For many retail investors, the income component of the portfolio tends to be both domestically focused and often significantly equity biased, with a degree of hybrids to achieve an income stream. In the analysts' view, a fundamental benefit of the Trust's investment strategy is that many domestic investors may be able to benefit from at least a comparable returns profile but in doing so significantly diversify the income component of their portfolio by geography, industry and credit quality tier.

IIR warns non-investment grade bonds tend to have a higher probability of default and this risk tends to cluster around specific events/economic environments.

IIR ascribes a Recommended Plus rating to the NB Global Corporate Income Trust. IIR has conviction in the Manager's ability to at least achieve the stated investment objectives over the foreseeable future. This is based on a comprehensive, proven and repeatable investment process, a broad and highly qualified investment team, strong risk-management processes, and a long-term track-record of generating "alpha" (return independent of the market return) primarily by mitigating downside risks in less benign market environments. IIR believes the investment processes, with a strong emphasis on downside risk mitigation, accords well with the investment objective of stable and consistent income and a moderately accretive net asset value.

Partners Group Global Income Fund ((PGG))

Manager: Partners Group Private Markets (Australia)

Listed: September 2019

Founded: 1996 (in Switzerland)

Loan Type: corporate, predominantly US and European private companies with a substantially smaller allocation to Australian and Asia Pacific companies.

Credit quality: 60-100% B to BB, 0-20% B- to CCC+, 0-25% "special situation" loans from senior first lien to mezzanine

Targeted annual return: RBA cash rate plus 4.00% (currently 4.75%) net of fees

Distributions: monthly

IRR view:

The Trust provides exposure to a diversified portfolio of private debt investments to predominantly large to mid-sized companies through direct lending and broadly syndicated loan (BSLs) investments. It will seek to do so through both active origination in primary issues and secondary market trading. The objective of the Trust is to provide monthly income with a focus on capital preservation.

IIR would generally characterise the Trust as sitting at the mid to lower end of the private debt risk-return spectrum and can be expected to deliver a relatively stable level of income that at least meets the performance with a relatively low degree of capital downside. This view is based on a combination of: i) the Manager's focus on a diversified portfolio of senior secured first lien loans; ii) a focus on middle-market companies in generally resilient industries and generally characterised by dominant market positions, competitive advantages, barriers to entry and strong/stable cashflow profiles; iii) borrowers backed by quality Private Equity sponsors with considerable equity invested in the borrower; iv) solid and prudent underwriting, facilitated by wide deal sourcing channels based on long-standing relationships; v) a track-record of relatively stable interest rate spreads (read, income distribution stability), and; vi) a track-record of very limited capital losses on both first and second lien loans since commencing in the private debt asset class in 2006.

As a sub-investment grade market, investors should expect that there may be periods of net asset value volatility (yet which may have no impact on either income stability nor default risk in the underlying loans).

IIR ascribes a Recommended rating to the Trust. Partners Group is a solid investment manager that plays to its relative abilities, which translate to income stability and capital preservation, rather than stretching for yield and capital upside by moving up the private debt risk-return spectrum. In this regard, IIR has a high degree of conviction in the Manager's ability to at least achieve the stated income objectives over the foreseeable future.

A key concern is while Partners Group has an established track-record in private debt and all three sub-strategies that make up the Trust (and has provided this data to IIR), each pre-existing fund and client mandate is different to the Trust in terms of its fund structure, weighting to the different investment strategies, use of leverage, geographical focus and other factors. As such, no fund is exactly comparable to the Trust's structure and investment strategy and no past performance track-record is directly comparable. This detracts from overall information transparency, particularly in relation to patterns of performance (volatility, drawdowns, consistency) and relative performance (vs benchmarks, peers).

Moelis Australia Fixed Income Fund (listing pending)

Manager: Moelis Australia Asset Management, subsidiary of Moelis Australia ((MOE))

Listed: pending, second half 2019

Founded: 2009

Loan Type: commercial, accounts receivable and consumer lending products diversified by market segments, borrowers, industries, credit qualities and origination channels

Credit quality: n/a

Targeted annual return: RBA cash rate plus 4.00% (currently 4.75%)

Distributions: monthly

IRR view:

Loan categories will include inventory funding (accounts receivable), specialised debtors (commercial), strata funding (consumer), personal lending (consumer), and, to a lesser degree, senior secured financing property loans (real estate).

The Fund benefits from a material co-investment by Moelis Australia, structured to prioritise investor returns and significantly reduce investor risk. Moelis has committed to invest, alongside the Fund, an amount equal to 10% of the Fund's capital, on terms that provide investors with the benefit of a capital buffer and income priority through what is referred to as a credit enhancement structure. Specifically, Moelis' capital will first absorb any realised losses, providing a buffer to protect investor capital, hence there is strong alignment of interest between investors and Moelis. Moelis will only ever receive a return on its co-investment if investors have been paid the Target Return and capital buffer is equal to 10% of the Fund's capital.

Moelis Australia is particularly well placed to identify, pursue, manage and deliver on specific credit investment initiatives capable of delivering attractive through-cycle, risk-adjusted returns with strong downside protection. The addition of the credit enhancement structure, prioritising income and capital to investors by creating a significant downside buffer to both, forms a very low risk investment vehicle characterised by an expectation of consistent monthly income and strong capital downside protection. As such, from a risk perspective IIR views the Fund sitting between the relatively low returns from cash and government bonds but materially below the risk of a well-managed corporate debt investment mandate.

IIR ascribes a Recommended Plus rating to the Moelis Australia Fixed Income Fund. The ability to identify and the analysts' confidence in the Manager's ability to capably pursue and manage the credit initiatives that comprise the underlying portfolio of the Fund are testament to Moelis Australia's market leading expertise in certain credit segments. It provides IIR with confidence of the Manager's ability to deliver on outsized returns relative to risk and to preserve capital.

While the credit enhancement caps investors participation in the upside, it serves to create a very low risk investment vehicle, with an expectation of highly predictable and consistent income and strong capital downside protection, making the Fund highly suitable for its intended place in an investor's overall investment portfolio.

KKR Credit Income Fund (listing pending)

Manager: KKR Credit (Australia), affiliate of Kohlberg Kravis Roberts & Co (US)

Listed: pending, November 2019

Founded: 2004

Loan Type: traded credit securities, mainly bank loans and high-yield bonds, B to CCC

Credit quality: sub-investment grade

Targeted annual return: 6-8% net of fees (including performance fee)

Distributions: quarterly

IIR view:

The Trust provides exposure to two underlying credit investment strategies, specifically a long-term target portfolio allocation of 50-60% to the Global Credit Opportunities Fund (GCOF) and a long-term target allocation of 40-50% to the European Direct Lending (EDL) investment strategy, via the soon to be launched KLPE II fund. GCOF, which is based on KKR Credit's Opportunity Credit Strategy (OCS), is managed according to a high conviction, market-driven opportunistic investment strategy with 60 to 80 core credit investments. It invests in a portfolio of sub-investment grade ('sub-IG') traded credit securities, mainly bank loans and high yield bonds.

The underlying OCS has an 11- year track record and has performed exceptionally well across the full credit cycle. KLPE II is a European direct lending strategy targeting upper middle-market companies in Western Europe by largely first lien, senior secured private debt, with a very selective provision of second lien secured facilities. The EDL strategy has a 7+ year track record and has generated a realised unlevered internal rate of return of 13.4% p.a. and a weighted average all-in-yield of 8.5% pa to date. While the two strategies differ, they are united by a common KKR wide philosophy, fundamental bottom-up investment process and access to KKR-wide resources.

Strong underwriting skills, cautious credit selection, and prudent full credit cycle portfolio management translates into consistency of income and the minimisation of default loss. IIR has a high degree of confidence in KKR Credit and the Trust delivering a stable and consistent monthly distribution and, over the long term, generating accretive net asset value. While there are distinct differences in the two underlying strategies, both are based on the same fundamental bottom-up assessment of cash flow variability and debt serviceability, driven by a mindset acutely aware of the asymmetry of downside risks in debt investments.

Importantly, both underlying strategies are not only well positioned to perform well in a late-cycle credit environment but to capitalise on any fall-out from a potential end of cycle credit environment.

IIR ascribes a Recommended Plus rating to the KKR Credit Income Fund. IIR has a very high degree of conviction in the Manager's ability to at least achieve the stated investment objectives over the foreseeable future and continue to generate well above broad market performance over the medium and long term. KKR Credit ticks every box with respect to track record, resources, and mandate flexibility. The risks in debt currently are not only cyclical but structural, with significant market inefficiencies in the traded sub-IG market and a general deterioration in underwriting in the private debt market (and an influx of untested managers that lack full cycle resources). In such an environment, the dispersion in performance by investment manager and strategy is not only likely to increase, but is almost guaranteed to do so while ever the current structural market inefficiencies persist.

KKR Credit, with its full cycle tested deep fundamental bottom-up credit assessment and flexible and market-driven opportunistic strategies is well placed to continue its excellent track record of outperformance.

IIR warns of the potential for heightened net asset value volatility and notes the performance fee has the potential to elevate total fees to a level above the majority of ASX-listed credit trusts.

In addition, stockbroker Morgans notes the Trust aims to invest in strategies representing diversified portfolios of primary loans, bonds, notes (fixed and floating) and other debt securities and financial instruments, including senior secured loans, traded senior secured bank loans and high-yield bonds. Access to KKR's credit strategies offered through the Trust is intended to provide investors with investment opportunities that are not available elsewhere and will supplement investors' existing portfolio holdings of equities, hybrid products and cash products.

Morgans does not provide a recommendation as yet.

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Treasure Chest: NextDC Still Driving Growth

FNArena's Treasure Chest reports on money making ideas from stockbrokers and other experts. NextDC has defied the critics so far, with sales in excess of what can be delivered and the next two years of operating earnings growth supported by existing contracts.

-Two years of operating earnings growth supported by existing contracts at S2 -NextDC not prepared to sacrifice price for volume -Debt position is tight but should ease over time

By Eva Brocklehurst

Data centre builder/operator NextDC ((NXT)) has been very active over the last 18 months, particularly in Sydney, with more MW (megawatt) sales contracted than can be delivered currently. Brokers expect this to underpin growth for the next few years.

Morgans points out, simplistically, NextDC needs to sell at least twice the FY19 sales rate to fill its generation 2 and generation 3 construction in under 10 years, calculating sales of around 10MW per annum are required for the next few years and accelerating towards 15MW as third-generation facilities come online.

The broker assesses M2 (Melbourne) and S3 (Sydney) are hyper-scale facilities and M3 and S2 are hybrid-scale. The former two should benefit from the rapid expansion of cloud computing and underpin a step up in growth for the company.

To date, hyper-scale demand has been limited to Sydney so the main risk relates to when demand lifts materially in Melbourne and Perth. Morgans has retracted previous concerns around the market's high expectations for sales, suspecting forecasts are now at more realistic levels.

The next two years of operating earnings (EBITDA) growth for the company are largely supported by existing contracted business at S2. There is also 10MW of contracted space in S2 which has not yet been billed but will become live over the next few years.

Citi has observed the company is very disciplined and not prepared to sacrifice price for volume. The broker has also emphasised that large-scale developments take time and investor patience should be rewarded in FY21.

That said, Citi has warned that further material contracts, particularly in Melbourne, are needed to avoid dousing investor sentiment. There is also increased potential for competition from Equinix if that company homes in on large cloud customers and wholesale deals.

Ord Minnett agrees that, while there is a surge in data usage stemming from 5G spectrum and AI (artificial intelligence), it may take longer than previously expected to build up scale. The broker maintains lingering concerns about the slow growth in M2 and B2 (Brisbane) and calculates these will take 10-11 years to fill.

At the FY19 results, UBS pointed out the construction environment has been more challenging, and S2 and the 15MW already contracted may take longer to activate. Nevertheless, the delays have little impact on the value over the life of the data centre.

Moreover, construction risk has diminished. Morgans points out the company's revolutionary continuous development methodology, which builds a vertical market on live facilities, was a world-first and significant lessons have been learned.

Assuming the assets will generate low double-digit returns, Morgans assesses there is meaningful upside over time. The main negatives include the need to improve sales in the tier 2 facilities in Melbourne and Perth as well as the balance sheet.

In terms of the latter, Morgans appreciates the company has long-term contracts that mean interest coverage increases in the outer years, as deployed capital starts to generate a return. For example, debt raised and spent in FY19-20 generates earnings in FY21-22.

The broker also remains conscious that the debt position is tight but expects this to be resolved over time. Hyper-scale contracted MW can take 2-3 years to reach full billing. The broker also emphasises the company's cost of equity remains attractive.

As the share price has weakened over the last two months the risk/reward appears more positive and Morgans takes the opportunity to upgrade to Add from Hold. FNArena's database has six Buy ratings. The consensus target is $7.81, suggesting 26.0% upside to the last share price. Targets range from $6.68 (Morgans) to $8.60 (UBS).

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