Week

22

Stories To Read From FNArena

Friday, 31 May 2019

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

Contents

Australia

1 BlueScope Steel Squeezed As US Tariffs Lifted
2 F&P Healthcare Needs To Lift Mask Growth
3 Uncertainty Hovers Over Woolworths

Commodities

4 Trade War Will Hasten Bull Market For Rare Earths
5 Iron Ore Price Ascending
6 Material Matters: Oil, Copper, Gold & Steel
7 Lithium M&A Heating Up Despite Trade War
8 Material Matters: Oil, Alumina & Base Metals
9 Iron Ore Peaking?

FYI

10 Weekly Ratings, Targets, Forecast Changes
11 Uranium Week: Buyers' Market
12 The Short Report
13 The Wrap: Oz Dollar, Radiology & Retailers

Small Caps

14 Strong Growth Expected From Think Childcare

Weekly Analysis

15 In Quality We Trust
16 Rudi's View: Citadel, Stockland & Expert Warnings

BlueScope Steel Squeezed As US Tariffs Lifted

BlueScope Steel is confronting higher input costs and slumping prices for its steel products in the US and several brokers fear a downgrade to the earnings outlook is on the cards.

-Numerous factors squeezing steel spreads in the US -Significant new US steel capacity forecast to come on line in 2022 -Is the outlook for North Star expansion affected?

By Eva Brocklehurst

As trade and tariff issues sweep across North America, BlueScope Steel's ((BSL)) FY19 guidance is under increasing pressure. US hot rolled coil (HRC) prices have softened following the removal of tariffs on Canadian and Mexican steel.

At the other end of the production chain, iron ore prices have surged. Additionally, the reduction in tariffs on Turkish imported scrap, another input for the company's North Star plant, is likely to mean scrap prices rise.

Ord Minnett estimates US steel spreads - the gap between input prices and steel prices - have fallen by -US$90/t since the company reported its interim result in February and the lagged US steel spread is now US$268/t. BlueScope Steel was expecting US steel spreads to rise back over US$400/t in the second half, and this has not eventuated.

Several brokers assess the potential for negative revisions to the company's estimates is acute. US/China trade tensions are also a risk to economic activity. Morgan Stanley already downgraded BlueScope to Equal-weight back in April, having noted a recovery in steel prices had stalled.

UBS downgrades to Neutral from Buy, citing the removal of Canadian and Mexican steel tariffs, higher iron ore prices and softening demand for detached houses in Australia. The broker reduces FY20 and FY21 earnings estimates by -36%. UBS estimates BlueScope Steel is pricing in a US spread of US$240/t versus spot of US$299/t.

Capacity Additions

Moreover, around 15mt of new US steel capacity is expected to come on line by 2022, almost entirely from EAF (electric arc furnace) producers and affecting mostly flat steel products.

The re-start of around 2.5mtpa of previously idled capacity in a 27mtpa market has put it into surplus and the price for HRC has slumped accordingly. Hence, Credit Suisse believes a collapse of HRC pricing in the US is inevitable, and will actually be required in order to force the closure of high-cost capacity.

Credit Suisse reduces US HRC and steel spread assumptions significantly, citing the expected capacity additions and declining tariff protection, as well as a likely rise in scrap prices. With tariff support gone, US domestic supply additions are likely to define US steel pricing, the broker asserts, and the removal of Canadian tariffs will mean freight-advantaged steel is likely to fight for US market share.

UBS counters that downside pressure could be dampened by Canadian and Mexican producers raising their prices into the US, although still selling sufficiently below domestic prices to recapture market share. UBS also enviages, with the pull back in US HRC prices, some of the expected re-starts may be delayed or cancelled.

Meanwhile, for the company as a whole, Credit Suisse believes BlueScope Steel's varied geographic and end-market exposures, as well as low production costs, will reduce its earnings volatility versus prior down cycles. UBS also believes recent changes to lending standards and a surprising federal election result have probably brought forward a floor in the Australian housing industry.

Macquarie acknowledges Australian end markets have actually improved, although volumes are likely to still be soft in the near term. Nevertheless, the broker points out, in the context of ongoing risks to assumptions from commodity prices, pressure remains on the downside for BlueScope Steel and downgrades to Underperform from Outperform.

Macquarie downgrades forecasts for net profit in FY20 by -16% and suspects, given movements in the spot market, there is risk of a further -35% downside to its revised base case. The broker's downgrade is driven by lower spreads amid pressure from input costs. Iron ore, in particular remains the challenge. In terms of iron ore prices, BlueScope Steel calculates a $10/t change affects full-year earnings (EBIT) by $60m, all else being equal.

North Star Expansion

Ord Minnett believes postponing the North Star expansion in favour of buybacks, to some extent, could be a more value-accretive proposition for shareholders. Given the volatility in US margins recently, combined with concerns the US steel market could become oversupplied, the sanctioning of an expansion to North Star could now be viewed as a negative.

Nevertheless, in the longer term the broker values the stock on the basis of mid-cycle steel spreads and maintains an Accumulate rating. Morgan Stanley, on the other hand, believes the formal announcement of the North Star expansion should provide a positive catalyst as the returns are potentially attractive.

Despite the weakening spreads, UBS expects the company will push ahead with the expansion, agreeing it is the right strategy for the long-term, and pointing out this is not an expansion but a removal of a bottleneck to maximise installed capacity of the hot strip mill. The upgrade is expected in the December half and nameplate production will be a further 1-2 years away from completion.

FNArena's database shows two Buy ratings, four Hold and one Sell (Macquarie). The consensus target is $14.39, signalling 26.7% upside to the last share price. Targets range from $10.15 (Macquarie) to $17.00 (Morgan Stanley). Added to this is the recent removal of tariffs on Turkish steel, likely to drive incremental demand for scrap steel.

F&P Healthcare Needs To Lift Mask Growth

Fisher & Paykel Healthcare requires a significant improvement in its OSA mask performance as well as high growth rates in new hospital applications to meet targets, brokers assess.

-Revenue affected by failure to launch new mask range in expected timeframe -Expected to continue losing market share in masks -Stock considered expensive relative to peers

By Eva Brocklehurst

Fisher & Paykel Healthcare ((FPH)) has continued its long-term trend of strong growth in hospital care, up 20% in FY19 for new applications such as Optiflow, and low growth in home care, amid negative growth in mask sales in the second half.

Yet guidance for FY20 has prompted downgrades from brokers, as slowing revenue growth is envisaged. Revenue of NZ$1.07bn met guidance, as did net profit, but the outlook for market share in masks worries brokers.

Fisher & Paykel Healthcare has noted consumables make up 86% of revenue now. Hospital revenue grew 11% over the year while, in home care, flow generators grew 30%. Geographically growth was slower in North America and Europe while Asia-Pacific accelerated.

Yet, OSA (obstructive sleep apnoea) mask growth was in negative territory in the second half for the the first time in seven years, amid strong competition. The company has guided for a net profit range of NZ$240-250m in FY20, below estimates.

A significant improvement in OSA mask performance and the maintenance of high growth rates in new hospital applications are both required to meet the company's target of doubling revenue every five years. UBS believes this is unlikely over the next three years.

In the long-term the myAirvo product for home treatment of COPD (chronic obstructive pulmonary disease) remains critical, but the broker points out supportive US clinical results and reimbursement are probably more than three years away.

Taking into account lower spending on litigation, an FX and R&D tax benefit and declines in gross margins, Citi calculates organic net profit slowed by -2%. As opposed to the prior guidance of 9-10% management has instead indicated R&D expenditure is likely to grow in line with expected constant currency revenue growth. Macquarie calculates this equates to expenditure at the top end of the previously stated range.

New Mask Launch

Earnings were affected by the company failing to launch its new mask range in the expected timeframe. Citi points out the company enjoyed several years where, as new masks were introduced, its position as number three in the market was consolidated. This came to an end in the first half of FY18 and ResMed ((RMD)) is likely to continue taking share into FY20.

Citi considers the stock overvalued and expects the company will continue to lose market share in OSA masks, at least until the Viterra mask is approved in the US. The company plans to launch another new mask in FY20. The broker's estimates are at the top end of guidance for net profit, given this could prove to be conservative in light of strong underlying hospitals growth.

On the positive side, UBS expects mask growth should pick up in the second half of FY20 once the new full face Viterra mask is released in the US. However, costs from the second Mexico site mean gross margins drop by -50 basis points in FY20 while costs of a new Auckland facility are likely to keep gross margin steady in FY21.

Continued decline in OSA masks is the main risk over the next year and Macquarie asserts the jury is out on whether the new mask will actually stem the loss of market share. The broker agrees the contraction in gross margin is of concern, as management has noted the both OSA mask growth and GP margin expansion out of the Mexican facilities go hand-in-hand.

Credit Suisse is also uncertain until US authorities clear the way for Viterra, which leaves the company exposed to worsening outcomes in the next six months. The broker has no doubt that the company is a high-quality business and there is impressive growth in key areas. However, the large multiples that were justified where there was broad-based growth and margin expansion are now less fitting.

Valuation

The stock may be off recent highs but it still trades on a one-year forward PE of 37x, well above global medical device peers, UBS points out. Macquarie agrees, relative to ResMed, the stock is expensive, considering respective operating earnings (EBITDA) growth forecasts.

Wilsons is more positive, although does not deny the stock is expensive, believing the premium can be maintained in the near term. Downside to current levels is considered unlikely, given the new product cycle in the sleep division and barring unforeseen events. However, the broker acknowledges investors could take advantage of the exaggerated valuation and trim their weightings.

FNArena's database shows four Sell ratings for Fisher & Paykel Healthcare. Wilsons, not one of the eight stockbrokers monitored daily on the FNArena database, maintains a Hold rating and NZ$14 target.

Uncertainty Hovers Over Woolworths

As long as inflation is building in the food sector, Woolworths is considered a worthwhile holding but several brokers question whether this will last.

-Significant profit growth not expected amid surging cost pressures -Woolworths at the forefront of grocery sector in terms of digital strategy -New competition entering the market in 2021 likely headwind to sales growth

By Eva Brocklehurst

Several brokers downgraded Woolworths ((WOW)) in May, believing the stock is overbought and the outlook is going to toughen. The grocery market may be rational and food inflation has reappeared, but will it last?

The share price has risen 11.5% in the past month and is now well above Ord Minnett's valuation. The price/earnings (PE) multiple is high, at 20.6x FY19 estimates and 24.9x FY20 estimates, for 6.3% and 7.0% growth in earnings per share respectively. The broker notes the PE multiple has not been this high since late 2007.

The company's off-market buyback has been supportive yet the broker expects some weakness as it completes and investors reassess their investment.

Ord Minnett has downgraded to Lighten because of the removal of valuation support after the share price rally. Earnings (EBIT) margins are expected to decline in Australian food in FY20 because of higher labour costs. The broker cites significant cost pressures in the food division, not just labour but the petrol discount, rising depreciation & amortisation charges and dual distribution centre costs.

The mitigation of supplier cost increases has become an increasing focus for the company and this has driven some suppliers to withhold stock. Also, a turnaround in liquor is proving difficult, while earnings losses at Big W continue.

The company performed strongly in the March quarter, with 4.2% like-for-like sales growth in its core Australian food business. Sales at Big W rose 5.6%, which brokers note is the best performance in over 10 years. Nevertheless, several do not believe the quarterly outcome will provide substantial profit growth amid surging cost pressures.

As long as inflation is building, Deutsche Bank considers, while not cheap, the stock is a good holding. UBS acknowledges the improving inflation outlook provides some upside risk to forecasts but believes this is priced into the stock. The broker forecasts 4.0% industry growth in 2019/20, excluding tobacco and health. Market growth has improved and online channels are performing best.

Credit Suisse upgrades estimates for like-for-like sales to 3% growth for FY20 and 2.8% from FY21, in view of continuing consistent execution by Woolworths on several fronts, including digital.

Digital Strategy

Credit Suisse believes the major supermarket chains, Woolworths and Coles, ((COL)), are positioned to leverage their growing digital capabilities and establish a competitive advantage in the food retail chain. Promotional expenditure comprises 20% of the food retail value chain and there are material efficiency gains to be had through targeting consumers.

Woolworths Rewards program, Fly Buys in the case of Coles, provides customer identification and behavioural data can also be collected as a result of activity on the respective websites and use of shopping apps. The main difference is that Woolworths has internalised most of its digital capability and this reduces complexity.

In contrast, the independent grocers are relatively weak in digital business and likely to suffer a continued decline in market share as a result. Credit Suisse upgrades its long-term forecasts for sales growth for both Woolworths and Coles, and assumes Coles improves its profit margin relative to Woolworths.

While Coles is upgraded to Neutral , a Neutral rating is retained for Woolworths and Metcash, which serves the independent sector, has been downgraded to Underperform.

UBS differs, moving Metcash to the front of the sector as it offers the best near-term exposure to inflation. Woolworths' execution is strong but it is very difficult to achieve sustained price increases, despite the improving inflation outlook and the broker has downgraded Woolworths to Neutral.

Competition

While the Australian grocery market has been rational over the past year, Citi expects, disruption to intensify once Kaufland enters the market in 2021. Kaufland has a 110,000 square metre distribution centre and nine stand-alone sites under construction. The distribution centre will provide sufficient capacity to support around 190 stores, likely to be a catalyst for a return to private-label price competition and this will weigh on earnings margins.

The broker downgrades long-term earnings margins by -20 basis points to 5.1% for Woolworths and downgrades to Sell. Coles is similarly downgraded to Neutral. Citi factors in investment by the major supermarkets in private-label pricing in order to compete with the newcomers, which will be a headwind to sales growth. The broker also points out that Lidl has followed Kaufland into each new market after around five years.

FNArena's database shows four Hold ratings and four Sell for Woolworths. The consensus target is $29.91, signalling -5.7% downside to the last share price. Targets range from $26.84 (Macquarie) to $32.90 (UBS).

See also, Big W Still A Headache For Woolworths on April 2, 2019.

Trade War Will Hasten Bull Market For Rare Earths

Richard (Rick) Mills Ahead of the Herd

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

Trade war will hasten bull market for rare earths

When the Canadian prime minister or US president visits an auto plant, people are reassured that the government understands the importance of the auto sector for jobs and exports. When the Chinese president recently toured a rare earth company on home soil, it invoked fear among China's trading partners, so critical are these metals for the supply chains of North American high-technology firms.

The presidential visit sent a very clear signal that rare earths could soon become bargaining chips in the trade war that is heating up between the US and China.

Consider that the United States relies on China, the dominant global supplier, for about 80% of its rare earth elements.

Rare earth metals, alloys and magnets needed by US defense contractors come either directly or indirectly from mostly China - it either mines or processes about 90% of all rare earth oxides.

A Chinese embargo on rare earths would be equally devastating to US industry, especially considering their use in permanent magnets - necessary for electric vehicles and wind turbines - two of the most important technologies to wean Americans off of fossil fuels.

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

In this article we take a look at what Chinese restrictions on rare earth elements could mean for the rare earths market.

Three steps to (trade) war

Last Friday week, citing security risks to the US due to the danger of Huawei's 5G network being used for espionage, President Trump signed an order that restricts Huawei and its competitor, ZTE Corp., from selling equipment in the US. American chipmakers like Intel Corp and Qualcomm Inc have confirmed they won't supply software and components to Huawei until further notice.

Then on the Sunday, Reuters reported that Google's parent company Alphabet has suspended all business with Huawei that requires transfer of hardware, software and technical services except those available publicly via open source licensing. That's a big deal. It means that the tech giant will no longer have access to updates to Google's Android operating system, thus hobbling its business outside of China, where Huawei does about half of its smart phone sales. Most of Google's products are banned in China. Alphabet's suspension could delay Huawei's rollout of 5G (the latest cellular network) services throughout the world, and even kill its ambition to become the world's leading smart phone brand.

Just hours after the Trump administration added Huawei to a blacklist that makes it very difficult for the Chinese telecom company to do business with American firms, China's president Xi Jinping went to a rare earth's facility in Jiangxi province.

So with China and the United States now into a full-blown trade war, and two of China's star companies under fire, a likely target is rare earths, the 17 elements in the Periodic Table that are used in dozens of military and industrial applications including electric vehicle motors, wind turbines and missile guidance systems.

Xi's visit to JL MAG Rare-Earth Co Ltd had an immediate effect on the Chinese rare earths market. Reuters reports the MVIS Global Rare Earth/Strategic Minerals Index, which tracks the shares of 20 producers from 10 countries, including China, Australia and Canada, jumped 6.4% in its biggest one-day gain since October 2011, last Tuesday week.

Among the top gainers were JL MAG Rare-Earth Co which soared 10%, Innuvo Technology Co which increased 10%, and Hong Kong-based China Rare Earth Holdings which vaulted 80%.

Beijing said last Monday it would raise tariffs on U.S. rare earth metal ores from 10 percent to 25 percent from June 1, making it less economical to process the material in China. That's clearly a red herring.

The only US producer of rare earths, currently, is the consortium that purchased the Mountain Pass rare earths mine in California. And their total production, in the scheme of the overall global REE concentrate market, is small. There is an interesting twist here though - one of the three companies in the consortium is Chinese, and that's where Mountain Pass rare earths concentrate gets shipped, so that it can be further processed into oxides, then transported back to the US for sale to end-users.

Because Beijing as a one-party state has the power to impose an industry-wide quota on rare earth production - something that would never get around anti-trust legislation in a Western country - and the fact that China has a global monopoly on rare-earth production and refining, China can easily spike rare earth prices.

On March 15 the Chinese government attempted to do just that, by restricting the domestic rare earths production quota. Reuters reported the mining output limit for the first half of 2019 was set at 60,000 tonnes, down 18.4% from the first six months of 2018. The smelting and separation quota was set at 57,500 tonnes, 17.9% lower than H1 2018.

Across-the-board rare earth mining production cuts within China are already happening. At AOTH we think the Chinese are going to further cut their annual production quotas for rare earths.

Hitting American rare earth metal exports with tariffs then, is a red herring, in terms of what drives the rare earth market. But the imposition of export restrictions, perhaps aimed directly at the US, would almost certainly, by exponentially higher prices, pump more steam into a rare earth bull market.

Of course, China could also cut their rare earth exports to the US 100%, just as the country did in 2010 when it banned shipments of rare earths to Japan over a territorial dispute. The result was a massive rise in rare earth oxide prices, and a corresponding flood of junior rare earth companies that formed to take advantage of high REE prices.

'1984'?

In George Orwell's book '1984', the British novelist paints a dystopian global landscape of three "superstates" - Oceania, Eurasia and Eastasia.

These three regions are ruled by totalitarian dictatorships and are constantly at war with one another.

The impetus for China taking the extreme measure of cutting or boycotting supplies of rare earths to the United States - the plot line, by the way, for an episode of the Netflix series 'House of Cards' - would be the continuance of the 25% tariffs. It's possible the tariffs could come off, just as the US and Canada agreed to do in moving forward on the re-negotiated NAFTA, but some of the commentary around this issue leads to the conclusion that conflict, and tariffs, between the US and China is here to stay.

Why is that? Because although this trade war started with seemingly benign and boring duties on aluminum and steel, it's really about technology and how both superpowers are positioning themselves in the world order - in other words, it's geopolitical, and from what it looks like to us, we are in fact moving away from globalization and towards a world of trading blocks, just like in '1984'.

Here's Zero Hedge, writing about the enormous implications of the trade war with China:

Because - as we explained last December - what is really at the basis of the ongoing civilizational conflict between the US and China, a feud which many say has gradually devolved into a new cold war if few top politicians are willing to call it for what it is, are China's ambitions to be a leader in next-generation technology, such as artificial intelligence, which rest on whether or not it can design and manufacture cutting-edge chips, and is why Xi has pledged at least $150 billion to build up the sector. China's plan has alarmed the US, and chips, or semiconductors, have become the central battlefield in the trade war between the two countries. And it is a battle in which China has a very visible Achilles heel.

But what if the "trade" conflict with China is about more than even technological development? If, as Bank of America assumes, the US-China trade war is about geopolitics and not just economics, as the bank notes, the "implications for markets are enormous."

The website goes on to explain three reasons why China managed to achieve such a fast rate of growth in only a few decades: American imports of Chinese goods, reflected in the trade imbalance between the US and China that Trump rails against; China's technology and intellectual property, gained by forcing foreign companies to transfer technology by setting up Chinese-controlled joint ventures; and commodity purchases.

The country is the world's largest importer of oil, coal, iron ore, copper and soybeans. Although this has given China tremendous clout over the prices of these goods, it's also put Beijing in a dependent situation with economic competitors like the US which last year became the largest oil producer.

The Globe and Mail's Barrie McKenna agrees, arguing the trade war is really a war for tech supremacy. In a column published on Saturday, McKenna writes:

The tariff fight between the two countries is a proxy for a much broader struggle for dominance in the digital economy. The tariffs on hundreds of billions of dollars of goods are just a prelude. And even an eventual deal to lift them won't resolve the underlying rift.

"This isn't going away," insists trade economist Dan Ciuriak, a fellow at both the C.D. Howe Institute and the Centre for International Governance Innovation.

"The basis for competition between nations has shifted from brains to brute force computing, and China excels at that."

The showdown predates Mr. Trump, and it will likely endure long after he's gone.

Even a full breakdown of China-U.S. trade would deliver a relatively small hit to these two economic titans – perhaps a loss of 2 per cent of gross domestic product for each country, Mr. Ciuriak estimates. The tariffs imposed so far cover US$260-billion of trade, but he says that's little more than a "skirmish" in a much longer game.

The fight is not about the price of U.S. pork and soybeans, or Chinese TVs and washing machines. It's about a rivalry in technology.

Over at Project Syndicate, economics professor Nouriel Roubini argues that China and the US are gradually moving towards war - maybe not a hot war, although the constant tensions in the South China Sea suggest otherwise - but likely a cold war, which is what historically happens when an emerging power (China) confronts an established power (the US), something called "the Thucydides Trap".

What started as a trade war now threatens to escalate into a permanent state of mutual animosity. This is reflected in the Trump administration's National Security Strategy, which deems China a strategic "competitor" that should be contained on all fronts.

A full-scale cold war thus could trigger a new stage of de-globalization, or at least a division of the global economy into two incompatible economic blocs. In either scenario, trade in goods, services, capital, labor, technology, and data would be severely restricted, and the digital realm would become a "splinternet," wherein Western and Chinese nodes would not connect to one another.

Are we not already seeing this split? The US has imposed sanctions on ZTE and Huawei over allegedly selling into US-sanctioned Iran and has just blacklisted Huawei and restricted buying and selling between Huawei, ZTE and US companies. There are 25% tariffs on $250 billion worth of Chinese products, and Beijing has responded in kind.

The US has put its differences aside with Canada and Mexico, dropping steel and aluminum tariffs in order to concentrate on the real target: China.

Meanwhile, China is progressing its Belt and Road Initiative. BRI consists of a vast network of railways, pipelines, highways and ports that would extend west through the mountainous former Soviet republics and south to Pakistan, India and southeast Asia.

So far over 60 countries, containing two-thirds of the world's population, have either signed onto BRI or say they intend to do so. According to the Center for Foreign Relations, the Chinese government has already spent about $200 billion on the growing list of mega-projects projects including the $68 billion China-Pakistan Economic Corridor. Morgan Stanley predicts China's expenditures on BRI could climb as high as $1.3 trillion by 2027.

An Asia geopolitical expert says that, while BRI satisfies a number of economic goals for China - including expanding its supply chains, accessing overseas labor, and preventing massive layoffs when companies run out of domestic infrastructure to build - the over-riding goal is regional influence.

Two economic blocks drawing closer together - the US, Canada and Mexico, versus China and the Eurasian countries it wants to bring into its BRI orbit. Toss the European Union into the US mix, which admittedly is more unraveling than raveling, considering Brexit, and you have something that eerily resembles the superstates of '1984'.

Defense Metals

Into this adversarial world of trading blocks, so different from the world envisioned by globalization, enter Defense Metals (TSX-V:DEFN), a small-cap junior aiming to bring a rare earths deposit in central British Columbia, into production.

But first, a little context.

Raising money for exploration in the junior resource market right now is difficult, to put it mildly. According to Oreinc, a Vancouver-based research and advisory firm, Canadian-listed mining companies are raising less money and inking fewer deals.

As reported by the Financial Post, Oreinc tracked around 1,400 Canadian mining companies between $100 million and $1.5-billion valuations. It found that in 2018, cannabis companies raised $4 billion versus $217 million by mining companies.

The situation is completely reversed comparing the top 10 Toronto Venture-listed companies in 2016 versus 2019. In 2016 there were nine mining companies and one pot company on the list; this year there are nine marijuana companies and one mining company.

What does this mean for the rare earths market? Well, as financings dry up, so does the exploration pipeline. Companies that would normally be out there kicking rocks, sampling, drilling and drumming up shareholders, are in a holding pattern, waiting for the market to come back. In the meantime, the supply of rare earths is not growing, while the demand certainly is; shrinking exploration, ergo, flat or depleted supply, equals higher prices.

One company that is not waiting for the tide to change is Defense Metals.

The first assay results of a bulk sample program at DEFN's Wicheeda Project have been released…they're spectacular. A 30-tonne random sample taken from the deposit revealed the presence of four defense and clean energy (magnet/ lithium-ion battery) rare earth elements: cerium (Ce), lanthanum (La), neodymium (Nd) and praseodymium (Pr).

These results are impressive for three reasons:

The presence of neodymium and praseodymium is critical, because these two REEs are used in the manufacture of Nd-Pr-Iron-Boron permanent magnets that go into a number of high-tech applications. All 4 rare earth elements are used in the manufacture of lithium-ion batteries found in electric vehicles. The results indicate a potential light rare earth deposit of significant value. Defense Metals will be targeting magnet manufacturers, lithium-ion battery manufacturers, green energy companies and defense contractors to buy their rare earth concentrate and oxides.

Rare earths are great multipliers, they are used in making everything from computer monitors and permanent magnets to lasers, guidance control systems and jet engines. In most cases there are no substitutes.

Shareholders of Defense Metals can expect significant news flow starting soon. Metallurgical testing of the 30 tonne bulk sample continues and the company is planning on a massive drill program for 2019 leading to a 43-101 compliant resource estimate this fall.

Conclusion

While the US-China trade war is negative for many people on many fronts, rare earths companies are not among them. In fact, if China goes forward and restricts its exports of rare earth elements to the United States, prices of REEs will definitely rise. That is good news for rare earth explorers. The prices of REEs have already climbed this year due to slashed production quotas in China; higher export restrictions will only fan the flames of a hotter rare earths market.

China has a lock on REE supply and the only significant non-Chinese supplier is Australia's Lynas, which processes its REEs in Malaysia. Lynas is having to revamp its entire mine-to-processor chain. We just learned that the Australian company is going to relocate its processing plant from Malaysia to Western Australia, in order to appease regulators unhappy about waste disposal. Lynas is also fending off a takeover attempt. In the news May 21st was an interesting piece regarding Lynas and Blue Line Corp. Because of a lack of REE processing outside China the two companies are teaming up to build the first rare earth processing plant in the US.

At Ahead of the Herd we've identified a project in northern BC that has all the elements in place for a successful, small-scale rare earth operation: Defense Metals' Wicheeda Project.

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

Content included in this article is not by association necessarily the view of FNArena (see our disclaimer).

Iron Ore Price Ascending

Global supply of iron ore has fallen over 2019 and China's port stocks are dwindling. So, how high can prices go?

-Iron ore markets currently facing a supply disruption of around -6% -The physical squeeze on stocks may be passed as China's steel production should seasonally slow -If India has to import more iron ore prices may linger above US$80/t, CBA analysts suggest

By Eva Brocklehurst

Supply and demand for iron ore have aligned and prices have risen above US$100/t, benefiting major Australian miners amid significant supply disruptions from their Brazilian counterpart, Vale, the world's largest supplier.

Sentiment regarding supply, after an acute tailings dam failure in Brazil this year, has weakened. Vale has recently indicated it expects another tailings dam, Gongo Soco (currently not producing), to fail if seismic activity at a nearby mine continues.

However, Australia has not been without its setbacks, as both BHP Group ((BHP)) and Rio Tinto ((RIO)) reduced 2019 shipment guidance after Cyclone Veronica cut a swathe through the north west in March.

Commonwealth Bank analysts believed a breach of US$100/t for iron ore was always a chance following the supply disruptions that have affected the market, including the fatal dam failure at Vale's Feijao mine in January, which triggered a series of mine closures across Brazil.

Vale has guided to reduced sales of iron ore, down -50-75mt this year, and its iron ore production is -93mtpa below levels before the dam disaster. Iron ore markets, the analysts calculate, are currently facing a supply disruption of around -6% of the seaborne market. Accounting for an increase in China's iron ore output, in response to higher prices, this is only slightly better, at -5.5%.

The CBA analysts upgrade estimates for iron ore prices by 7% to US$92/t in 2019 and by 3.5% to US$74/t in 2020 on the back of further downside to China's iron ore port stockpiles. UBS has lifted forecast prices for 2019 and 2020 by 8% and 4% to US$90/dmt and US$80/dmt, respectively.

The broker expects earnings for major iron ore miners will be lifted by up to 17% in 2019 and, in Australia, Rio Tinto will be the largest beneficiary. China accounts for 70% of the world seaborne imports and, more specifically, iron ore prices are primarily driven by physical changes to supply and demand.

Significantly, cost curves are steep at these prices such that that any change in supply conditions can cause iron ore prices to move wildly, in either direction, the CBA analysts assert. Warnings have been sounded that volatility will be extreme if China's iron ore port stocks fall below 100mt. As seaborne markets are missing around -90mt of production right now there is a risk this will occur.

The lag between the drop in China's port stockpiles and the dam disaster reflects the timing of shipments from Brazil to China, and the efforts by Vale to deplete any existing stockpiles. The CBA analysts note, in the past, port stocks in China been overlooked because of a higher proportion of low-grade ore. Not only has this proportion moderated but low grades are becoming more attractive following the surge in prices.

Iron ore port stocks may be a two-year lows but do not look particularly low versus recent history, in Macquarie's view. The broker suggests it is better to look at stocks relative to some estimates of demand. While demand continues to outpace supply for now, and stocks may drop for another week or so, Macquarie believes the physical squeeze is past and steel production should seasonally slow.

Also, Australian supply is running above its average and more Brazilian cargo should arrive in China by early June. The CBA analysts point out that around 40mt of production from Vale that is off-line is largely because of Brazilian regulator intervention. The 30mt Brucutu mine has received most of the scrutiny, in that this could return to production quickly if approval is obtained.

Since the mine was first ordered shut in on February 5 there have been two occasions when approval was granted and then withdrawn. Vale's production is expected to be normalised over three years and Brucutu, which does not use the same type of dam at that which collapsed at Feijao earlier, is expected to come back on line over the next 6-12 months.

Australian Supply

Australian iron ore majors have shipped volumes at above-average levels in the last few weeks, yet Macquarie notes Rio Tinto is currently running well short of guidance following a weak first quarter. Sustaining very recent levels of shipments may prove difficult and the broker expects a reversion to the average. Fortescue Metals ((FMG)) and BHP Group are shipping in line with guidance.

While tonnage has been variously lost from Vale, Rio Tinto and BHP Group, UBS observes growth in Anglo-American's Minas Rio mine and notes Australia's Roy Hill is at capacity. All up, the broker forecasts 2019 seaborne demand to lift by around 30mt and supply to shrink by -40mt. The latter is based on known outages and prior to any lift in production from countries which previously used to export iron ore at higher prices.

Steel

Macquarie's latest survey of Chinese steel shows sentiment on the 3M steel market has become a little less positive. End-user demand remains driven by general construction activity and demand for flat steel has declined sequentially in April.

Steel margins, which reflect the ability of mills to absorb higher iron ore prices, have been supported by rising steel prices. China's crude steel output rose to a record high in April and China's policymakers still plan to increase expenditure on infrastructure.

Meanwhile, India is expected to face an iron ore shortfall next year and, if it has to import more iron ore as a result of its bureaucratic processes, the CBA analysts suspect iron ore prices may linger in the US$80 region, or even the US$90, next year.

See also, Material Matters: Iron Ore, Met Coal & Copper on May 21, 2019.

Material Matters: Oil, Copper, Gold & Steel

A glance through the latest expert views and predictions about commodities. Oil; lithium; titanium dioxide; copper; gold; and steel.

-Bearish view continues for global lithium prices -Downside risk to oil supply meets weak demand, hard to argue bull case beyond 2020 -Growth projects should put titanium feedstock market into modest surplus by around 2022 -Increased probability of copper supply disruptions -High-quality Australian gold companies a key opportunity -Market sentiment on steel slightly less positive

By Eva Brocklehurst

Oil

Macro economic data has recently deteriorated, reflected in weak oil demand. At the same time, Morgan Stanley observes downside risk to supply is also emerging. On balance, tightness is still expected in the second half of 2019.

While the OECD is hardly a driver of global oil demand growth, a drop-off in demand in March is considered a weak signal. There was also a slowdown in demand growth in China and India. Meanwhile, oil exports from Iran appear to be falling and a further decline is expected in Venezuela.

On balance, Morgan Stanley expects a deficit in the second quarter and undersupply in the third quarter. Hence, it becomes hard to argue that the bull case for oil will last much longer in 2020 and prices are likely to return to their long-term levels, which the broker estimates around US$65/bbl.

Citi believes oil markets are retreating in sympathy with other risk assets, as weakness over the US/China trade dispute offsets the earlier constructive signs emanating from the OPEC meeting in Jeddah.

Several members reiterated a need to stay the course on production limits in support of a slow reduction in inventory, while Russia called for a more flexible approach. As fixed capital investments in oil and natural gas fell -2.3% to an exceptionally low rate of growth, the likelihood that Russia opposes an OPEC extension to cuts may have increased. Citi observes the divergence between physical and financial indicators for oil continues.

Lithium

Prices for lithium are falling faster than previously expected. Sociedad Quimica y Minera de Chile's (SQM) CEO is guiding for a -30% fall to US$11-12,000/t by the end of the year. This is considerably below Morgan Stanley's estimates and indicates that contract prices in Chile are converging with spot prices in China because of oversupply.

Morgan Stanley remains bearish on global lithium prices and equities. Behind this view is the maths regarding the new fee structure and SQM gradually recovering back to its traditional price setter role in lithium. The broker believes SQM has economic incentives to reduce lithium prices to around US$8000/t which is comparable with its view of prices bottoming at US$7300/t in 2021.

Major lithium brine expansion announcements a year ago by both Albemarle and SQM started the ball rolling in pressuring prices. Expansions have been delayed by SQM and Albemarle is now flagging curtailments to hard rock supply as, along with other Chinese converters, it struggles to profit from downstream processing at current prices.

The company has also indicated the Wodgina JV with Mineral Resources ((MIN)) may restrict concentrate sales for the first two years until downstream plans are built. Albemarle's comment suggests to Ord Minnett it is close to marginal costs at US$10,500/t.

Ord Minnett reduces global supply forecast by -8% for 2020 and -14% the 2021 but still considers a surplus likely. Battery-grade prices for the next two years are lowered by -10% to US$11,500-12,000/t of lithium carbonate equivalent. Concentrate pricing is lowered -14% to US$550/t.

While preferring Mineral Resources and Orocobre ((ORE)) as companies with first quartile assets and rating them Accumulate and Buy respectively, Ord Minnett downgrades Kidman Resources ((KDR)) to Hold and Pilbara Minerals ((PLS)) to Lighten, as falling concession prices increase the pressure for improved operating rates in order to deliver positive cash flow.

Titanium Dioxide

Average prices, globally, for titanium dioxide have declined over recent quarters to US$3000/t versus a peak of over US$4000/t in 2011-12. Prices have held up more so in North America, while Europe has stabilised amid lower imports from China.

Citi expects low single-digit price increases in subsequent years helped by higher feedstock costs. The broker also notes some western producers have implemented a longer contract strategy to avoid boom-bust cycles. This has maintained pricing in the current trough but is expected to drag in up-cycles.

Utilisation rates are expected to rebound in 2019, with upside risk and potential project delays or capacity closures. Improved pricing has encouraged a modest expansion in supply. In the long-term there should be sufficient growth projects in the pipeline to put the feedstock market into a modest surplus in around 2022.

Copper

The probability of copper disruptions occurring is rising rapidly. So far this year disruptions are running in line with Citi's annual disruption allowance. As the bulk of Zambia's power is sourced from hydro, the ongoing drought may lead to load shedding lasting as long as 6-9 months and potentially affecting copper production.

River flows are extremely low and dam levels appear set to reach critical levels by the first quarter of 2020, absent load shedding. This matters because Zambia is an important copper producer, accounting for 4% of supply and around 15% of supply growth. Meanwhile, in Peru, Las Bambas shipments are being disrupted by a road blockade, affecting around 400,000tpa or 2% of mine supply.

Gold

Australian gold miners continue to outperform because of solid cash flow, strong balance sheets, and a weakening Australian dollar which supports the Australian gold price. JPMorgan believes positioning in the highest quality companies presents the best risk-weighted opportunity. Moreover, the Reserve Bank of Australia's recent indication that official rate cuts are on the way is pressuring the local currency.

St Barbara ((SBM)) is among the broker's top global picks, having recently acquired a Canadian producer and diversified an undervalued Australian business. JPMorgan downgrades Evolution Mining ((EVN)) and Northern Star ((NST)) to Neutral on valuation. Both companies are considered in great shape and, until next reporting season, gold sentiment is expected to be the main driver.

Steel

Macquarie's latest survey of China's steel industry reveals market sentiment has become less positive. Domestic sales growth has slowed over the past month. End-user demand is driven by general construction and demand for flat steel has declined sequentially. Steel mills lifted raw material inventory over the past month and still plan to lift raw material purchases in the near term but the re-stocking appetite is not as strong, the broker notes.

By sector Macquarie notes demand from infrastructure, construction and machinery improved but the growth rate month on month decelerated. The broker's deduces that demand for long steel remains in a better position versus flat steel products.

Steel mills have reported a continued positive profit margin, despite the fact raw material costs have increased, and the positive margin encourages steel supply in China. Macquarie does not believe the mills are yet under pressure to cut prices to promote sales but may try to shift inventory from plant to traders in coming weeks and this could influence the spot steel market.

Lithium M&A Heating Up Despite Trade War

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.

Lithium M&A heating up despite trade war

After several months without a significant deal, a lithium exploration company and a lithium producer are the latest investment targets, as demand for the white metal crucial for the manufacture of lithium-ion batteries continues to soar.

This is in spite of the fact that China, a major player in the lithium sector, is going toe to toe with the United States in a trade war that, as of June 1, subjects critical metals like lithium and rare earths to Chinese import tariffs.

In this article we take a deep dive into lithium and examine what effects an escalation of the trade war could have on the global lithium market, in particular the United States as it aims to reduce its dependency on foreign lithium suppliers.

Bacanora Minerals deal

On May 20 Bacanora Minerals (LSE AIM:BCM) announced that Ganfeng Lithium, China's second biggest lithium producer (the largest is Tianqi Lithium), will buy close to one third of the company. According to a press release, Ganfeng will pay GBP14.4 million (US$17.7 million), or 25 pence a share, for a 30% stake in Bacanora, which is developing the Sonora claystone lithium deposit in Mexico.

The cash payment for 56 million BCM shares also gives Ganfeng the option to buy a 22.5% stake in the Sonora project for $9.6 million, nominate a director to sit on Bacanora's board, and increase the project stake to 50% within six months. In exchange for its investment, Ganfeng will have the right to purchase one half of all lithium produced at Sonora during its first stage of production.

Alliance Mineral Assets deal

Then on Monday, Alliance Mineral Assets (A40: AX), an Australian lithium producer, said it has entered into a memorandum of understanding with Jiangxi Special Electric Motor, a major Chinese EV maker.

According to a press release, the companies plan to form a 50-50 joint venture to produce and sell battery-grade lithium hydroxide within the next six months to a year. The lithium would be sourced from Alliance's Bald Hill spodumene operation, then shipped to Jiangxe province where the Chinese EV company would convert it to lithium hydroxide, used in EV battery cathodes.

Alliance notes that one of the agreement's key benefits is it provides Alliance access to a nearly completed lithium hydroxide circuit in China, rather than having to build a new conversion facility from scratch.

Trade war escalates

Of interest to us at Ahead of the Herd, is not only the interest that Chinese companies are taking in lithium projects, but the timing. They are occurring at the same time as China and the US are ratcheting up the rhetoric in the ongoing trade war and putting more on the table by increasing tariffs on each other.

Could it be that China wants to lock up more lithium supply before lithium prices rise? We know that the lithium market in the long term is likely to be in deficit as troubles ramping up production meet a mounting wall of demand. We also know that China produces roughly two-third of the world's lithium-ion batteries and controls most of its processing facilities. This give China tremendous clout should it decide to deprive the United States of lithium batteries or raw materials, just as the US is planning a mine-to-EV battery supply chain.

After several weeks of trade negotiations in Washington failed, the US decided to walk away and raise duties on $200 billion in Chinese products to 25% from 10%. In retaliation, Beijing hit $60 billion worth of US exports to China - raising import tariffs to between 10% and 25% on an extensive list of over 5,000 US products. About half are being tariffed at 25%. Among the mineral and chemical products about to be punished on June 1, are sulfur, graphite, asbestos, borate, feldspar, rare earth metal ore, titanium oxide, lithium carbonate, and metal concentrates including iron ore, manganese, copper, nickel, zinc, titanium, zirconium, vanadium, precious metals and mineral sands.

It's also been reported that the US started a formal process Monday to slap tariffs on China's remaining exports to the United States - likely leading to higher prices for iPhones, toys and sneakers, among the goods affected.

So far the United States has refrained from ensnaring critical minerals in its net of Chinese goods subject to tariffs, and for good reason; many US companies (and the military) rely on imports of rare earth oxides to make high-tech materials such as electric motors used in EVs, wind turbines and a myriad of defense applications. Disrupting their supply chains would inflict serious harm on them. Same with manganese, necessary for smelting iron ore into steel, and various lithium products plus graphite needed for lithium-ion batteries; for the latter, China is by far the largest producer.

China feels no such need to hold back on critical metals tariffs. But this trade really only goes one way. Very small volumes of minerals and chemicals on the above list are exported from the United States to China. It's China that holds the power to disrupt these markets, which in several cases is a major producer.

In Trade war will hasten bull market for rare earths, we argued that hitting American rare earth metal exports with tariffs is a red herring, in terms of what drives the rare earth market. But the imposition of export restrictions, perhaps aimed directly at the US, would almost certainly, by exponentially higher prices, pump more steam into a rare earth bull market.

It's the same thing with lithium; tariffs on US lithium exports are inconsequential. Currently the only US lithium producer is chemicals giant Albemarle. Lithium products from Albemarle's Silver Peak lithium brine operation in Nevada are sent to its processing plant in North Carolina. This material is then loaded on ships and sent to Asian battery manufacturers, which sell the batteries to automakers.

We don't know how much lithium hydroxide Albemarle exports to China from Kings Mountain (the company does not disclose the amount to the USGS in tabulating global production statistics), but we do not think it is significant in global terms. According to Visual Capitalist, Silver Peak only produces 1,000 tonnes per year of lithium hydroxide, within a current lithium market of roughly 280,000 tonnes per annum of lithium carbonate equivalent (LCE), a term that encompasses both lithium hydroxide and carbonate used in EV batteries.

Rather, the larger weapon in China's arsenal is the ability to use its size in the EV batteries market to bully US lithium consumers. Remember China produces two-thirds of the world's lithium-ion batteries and has a lock on most lithium-ion processing facilities.

Chinese lithium suppliers and battery makers could restrict lithium sales or stop supplying batteries to US companies, or companies that are planning on manufacturing EVs in the US. Other automakers are planning on building EV and EV battery plants in the United States, but with the threat of their battery supplies being cut off, these new factories are also unlikely to proceed.

Think the China-US trade spat could blow over? It doesn't look like it. A recent news headline has Chinese President Xi Jinping evoking the iconic Chairman Mao in his quest for world domination.

"We are here at the starting point of the Long March to remember the time when the Red Army began its journey," Xi said at a rally in Jiangxi province. "We are now embarking on a new Long March, and we must start all over again!" according to a report from the South China Morning Post.

While the trade war wasn't mentioned, the implication was clear - China is not planning to cave in any time soon, noted CNBC.

China's lithium domination

A Tesla executive said recently the company is worried about a shortage of lithium. And while the number of EVs on the roads are expected to multiply in coming years, they can only progress as fast as the lithium-ion batteries that go in them.

The pendulum is clearly China. Consider that in 2017, China sold 750,000 electric cars, 50% more than in 2016. And that was only 3% of the Chinese vehicle market. By 2025, the Chinese government wants EVs to represent 20% of all cars sold.

As Quartz notes, in order to maintain its dominance in the lithium market, Chinese manufacturers need a lot of cheap lithium. That explains why its largest lithium miner, Tianqi Lithium, owns 51% of Australia's Greenbushes spodumene mine - the world's dominant hard-rock lithium mine. And why China bid for, and got, a 23.7% stake in Chilean state lithium miner SQM, the second largest in the world, for $4.1 billion.

EV growth continues

As noted at the top, two Chinese companies this week inked deals to obtain more lithium, thereby further solidifying China's position at the top of the lithium heap.

As China's mark on the lithium market becomes more pronounced, growth in electric vehicles is taking off.

According to Adamas Intelligence, this past February 75% more lithium carbonate was deployed for batteries in electric and hybrid passenger vehicles compared to February, 2018.

Europe in particular is becoming more important, due largely to renewable energy initiatives and buyer incentives.

According to an article in Seeking Alpha, stringent CO2 emissions starting in 2020 "are paving the way for the meteoric rise of electric vehicles." Germany is looking at doubling subsidies for EVs costing under 30,000 euros and raising subsidies for more expensive electrics. Mercedes Benz wants to make its entire fleet of vehicles carbon neutral by 2039.

GM has just come out with new "electronic architecture" for the interiors of its EVs and self-driving cars. The new systems are capable of carrying 4.5 terabytes of processing power per hour, five times that of current electronics. The new architecture will be deployed in GM's first EV, the 2020 Cadillac CT5 sedan.

According to Bloomberg, EV sales are expected to increase from 1.1% of the total auto market in 2017, by a factor of 10 by 2025, 27x by 2030 and 50x by 2040. JP Morgan meanwhile is forecasting electric cars to be 35% of the global market by 2025 and 48% by 2030.

A recent article in MINING.com has the world's largest mining company, BHP, saying that it has raised its forecasts for global adoption and sales of EVs. The diversified miner estimates in 2035 there will be at least 132 million EVs on the road - comprising 7% of the world's vehicle fleet versus its earlier 5% estimation.

According to Benchmark Intelligence, the growth of lithium-ion gigafactories to supply batteries to all of those EVs, is expected to blossom from 45 in production currently, to 76 by 2028.

Need to develop North American lithium supply

In 2008 the National Research Council saw lithium as potentially becoming a critical mineral due to the expected growth of hybrid vehicle batteries. Two years later the US Department of Energy's Critical Materials Strategy included lithium as one of 16 key elements.

Lithium is also among 23 critical metals President Trump has deemed critical to national security; in 2017 Trump signed a bill that would encourage the exploration and development of new US sources of these metals.

MINING.com noted that according to the USGS, the United States last year imported around half of 48 minerals last year and 100% of 18 minerals - including 100% of rare earths, graphite and indium.

The publication also quotes Simon Moores, managing director of Benchmark Mineral Intelligence, stating that the US only produces 1% of global lithium supply and 7% of refined lithium chemicals, versus China's 51%.

The US government recently introduced bipartisan legislation, led by Republican Senator Lisa Murkowski, to secure local mineral resources including battery metals lithium, graphite, cobalt and nickel.

The Newswheel reported that the pending bill, called the American Mineral Security Act, "would help boost domestic production of minerals used in making EV batteries" such as GM's objective of "expanding its battery-production facilities so it can introduce 20 new EV models by 2023."

Significantly for the current trade war, the legislation would also exempt automakers from paying tariffs for shipping extracted minerals like lithium carbonate and hydroxide overseas for processing, The Newswheel adds.

Junior financing breakdown

The problem is, in order to kickstart exploration for critical minerals, the industry needs more than government support; it requires money.

Raising cash for exploration in the junior resource market right now is difficult, to put it mildly. According to Oreinc, a Vancouver-based research and advisory firm, Canadian-listed mining companies are raising less money and inking fewer deals.

As reported by the Financial Post, Oreinc tracked around 1,400 Canadian mining companies between $100 million and $1.5-billion valuations. It found that in 2018, cannabis companies raised $4 billion versus $217 million by mining companies.

What does this mean for the lithium market? Well, as financings dry up, so does the exploration pipeline. Companies that would normally be out there kicking rocks, sampling, drilling and drumming up shareholders, are in a holding pattern, waiting for the market to come back. In the meantime, the supply of lithium is not growing, especially in North America; shrinking exploration, ergo, flat or depleted supply, plus increasing demand for electrical vehicle batteries, equals higher prices.

Conclusion

The current M&A we are experiencing in the lithium space is interesting for the fact that it’s coming at the same time as the screws are being tightened on both the lithium and rare earths markets - US exports of both are now subjected to Chinese import tariffs.

However the trade war is really just a smoke screen for what’s actually occurring in lithium - a further locking down of lithium supplies by China - with the two latest examples occurring this week - first, an investment by Ganfeng Lithium into Bacanora Minerals, and second, an offtake agreement between Alliance Mineral Assets and a major Chinese electric vehicle manufacturer.

If things get uglier on the trade front, there’s nothing stopping China from slapping an embargo of its processed lithium, or lithium-ion batteries, on US lithium consumers, thereby hurting US companies that rely on these products.

It all points to the need to take steps to end North American dependence on foreign lithium, by exploring for and developing local mines.

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

Material Matters: Oil, Alumina & Base Metals

A glance through the latest expert views and predictions about commodities. Oil; alumina & aluminium; and base metal miners.

-Are deflationary forces gathering in oil? -Few reasons for a sustained increase in alumina prices -US remains shy of meeting aluminium needs -Despite pressure on base metals, Australian miners likely to outperform

By Eva Brocklehurst

Oil

Deflationary forces may be gathering in oil, despite the strength in the price. Morgan Stanley reviews the scope for oil prices to trend down over the medium term and notes some weakness in demand is developing while observable draws on inventory have been hard to find.

However, there are large downside risks to supply from Iran and Venezuela and the market is likely to be undersupplied by around 1.1mb/d by the September quarter. By the fourth quarter IMO 2020 regulation should boost refinery runs and the broker expects this will keep the oil market tight.

Alumina & Aluminium

Amid continued outages in China, Norsk Hydro has announced that the production embargo against its Alunorte alumina refinery has been lifted and it will rapidly increase operations to full capacity. Norsk Hydro has also announced a decision to re-start its partly-curtailed Albra aluminium smelter. Full production is expected in the second half of 2019.

Seaborne Australian alumina prices were set back after this announcement but the re-start of Albra and growing buyer interest from China are expected to support prices at elevated levels for the next two months.

However, the key issue is whether disruptions in Shanxi could continue, JP Morgan assesses. Other alumina capacity is also at risk in China, the broker points out, with disruptions caused by shortages of bauxite or technology issues. Still, outages at this stage in Shanxi are not expected to last longer than 5-6 weeks. Hence, JP Morgan does not find any strong reasons for a sustained increase in alumina prices.

Meanwhile, aluminium, as with other base metal markets, will remain receptive to developments in the US/China trade negotiations. The US administration has lifted the 10% tariff on primary aluminium imports from Canada into the US. Regardless, the US will be shy of meeting its requirements, JP Morgan calculates. US domestic aluminium stocks are quite low, meaning there is no longer a buffer when it comes to reduced imports.

Despite the exemption for Canada, marginal tonnage to fill the supply gap is still likely to come from non tariff-exempt imports. The broker suggests the reduced non-exempt supply gap warrants some discount in forward premiums as most risks are skewed quite steeply to the downside. The other three countries, besides Canada, that are exempt include Australia, Argentina and Mexico. Mexico is a small operator and Argentina's exemption comes with a quota.

While Australian exports to the US have risen, now around 3.5 times the level of a year ago, they remain far from potential, were Australian producers to aggressively divert exports. The broker addresses the question of why there has not been a larger amount of Australian aluminium being diverted to the US, suggesting this stems from long-standing contracts that Australian producers have with Asian consumers.

Over the last three years Australia has exported more than 50% of its aluminium by value to Japan and South Korea and another 30% to Taiwan, Thailand, Vietnam and Indonesia. There appears to be little attraction in the US market for Australian producers, as yet.

Base Metal Miners

Macquarie notes the US/China trade war has put pressure on base metal prices, with copper and nickel down -8-9% since April. Lead, tin and zinc prices are all down -9% and only cobalt has bucked the trend, rising 12%, largely on the back of concerns about supply from the Democratic Republic of the Congo.

For Australian base metal miners, there are a number of catalysts that should drive outperformance and high margins insulate the miners as well. The broker considers Sandfire Resources ((SFR)), OZ Minerals ((OZL)) and Independence Group ((IGO)) offer the best protection on near-term downside risks. OZ Minerals remains the broker's preferred stock in the grouping, with several material announcements due this year, culminating with the commissioning of the Carrapateena project.

Meanwhile, Western Areas ((WSA)) offers the most significant earnings leverage to a resolution of the trade conflict. The broker envisages limited risk to the near-term production outlook while the development of Cosmos is reliant on an assumed recovery in nickel prices. The poor performance at Nifty has weighed heavily on Metals X ((MLX)) and Macquarie expects a re-start will be a significant catalyst. Similarly, securing funding for Sunrise will be the key catalyst for Clean TeQ ((CLQ)).

The downside risk to earnings forecasts is significant for high-cost miners. For Panoramic Resources ((PAN)) the downside risk is over -50% in FY20/21 although a successful ramp up of Savannah will reduce the earnings risk in FY21. A similar downside scenario exists for both Western Areas and Metals X, in the broker's estimates.

Iron Ore Peaking?

Brazil's Vale is plagued by problems at its iron ore mines and, despite surging prices, other suppliers are finding it difficult to make up the difference. Yet are prices peaking?

-Australian-sourced iron ore experienced the largest decline in stockpiles in China -Iron ore prices may find a top as steel output in China is curbed -Lump ore premiums still likely to be above historical averages

By Eva Brocklehurst

A structural shift has occurred in the global iron ore market as the top source of supply in Brazil has been sharply reduced. Brazil's Vale, the world's largest producer of iron ore, had believed it could mitigate lost production through expanding other operations but has found this difficult.

Investigations have found even more problems beyond the fatal tailings dam failure that started the ball rolling. Credit Suisse cites news reports that a rock slide at the abandoned Gongo Soco open pit is moving at the rate of 20cm a day, indicating a collapse is imminent.

ANZ analysts do not expect any material rise in Vale's output in 2019 and forecast supply to be short of expected demand by -45mt. Macquarie also suspects a recovery to 400mtpa from Vale is likely to take longer than previously expected, noting while the company has reiterated guidance for 2019 of 307-332mt its commentary has shifted to emphasise the lower end of the range.

Shipments from Vale in April were at record lows. However, the real significance is for 2020 when the deficit could increase, as port stocks dwindle and other suppliers fail to fill the gap. ANZ analysts expect tightness in the iron ore market to linger well into 2020 and expect prices to remain above US$85/t in 2019.

Usually, across commodities, supply from other quarters quickly fills the gap from any disruptions but this is not occurring for iron ore in any significant way. Weather-related disruptions have also coincided, as Vale experienced heavy rain in its northern system in the March quarter and Australian producers were forced to lower output guidance because of Cyclone Veronica.

BHP Group ((BHP)), which cut production guidance to 265-270mt, has noted that output for the current year will fall for the first time since 2000. Rio Tinto ((RIO)) recently cut its 2019 shipment guidance to 333-343mt. Fortescue Metals ((FMG)) has not changed guidance, expecting 165-170mt.

Moreover, the ANZ analysts note Australian-sourced iron ore has experience the largest decline in stockpiles in China. Tradable port inventory for medium-grade fines is at very low levels and Chinese buyers have few high-grade alternatives for use in sinter feed.

The port squeeze has begun. Credit Suisse expects inventory to shrink further, while prices should climb before supply increases on a seasonal basis from the fourth quarter of FY19. Meanwhile, a short-lived increase in steel margins has been erased by rising iron ore prices and this has allowed Fortescue to maintain narrow contract discounts for its lower-grade ore.

Premiums

Premiums for high-grade ore and discounts for lower grades have contracted since the dam tragedy. Lower grade prices, Macquarie notes, have risen by around 100% in the year to date and currently trade at around US$93/t. Higher grades have increased to a lesser extent, trading at around US$120/t.

The premium for 65% iron over 62% peaked at over 40% in August 2018 but has moved back to around 15%. Macquarie assesses the current spread of US$30/t between high and low grade remains in line with the average.

However, Morgan Stanley believes the iron ore price is now starting to find a top as output of steel in China takes a breather. Utilisation rates have fallen -1% from the peak in early May and some steel production curbs are in place in Tangshan until September.

The broker expects the current market deficit in iron ore will narrow, although not disappear, as supply modestly improves and China's demand eases. Credit Suisse also points out the province of Hebei will reduce annualised capacity by -14mt in 2019 and 2020 and maintain capacity below 200mt by 2020.

Macquarie expects an increase in supply will come from Australian iron ore miners and this should mean the premium for lump ore will come under pressure. Pellet pricing is also more competitive in China's spot market. Supply disruptions in the Pilbara, where the majority of lump comes from, have eased and Rio Tinto and BHP Group dominate lump supply. Fortescue Metals has recently entered the lump market, with shipments annualising close to 10mtpa.

Yet, new supply should be easily absorbed by the market, Macquarie asserts, given the expected shift to directly charge ore in China, amid growing productivity as well as environmental pressures that favour higher quality. This boost in demand means the broker forecasts the lump premium will stay above the historical average in the next few years, at around US$14-15/t versus the 10-year average of US$12/t.

Higher Prices But Not Supply

ANZ analysts believe higher iron ore prices may still struggle to incentivise new supply. Chinese domestic producers are constrained by policy measures restricting the re-opening of operations. Moreover, iron ore has slipped in terms of investment by the large diversified miners, where the focus has shifted to copper and offshore oil assets.

This leaves traditional swing producers such as India and China to fill the gap. However, much of Indian iron ore is low quality and not a good replacement for imports from Brazil and Australia. India's high-grade iron ore imports have surged as its mills have been keen to use better grades. The analysts note there is an estimated oversupply of more than 150mt of Indian low-grade iron ore. Importing this material into China attracts a 30% duty but Indian exports to China have increased.

Beyond this low-grade source, growth appears unlikely. Morgan Stanley also flags production disruptions have the potential to force Indian steelmakers to the already-tight seaborne market, although this is not a base case.

Macquarie notes, in the long-term, development of BHP's South Flank should supply up to 25mt of lump to the market from 2022 and the company's lump share is expected to increase to 35% from 25%, placing it ahead of Rio Tinto in terms of lump exposure.

Lump

What is lump? Lump is a naturally coarse form of iron ore and a niche market versus the larger global trade in fines. Lump can be directly charged into the blast furnace and typically trades at a premium, equivalent to the cost of sintering fines.

The other main category, pellet, is a high quality product which requires little additional processing. Lump is considered a substitute for pellet, particularly low-quality pellet from China, and the price of pellet plays a role in the lump premium.

While a pick up in China's pellet production is potentially bearish for lump, Macquarie finds little evidence of mines re-starting, although capacity utilisation continues to improve and the rally in spot prices creates a risk that more concentrate and pellet will come back on line.

Several other factors drive the premium in lump including Chinese environmental policy and profitability at steel mills. Chinese demand is set to receive a boost from policy measures protecting economic growth while the outlook for steel demand remains strong as infrastructure expenditure increases.

Weekly Ratings, Targets, Forecast Changes

By Rudi Filapek-Vandyck, Editor FNArena

Guide:

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

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

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

Summary

Period: Monday May 20 to Friday May 24, 2019 Total Upgrades: 14 Total Downgrades: 18 Net Ratings Breakdown: Buy 40.71%; Hold 42.85%; Sell 16.44%

Against a background of portfolio reshuffling and short covering post surprise election outcome in Australia, local stockbroking analysts are equally busier than one would expect this time of the year.

For the week ending Friday, 24rd May 2019, FNArena registered no less than 14 upgrades in recommendations for individual ASX-listed stocks and 18 downgrades. Not unexpected, the tally represents value seen opening up on a change in forecasts (same government, unexpected) and increasing valuation constraints as share prices continue to rise.

Hence, it would be pleasing to note for most investors only four out of the 14 upgrades stopped at Neutral/Hold. On the flip side, 13 of the 18 downgrades sank the recommendation to Sell. It truly is a bifurcated market indeed.

Computershare was the sole recipient of more than one upgrade during the week (one to Neutral only). On the flip side, AGL Energy, ALS ltd, NRW Holdings and TechnologyOne all received two downgrades. Woolworths received three, all went to Sell.

There is more good news from valuation adjustments and earnings estimates updates.

For once, or so it appears, the pendulum has swung towards more positive amendments. It has been a long while (ironically, this coincides with the local index potentially having peaked for the time being).

On the positive side for adjustments to valuations and price targets, Xero, CSR, Medibank Private and Adelaide Brighton all enjoyed noticeable increases. The negative side is characterised by smaller reductions and only three companies worth mentioning: Computershare, ALS ltd and St Barbara.

A similar pattern has formed in forecast changes with Xero, Aveo Group, James Hardie and ALS ltd leading the pack on the positive side, and with only three companies worth pointing at on the negative side: Virgin Australia, Incitec Pivot, and St Barbara.

Out of season reporting results remain on the calendar in the week ahead, while profit warnings continue to feature as well.

Upgrade

ADELAIDE BRIGHTON LIMITED ((ABC)) Upgrade to Outperform from Neutral by Macquarie .B/H/S: 1/4/2

Earnings forecasts for Adelaide Brighton have been trending lower recently, Macquarie notes, on concerns over a falling housing market. But on a combination of the surprise election win, a likely RBA rate cut and APRA's plan to reduce the mortgage serviceability threshold, confidence should be restored and this will filter into housing.

Thus Macquarie now sees greater upside risk to earnings, particularly in FY20. Upgrade to Outperform from Neutral. Target rises to $4.80 from $3.70.

ANSELL LIMITED ((ANN)) Upgrade to Outperform from Neutral by Credit Suisse .B/H/S: 4/4/0

Raw material prices have eased. Raw materials account for around 60% of the company's cost of goods sold. Credit Suisse expects Ansell will achieve only a modest benefit in the second half but forecasts a benefit of around 5% for the first half of FY20.

The broker suspects the company will miss its 3-5% organic growth target in FY19, given indications that demand has moderated.

While wary of a subdued macro economy, Credit Suisse still expects 13% growth in earnings per share in FY20 and upgrades to Outperform from Neutral. Target is raised to $27.50 from $24.00.

CHARTER HALL LONG WALE REIT ((CLW)) Upgrade to Buy from Hold by Ord Minnett .B/H/S: 1/1/1

Ord Minnett has conducted a review of the company's portfolio and notes the exposure to a shift in demand for long-weighted lease expiry assets in Australia. The broker anticipates a flight of capital to these assets in a low interest-rate environment.

The main leasing risk in the portfolio is the Metcash ((MTS)) facility in Perth, which Ord Minnett considers is materially over-rented. The broker would prefer the risk to be mitigated via a sale of the asset but notes it is one of the better located sites in Perth and has development potential.

Rating is upgraded to Buy from Hold and the target lifted to $5.25 from $4.25.

COMPUTERSHARE LIMITED ((CPU)) Upgrade to Neutral from Underperform by Macquarie and Upgrade to Hold from Lighten by Ord Minnett .B/H/S: 0/7/1

Macquarie notes most of the information in the investor briefing dealt with near-term implications of UK mortgage services. The broker anticipates consensus expectations, which were too optimistic on both margin income and UK mortgage services, will converge with its earnings forecasts.

Following delays in completing the migration of clients from the legacy UKAR platform the company has confirmed this will result in an additional $35m in costs in FY20. Following the response in the share price, Macquarie upgrades to Neutral from Underperform. Target is raised to $17.00 from $16.50.

The company has maintained FY19 guidance at its investor briefing, although highlighted some risks from UK mortgage services. An improvement in the US mortgage servicing business is expected.

Ord Minnett considers guidance achievable and upgrades to Hold from Lighten. Target is steady at $16.50.

CSR LIMITED ((CSR)) Upgrade to Outperform from Neutral by Macquarie .B/H/S: 1/3/3

Earnings forecasts for CSR have been trending lower recently, Macquarie notes, on concerns over a falling housing market. But on a combination of the surprise election win, a likely RBA rate cut and APRA's plan to reduce the mortgage serviceability threshold, confidence should be restored and this will filter into housing.

Thus Macquarie now sees greater upside risk to earnings. Upgrade to Outperform from Neutral. Target rises to $4.70 from $3.40.

ILUKA RESOURCES LIMITED ((ILU)) Upgrade to Buy from Neutral by Citi .B/H/S: 5/1/0

Citi has upgraded to Buy from Neutral on the belief that de-stocking has ended and producers like Iluka can look forward to increased prices. Plus if Sierra Rutile can deliver, there should be substantial upside through significantly increased output volume, estimated at circa 40% potential.

Citi has lifted earnings forecasts by 6%-7% for the years ahead. AUD/USD forecasts have been reset at 0.70 and 0.73 respectively for this calendar year and next. Price target improves to $11 from $10.40.

MEDIBANK PRIVATE LIMITED ((MPL)) Upgrade to Hold from Lighten by Ord Minnett .B/H/S: 1/4/3

Ord Minnett observes the Coalition win in the 2019 federal election removes the downside risk from Labor's proposed 2% cap on premium rates. The broker still believes margins will fall but now at a slower rate.

The broker upgrades to Hold from Lighten and raises the target to $3.05 from $2.30. The broker expects the incoming government will allow premium rate increases that are only modestly behind claims inflation, even with increasing efforts by health insurers to offset those costs.

NATIONAL AUSTRALIA BANK LIMITED ((NAB)) Upgrade to Overweight from Equal-weight by Morgan Stanley .B/H/S: 4/3/1

Morgan Stanley believes National Australia Bank offers a sound retail and business bank performance and better capital generation, as well as more flexibility following the decision to cut the dividend and partially underwrite the reinvestment plan.

The result of the federal election now lowers the tail risks in relation to credit quality, the mortgage market and regulatory environment and the broker upgrades to Overweight from Equal-weight. Target is raised to $25.70 from $25.10. Industry view: In-line.

QANTAS AIRWAYS LIMITED ((QAN)) Upgrade to Outperform from Neutral by Credit Suisse .B/H/S: 3/3/1

Credit Suisse believes an outright election win, as opposed to a hung parliament, is a positive for corporate travel demand, which has been weak in the run-up. Qantas will also benefit from Virgin Australia's ((VAH)) plans to cut capacity, which will be positive for Qantas domestic and Jetstar, some 70% of earnings.

Lower risk of industrial action, with Labor failing to get up, is another positive. Put it all together and Credit Suisse upgrades to Outperform. Target rises to $6.40 from $6.00.

RAMSAY HEALTH CARE LIMITED ((RHC)) Upgrade to Accumulate from Hold by Ord Minnett .B/H/S: 2/5/1

Ord Minnett's main concern was a challenge to industry profitability posed by plans by the Labor Party for caps of 2% for two years to premiums. The broker is now confident the pricing environment will be more benign and raises domestic margin forecasts.

As there are fewer challenges in Australian business and improved tariffs in the UK and France, the broker considers the outlook has improved. Rating is upgraded to Accumulate from Hold and the target raised to $75 from $60.

STOCKLAND ((SGP)) Upgrade to Outperform from Neutral by Macquarie .B/H/S: 2/2/2

Despite the recent rally in the stock, Macquarie notes it is trading at a -30% discount to the A-REIT sector. While not expecting the spreads to close completely, the broker believes the stock is supported, given residential headwinds have largely passed.

Rating is upgraded to Outperform from Neutral, as recent macro changes have led to a reduction in downside risks. Target is increased by 25% to $4.48.

SUPER RETAIL GROUP LIMITED ((SUL)) Upgrade to Overweight from Equal-weight by Morgan Stanley .B/H/S: 3/5/0

Morgan Stanley believes the company has the opportunity to move the focus back on productivity after some value-destructive acquisitions. The broker considers the automotive business undervalued and pressures overstated.

Super Retail is post a significant capital expenditure cycle and should deliver strong free cash flow, in Morgan Stanley's view. Rating is upgraded to Overweight from Equal-weight. Target is raised to $10.00 from $8.20. Industry View: Cautious.

VIRGIN AUSTRALIA HOLDINGS LIMITED ((VAH)) Upgrade to Neutral from Underperform by Credit Suisse .B/H/S: 0/2/1

Virgin has noted domestic demand has weakened and failed to much recover post the Easter period. Virgin's outlook appears worse, Credit Suisse notes, than was provided in last week's Qantas ((QAN)) update.

Virgin is responding by reducing capacity, which is a positive for Qantas, but does have the potential to drive higher per unit revenue. The broker upgrades to Neutral, retaining an 18c target.

Downgrade

AGL ENERGY LIMITED ((AGL)) Downgrade to Underperform from Neutral by Macquarie and Downgrade to Sell from Buy by UBS .B/H/S: 0/2/6

Macquarie lowers earnings expectations across the gas division to reflect a step up in gas costs. Meanwhile, wholesale electricity faces a structural challenge, with the LREC contribution dropping towards zero.

Macquarie believes AGL does not justify a long-term market PE premium, especially as earnings are vulnerable to technology changes. Rating is downgraded to Underperform from Neutral and the target lowered to $19.99 from $20.67.

UBS remodels its view on AGL and downgrades to Sell from Buy. The broker has identified issues that will erode earnings by around -$500m. Despite growth opportunities that add back $150m, net operating earnings (EBITDA) are expected to decline by -$380m over FY19-23.

The broker remains bearish on the company's earnings outlook relative to Origin Energy ((ORG)). The broker acknowledges that, despite the weakening fundamentals, it is possible the share price will be supported by yield investors. Target is reduced to $21.00 from $22.70.

ALS LIMITED ((ALQ)) Downgrade to Sell from Hold by Deutsche Bank and Downgrade to Neutral from Buy by Citi .B/H/S: 2/4/1

Deutsche Bank observes that, over the last few years, the company has benefited from a recovery in global minerals drilling expenditure. However, the rate of growth has slowed.

Geochemistry volume growth was flat in the second half. The broker downgrades to Sell from Hold and reduces the target to $6.57.

Citi found the FY19 results solid as margins in life sciences were better than expected and there was double-digit growth in commodities.

However, the broker downgrades to Neutral from Buy, maintaining concerns around the weak trends in geochemistry which is still the company's largest business and 44% of group earnings (EBIT).

The broker does not expect the second half margin improvement in life sciences to be repeated. Target is reduced to $8.25 from $8.60.

AMP LIMITED ((AMP)) Downgrade to Sell from Neutral by Citi .B/H/S: 0/6/1

Citi envisages material risk there will be minimal capital returns from AMP and the road to releasing value will be difficult. The broker believes the adviser industry is likely to transform to one dominated by salaried advisers and away from the aligned model that makes up 90% of the company's adviser base.

A new business model could require significant investment and take time to be profitable. Citi downgrades to Sell/High Risk from Neutral. Target is $1.90.

COLES GROUP LIMITED ((COL)) Downgrade to Neutral from Buy by Citi .B/H/S: 0/5/2

German competitor Kaufland is looking to start a battle for its share of the Australian households' groceries spending and Citi thinks this will act as the catalyst for a resumption of an industry-wide private label price war.

The analysts have, in anticipation, lowered long term margin assumptions for the incumbents Woolworths and Coles.This leads to lowered forecasts, and a lower valuation.

Price target for Coles drops to $13 from $13.40. Recommendation is downgraded to Neutral from Buy.

EVOLUTION MINING LIMITED ((EVN)) Downgrade to Hold from Accumulate by Ord Minnett .B/H/S: 1/4/3

Gold has been a relatively strong performer among the metals in the past six weeks, although Ord Minnett assesses the short-term outlook is mixed. US/China trade tensions are re-emerging at a time when the US dollar is strengthening.

Australian gold stocks continue to outperform because of solid cash flow, strong balance sheets and a weakening Australian dollar. However, Ord Minnett downgrades Evolution Mining to Hold from Accumulate based on valuation. Target is steady at $3.50.

IOOF HOLDINGS LIMITED ((IFL)) Downgrade to Sell from Neutral by UBS .B/H/S: 0/4/1

UBS believes the structural shake-up has only just begun and, while IOOF continues to enjoy greater stability versus the rest of the sector, momentum is likely to come under increasing pressure if its elevated contemporary platform pricing is not addressed.

UBS acknowledges there is less reliance on higher-margin legacy products but believes platform earnings could compress by -25% over five years. Rating is downgraded to Sell from Neutral and the target lowered to $5.05 from $5.80.

JAMES HARDIE INDUSTRIES N.V. ((JHX)) Downgrade to Neutral from Buy by UBS .B/H/S: 6/1/0

UBS believes the risk/return is now more balanced and downgrades to Neutral from Buy. US housing starts have commenced 2019 on a weaker footing while Australian detached housing approvals are falling.

The broker suspects restoring above-market growth could take longer than previously expected, while the company has toned down its targets for FY20. Target is reduced to $19.60 from $20.20.

NORTHERN STAR RESOURCES LTD ((NST)) Downgrade to Hold from Accumulate by Ord Minnett .B/H/S: 1/3/3

Gold has been a relatively strong performer among the metals in the past six weeks, although Ord Minnett assesses the short-term outlook is mixed. US/China trade tensions are re-emerging at a time when the US dollar is strengthening.

Australian gold stocks continue to outperform because of solid cash flow, strong balance sheets and a weakening Australian dollar. The broker downgrades Northern Star to Hold from Accumulate on valuation. Target is $9.80.

NRW HOLDINGS LIMITED ((NWH)) Downgrade to Neutral from Buy by UBS and Downgrade to Sell from Hold by Deutsche Bank .B/H/S: 1/1/1

The company has been awarded the Koodaideri earthworks contract, to be delivered primarily in FY20. UBS upgrades FY20 revenue estimates by 5%.

The broker expects a further $200m in contracts will be won and delivered over the year. The 80% gain in the share price in the year to date means UBS downgrades to Neutral from Buy. Target is raised to $3.10 from $2.55.

The company has won the contract for Koodaideri. Deutsche Bank believes the win was already factored in and, although the contract size is close to forecasts, at $150m over 80 weeks it is likely to be a disappointment to consensus expectations.

The broker marginally reduces revenue forecast for FY20 because of the current outlook and the expectation the company will face capacity constraints. Rating is downgraded to Sell from Hold and the target is steady at $2.31.

OIL SEARCH LIMITED ((OSH)) Downgrade to Underperform from Neutral by Credit Suisse .B/H/S: 2/4/2

Credit Suisse believes PNG LNG expansion volumes will be contracted well below what the market is valuing. The broker suspects contractual price reviews may be pursued more aggressively by buyers.

The country risk profile could also be back to the fore, given recent political instability. Credit Suisse assesses the departure of CEO Peter Botten could cause a de-rating event for the stock.

Amid scepticism about the upside in Alaska, Credit Suisse downgrades to Underperform from Neutral on the basis of a softer LNG contracting environment. Target is reduced to $6.96 from $7.33.

SONIC HEALTHCARE LIMITED ((SHL)) Downgrade to Sell from Neutral by UBS .B/H/S: 3/4/1

With declining organic revenue growth rates in several regions and rising costs, UBS notes the company has relied on acquisitions to boost revenue and earnings growth.

Current forecasts capture an improving margin profile but the broker's revised valuation results in the rating moving to Sell from Neutral. UBS points out the market is applying a large multiple to Australian pathology. Target is raised to $24.90 from $24.00.

TECHNOLOGYONE LIMITED ((TNE)) Downgrade to Sell from Neutral by UBS and Downgrade to Lighten from Hold by Ord Minnett .B/H/S: 0/2/1

First half results were affected by material accounting changes. UBS is comfortable with guidance because of the stronger second half contributions from consulting and on-premises business, in addition to the momentum in high-quality SaaS revenue.

The broker expects 15% compound growth in earnings per share from FY19-21. However, valuation appears stretched and the rating is downgraded to Sell from Neutral. Target is raised to $7.00 from $5.60.

First half results were in line with expectations and Ord Minnett notes momentum is clearly building across both software-as-a-service and in the UK. SaaS metrics were particularly strong and signal the company continues to enjoy larger customers migrating to its cloud offering.

The main drawback for the broker is cash flow, which likely reflects lower upfront cash payments from customers migrating to SaaS. Valuation is now considered stretched and the rating is downgraded to Lighten from Hold. Target is raised to $6.70 from $6.10.

WOOLWORTHS LIMITED ((WOW)) Downgrade to Lighten from Hold by Ord Minnett and Downgrade to Sell from Neutral by Citi .B/H/S: 0/4/3

The share price of Woolworths is now well above Ord Minnett's discounted cash flow valuation, with the PE multiple high at 26.6x FY19 estimates and 24.9x at FY20 estimates for 6.3% and 7.0% growth in earnings per share, respectively.

The $1.7bn off-market buyback has been supportive , and may remain so, but the broker suggests there could be some weakness to follow, as investors reassess. Rating is downgraded to Lighten from Hold and the target raised to $31 from $30.

German competitor Kaufland is looking to start a battle for its share of the Australian households' spending on groceries and Citi thinks this will act as the catalyst for a resumption of an industry-wide private label price war.

The analysts have, in anticipation, lowered long term margin assumptions for the incumbents Woolworths and Coles.This leads to lowered forecasts, and a lower valuation.

The price target for Woolworths falls to $28.75, the recommendation is downgraded to Sell from Neutral.

Total Recommendations Recommendation Changes

Broker Recommendation Breakup

Broker Rating Order Company New Rating Old Rating Broker Upgrade 1 ADELAIDE BRIGHTON LIMITED Buy Neutral Macquarie 2 ANSELL LIMITED Buy Neutral Credit Suisse 3 CHARTER HALL LONG WALE REIT Buy Neutral Ord Minnett 4 COMPUTERSHARE LIMITED Neutral Sell Macquarie 5 COMPUTERSHARE LIMITED Neutral Sell Ord Minnett 6 CSR LIMITED Buy Neutral Macquarie 7 ILUKA RESOURCES LIMITED Buy Neutral Citi 8 MEDIBANK PRIVATE LIMITED Neutral Sell Ord Minnett 9 NATIONAL AUSTRALIA BANK LIMITED Buy Neutral Morgan Stanley 10 QANTAS AIRWAYS LIMITED Buy Neutral Credit Suisse 11 RAMSAY HEALTH CARE LIMITED Buy Neutral Ord Minnett 12 STOCKLAND Buy Neutral Macquarie 13 SUPER RETAIL GROUP LIMITED Buy Neutral Morgan Stanley 14 VIRGIN AUSTRALIA HOLDINGS LIMITED Neutral Sell Credit Suisse Downgrade 15 AGL ENERGY LIMITED Sell Neutral Macquarie 16 AGL ENERGY LIMITED Sell Buy UBS 17 ALS LIMITED Neutral Buy Citi 18 ALS LIMITED Sell Sell Deutsche Bank 19 AMP LIMITED Sell Neutral Citi 20 COLES GROUP LIMITED Neutral Buy Citi 21 EVOLUTION MINING LIMITED Neutral Buy Ord Minnett 22 IOOF HOLDINGS LIMITED Sell Neutral UBS 23 JAMES HARDIE INDUSTRIES N.V. Neutral Buy UBS 24 NORTHERN STAR RESOURCES LTD Neutral Buy Ord Minnett 25 NRW HOLDINGS LIMITED Neutral Buy UBS 26 NRW HOLDINGS LIMITED Sell Neutral Deutsche Bank 27 OIL SEARCH LIMITED Sell Neutral Credit Suisse 28 SONIC HEALTHCARE LIMITED Sell Neutral UBS 29 TECHNOLOGYONE LIMITED Sell Neutral UBS 30 TECHNOLOGYONE LIMITED Sell Neutral Ord Minnett 31 WOOLWORTHS LIMITED Sell Neutral Citi 32 WOOLWORTHS LIMITED Sell Neutral Citi 33 WOOLWORTHS LIMITED Sell Neutral Ord Minnett Recommendation Positive Change Covered by > 2 Brokers Order Symbol Company New Rating Previous Rating Change Recs 1 VAH VIRGIN AUSTRALIA HOLDINGS LIMITED -38.0% -63.0% 25.0% 4 2 CPU COMPUTERSHARE LIMITED -13.0% -31.0% 18.0% 8 3 ILU ILUKA RESOURCES LIMITED 75.0% 58.0% 17.0% 6 4 QAN QANTAS AIRWAYS LIMITED 29.0% 14.0% 15.0% 7 5 ABC ADELAIDE BRIGHTON LIMITED -14.0% -29.0% 15.0% 7 6 CSR CSR LIMITED -29.0% -43.0% 14.0% 7 7 ANN ANSELL LIMITED 50.0% 38.0% 12.0% 8 8 NAB NATIONAL AUSTRALIA BANK LIMITED 31.0% 19.0% 12.0% 8 9 SUL SUPER RETAIL GROUP LIMITED 31.0% 19.0% 12.0% 8 10 RWC RELIANCE WORLDWIDE CORPORATION LIMITED 58.0% 50.0% 8.0% 6 Negative Change Covered by > 2 Brokers Order Symbol Company New Rating Previous Rating Change Recs 1 XRO XERO LIMITED -25.0% 17.0% -42.0% 6 2 AGL AGL ENERGY LIMITED -75.0% -38.0% -37.0% 8 3 SBM ST BARBARA LIMITED -10.0% 10.0% -20.0% 5 4 WOW WOOLWORTHS LIMITED -44.0% -25.0% -19.0% 8 5 ALQ ALS LIMITED 7.0% 21.0% -14.0% 7 6 JHX JAMES HARDIE INDUSTRIES N.V. 79.0% 93.0% -14.0% 7 7 SHL SONIC HEALTHCARE LIMITED 19.0% 31.0% -12.0% 8 8 SYD SYDNEY AIRPORT HOLDINGS LIMITED -25.0% -13.0% -12.0% 8 9 COL COLES GROUP LIMITED -31.0% -19.0% -12.0% 8 10 NST NORTHERN STAR RESOURCES LTD -29.0% -21.0% -8.0% 7 Target Price Positive Change Covered by > 2 Brokers Order Symbol Company New Target Previous Target Change Recs 1 XRO XERO LIMITED 52.750 44.933 17.40% 6 2 CSR CSR LIMITED 3.407 3.221 5.77% 7 3 MPL MEDIBANK PRIVATE LIMITED 2.780 2.636 5.46% 8 4 ABC ADELAIDE BRIGHTON LIMITED 3.886 3.729 4.21% 7 5 JHX JAMES HARDIE INDUSTRIES N.V. 21.571 21.029 2.58% 7 6 SUL SUPER RETAIL GROUP LIMITED 9.110 8.885 2.53% 8 7 ANN ANSELL LIMITED 26.654 26.216 1.67% 8 8 QAN QANTAS AIRWAYS LIMITED 5.921 5.864 0.97% 7 9 ILU ILUKA RESOURCES LIMITED 10.558 10.458 0.96% 6 10 SYD SYDNEY AIRPORT HOLDINGS LIMITED 7.141 7.089 0.73% 8 Negative Change Covered by > 2 Brokers Order Symbol Company New Target Previous Target Change Recs 1 CPU COMPUTERSHARE LIMITED 17.096 17.914 -4.57% 8 2 ALQ ALS LIMITED 7.914 8.280 -4.42% 7 3 SBM ST BARBARA LIMITED 3.284 3.364 -2.38% 5 4 AGL AGL ENERGY LIMITED 20.401 20.724 -1.56% 8 5 VAH VIRGIN AUSTRALIA HOLDINGS LIMITED 0.183 0.185 -1.08% 4 6 COL COLES GROUP LIMITED 11.951 12.001 -0.42% 8 Earning Forecast Positive Change Covered by > 2 Brokers Order Symbol Company New EF Previous EF Change Recs 1 XRO XERO LIMITED 13.834 -7.369 287.73% 6 2 AOG AVEO GROUP 12.733 9.733 30.82% 3 3 JHX JAMES HARDIE INDUSTRIES N.V. 108.005 93.378 15.66% 7 4 ALQ ALS LIMITED 41.667 36.682 13.59% 7 5 CYB CYBG PLC 48.387 45.670 5.95% 3 6 MYX MAYNE PHARMA GROUP LIMITED 1.258 1.210 3.97% 4 7 RIO RIO TINTO LIMITED 1000.832 971.723 3.00% 8 8 ALL ARISTOCRAT LEISURE LIMITED 132.150 129.583 1.98% 7 9 ANN ANSELL LIMITED 147.375 146.234 0.78% 8 10 SCG SCENTRE GROUP 25.567 25.400 0.66% 6 Negative Change Covered by > 2 Brokers Order Symbol Company New EF Previous EF Change Recs 1 VAH VIRGIN AUSTRALIA HOLDINGS LIMITED -0.567 0.100 -667.00% 4 2 IPL INCITEC PIVOT LIMITED 12.171 15.647 -22.22% 8 3 SBM ST BARBARA LIMITED 30.745 31.995 -3.91% 5 4 ILU ILUKA RESOURCES LIMITED 91.562 92.852 -1.39% 6 5 WOW WOOLWORTHS LIMITED 128.683 129.929 -0.96% 8 6 CPU COMPUTERSHARE LIMITED 97.821 98.713 -0.90% 8 7 COL COLES GROUP LIMITED 63.635 64.173 -0.84% 8 8 SUN SUNCORP GROUP LIMITED 74.714 75.143 -0.57% 8 9 CGC COSTA GROUP HOLDINGS LIMITED 23.775 23.908 -0.56% 6 10 RWC RELIANCE WORLDWIDE CORPORATION LIMITED 19.260 19.325 -0.34% 6 Technical limitations

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

Uranium Week: Buyers' Market

Sellers continue to chase down ever more empowered buyers in an ongoing weak uranium market.

-Uranium spot price continues to fall -Rio Tinto may shut down Rossing -US production falls dramatically

By Greg Peel

It was Groundhog Week last week in the uranium market. With utilities largely out of the market pending a section 232 decision, sellers continue to lower prices in order to flush out buying interest.

And the buyers are not making it easy. Having the upper hand, they are not simply insisting on lower prices, industry consultant TradeTech reports, but on specific origins, delivery locations and other restrictive terms and conditions.

Four transactions totalling 500,000lbs U3O8 equivalent were recorded in the spot market last week. TradeTech's weekly spot price indicator has fallen -US20c to US$24.30/lb.

The spot price has now fallen -16% in 2019, whittling a 12-month gain down to 6%.

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

Supply Response

Australian-listed diversified miner Rio Tinto ((RIO)) has announced it will advance the closure of its 69% owned Rossing uranium mine in Namibia to June 2020 if the Namibian competition regulator blocks the US$104m sale of the mine to China National Uranium Corp.

Rio cannot continue to operate the loss-making business and would rather cease operations ahead of a forecast 2025 mine life if the sale is rejected.

The Namibian government owns a 3% stake in Rossing but 51% of the voting rights. The Iranian Foreign Investment Co holds 15% and the Industrial Development Corp of South Africa owns 10%.

Persistently low uranium prices continue to impact on global supply. Last week the US Energy Information Agency reported US uranium mines produced 700,000lbs U3O8 in 2018, down -37% from 2017.

Total shipment of uranium concentrate from US mills fell -35%. US producers sold 1.5mlbs of concentrate at an average price of US$32.51/lb.

The Short Report

Guide:

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

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

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

Summary:

Week ending May 23, 2019

Last week saw the ASX200 rocket to 6500 on the Coalition's election victory, an easing of mortgage restrictions from APRA and a big hint that RBA was set to cut. It's been a different story since.

As the sea of red on the table below suggest, short traders took the opportunity provided by the rally to increase positions. No less than four stocks saw short position increases of one percentage point or more last week, with only one going the other way.

See below.

Of particular note last week was movement in big bank short positions, given the election/APRA/RBA news was worth about 10% in gains for the Big Four last week. The banks were not carrying major short positions in relative terms but their significant market caps mean any small move can have a big impact.

Last week saw ANZ Bank ((ANZ)) shorts fall to 0.8% from 1.1%, Commonwealth Bank ((CBA)) fall to 1.4% from 1.7%, National Bank ((NAB)) fall to 0.8% from 1.2%, and Westpac ((WBC)) fall to 1.8% from 2.5%. As was suspected, the big bank bounce had a lot to do with short-covering.

See table below.

Weekly short positions as a percentage of market cap:

10%+ ING 17.4 SYR 16.0 NUF 15.6 JBH 15.4 NXT 15.1 GXY 14.0 BAL 14.0 ORE 12.5 BWX 11.9 MTS 11.6 BIN 11.1 SDA 10.5 IFL 10.1

In: BIN, IFL

9.0-9.9

SUL, KGN, CSR, RWC, SGM, BKL, PLS, PPT, HVN

In: RWC, SGM, PLS, HVN Out: BIN, IFL 8.0-8.9%

IVC, MYR, HUB, DMP, BGA

In: BGA Out: RWC, SGM, PLS, HVN, AMC

7.0-7.9%

AMC, BOQ, AMP

In: AMC, AMP Out: BGA

6.0-6.9%

WSA, CGF, SEK, MSB, NEC

In: NEC Out: AMP

5.0-5.9%

GMA, RSG, BEN, MLX, COE, HT1, CLQ

In: MLX, CLQ Out: NEC

Movers & Shakers

The rollercoaster ride for battery-related miners, which are amongst the most shorted stocks on the market, continued last week. Graphite miner Syrah Resources ((SYR)) shot up ahead of its AGM, at which guidance was reaffirmed, and then shot back down again. At some point Syrah shorts were reduced to 16.0% from 17.2%, leaving Inghams Group ((ING)) currently playing chicken as the most shorted stock.

The week before last, Bingo Industries ((BIN)) was the only stock that week to see a short position move of one percentage point or more. As noted in last week's Report, Bingo shorts rose to 9.9% from 8.2%.

Last week they rose to 11.1%.

The fortunes of infant formula exporter Bellamy's Australia ((BAL)) have taken a turn, in least as far as market perception is concerned, since US-China trade negotiations broke down and tit-for-tat recriminations were rekindled. Deriving the bulk of its earnings from China, Bellamy's has become the shorters' pin-up for trade war escalation, and shorts rose last week to 14.0% from 12.9%.

Skin care company BWX ltd ((BWX)) issued its third profit warning in seven months last week while pulling the trapdoor on its only recently appointed new CEO. Hopes are now pinned on a new new CEO, formerly of Blackmores.

The share price of plumbing parts supplier and former market darling Reliance Worldwide ((RWC)) took a dive (-26%) on May 13 when the company downgraded earnings guidance. The company assured there were no structural issues.

Channel partners had recently taken to reducing their inventories, Reliance explained, while a mild US winter meant a lot fewer burst pipes to repair with new parts. Morgan Stanley agreed that the downgrade was largely a one-off affair when it initiated coverage of the stock last week with an Overweight rating.

ASX20 Short Positions (%)

Code Last Week Week Before Code Last Week Week Before AMC 7.8 8.2 RIO 4.5 4.5 ANZ 0.8 1.1 S32 1.0 1.1 BHP 3.3 3.4 SCP 1.0 0.9 BXB 0.2 0.1 SUN 0.3 0.2 CBA 1.4 1.7 TCL 1.3 1.3 COL 1.4 1.5 TLS 0.5 0.5 CSL 0.2 0.2 WBC 1.8 2.5 IAG 0.8 0.6 WES 1.9 1.9 MQG 0.6 0.4 WOW 2.6 2.4 NAB 0.8 1.2 WPL 0.7 0.6 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.

Find out why FNArena subscribers like the service so much: "Your Feedback (Thank You)" - Warning this story contains unashamedly positive feedback on the service provided.

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

The Wrap: Oz Dollar, Radiology & Retailers

Weekly Broker Wrap: Australian dollar; radiology; chemicals; aquaculture; food retailers; department stores; and telco/fibre infrastructure.

-Potential for substantial weakness in Australian dollar exists -SaaS models underpin heightened interest in radiology services/informatics -Downside risk for Incitec Pivot and Nufarm amid inclement US weather -Australian salmon market expected to be balanced in FY20 -Woolworths and Coles best positioned to leverage competitive advantage via digital -Traditional department stores need to cut costs or lift productivity -Telco/fibre infrastructure sector retains high strategic value

By Eva Brocklehurst

Australian Dollar

The Australian dollar has dropped below US$0.70, the trough ANZ analysts had previously forecast for this cycle. The global outlook has deteriorated and this no longer provides a buffer to the inevitable reduction in Australian cash rates. Hence, the trough in forecasts is lowered to US$0.65. ANZ analysts had expected US/China trade tensions would ease and improve the external outlook but this is escalating and the likelihood of a resolution is diminished.

Hence, the potential for substantial weakness in the Australian dollar exists. Recent indicators have shown there is a risk Australia's unemployment rate will rise and that the cash rate is likely to be 1% by the end of 2019. As a result the yield structure on the Australian dollar has significantly changed. While two reductions to official interest rates in the next 12 months are largely priced in, the analysts do not believe this will stall the decline.

External conditions will be the next catalyst for weakness. The analysts believe the recent run of disappointing US data is an issue for risk appetite rather than for the US dollar. An environment of weaker growth and heightened uncertainty suggests the Australian dollar should decline further.

Radiology

There has been a significant increase in the price and turnover for a number of ASX-listed companies with direct exposure to radiology services/informatics. A contributing factor, Morgans believes, is interest in the use of software-as-a-service (SaaS) revenue models, which create a trackable metric that can be ascribed value, among others such as profitability and gross margins.

The long-term drivers of this include artificial intelligence, ageing populations, a focus on better patient outcomes and regulatory requirements for centralised records. Global market estimates for medical imaging analysis software, the broker cites, were around US$2.4bn in 2016, expected to be growing at an 8% compound rate through to 2024.

Morgans highlights four companies with direct radiology exposure on which it is keeping a close eye. These include Pro Medicus ((PME)), Volpara ((VHT)), ImExHS ((IME)) and Mach7 ((M7T)). Strong growth, at Pro Medicus and Volpara in particular, has a number of years to play out.

Chemicals

Wet weather and a switch to soy from corn plantings, as well as insurance pay-outs, are resulting in lower urea demand in the US and JP Morgan believes this is negative for Incitec Pivot's ((IPL)) Dyno Nobel Americas business. Total corn and soybean plantings as of May are below historical averages and present downside risk, if weather worsens, for Nufarm ((NUF)) as well.

The broker also notes diammonium phosphate prices, currently at US$375/t in India, are being supported by a drop in Tampa ammonia prices, with margins benefiting by around US$24/t.

Aquaculture

Tight supply domestically and strength in demand have supported high prices in the salmon industry. Credit Suisse expects the market should remain balanced in FY20, assuming Tassal Group ((TGR)) keeps volumes flat, albeit with a higher domestic contribution, and Huon Aquaculture ((HUO)) increases tonnage by around 6000t.

Tassal expects a more gradual growth curve in salmon and this suggests that its FY20 growth will be reliant on prawns. Management's strategy is considered well constructed, although Credit Suisse acknowledges risks to forecasts, given the relative immaturity of the business and timing risk, as the earnings from prawns will be skewed to the second half.

Meanwhile, Huon Aquaculture has experienced earnings volatility recently, although a recovery in harvest volumes should drive a strong recovery. The broker retains Neutral ratings on the stocks for now, inclined to wait a little longer to obtained a better understanding of the risk profile.

Food Retailers

Credit Suisse considers Woolworths ((WOW)) and Coles ((COL)) are positioned to leverage their digital capabilities and establish a competitive advantage in the food retail value chain. Promotional expenditure comprises 20% of the food retail value chain and there are material efficiency gains to be had through targeting consumers with promotional expenditure.

The companies' programs, Rewards in the case of Woolworths and Fly Buys in the case of Coles, provide an unmatched capability that can engage with customers on a unique basis. When linked to vast transaction volumes through the stores digital provides unprecedented data that can be leveraged.

Credit Suisse expects the benefits of cost reductions in digital are likely to be reflected in market share gains by both Coles and Woolworths. In contrast, the independent supermarket sector is likely to lose market share and, as a consequence, so will Metcash ((MTS)). Credit Suisse upgrades Coles to Neutral and retains a Neutral rating on Woolworths. The broker downgrades Metcash to Underperform.

Department Stores

UBS takes a wide-angled view of Australian department stores to assess the outlook. The broker concludes the discount department stores still resonate with customers and have an opportunity to lift share. This is less the case for traditional department stores. Their online business will grow but this will take time as purchase intentions are weak and, the broker notes, purchase frequency on Amazon remains low

While local department stores also have potential to improve margins they need to cut costs or lift productivity, with the former being the larger opportunity. To grow profit, high fixed cost bases need to be cut or sales per square metre lifted. This can be improved, in the broker's view, by space consolidation and also improving the engagement with consumers. UBS has become more positive about Big W (Woolworths) and Kmart/Target ((WES)) but remains cautious about Myer ((MYR)).

In terms of fashion, the broker's study found consumers were positive about the Amazon shopping experience but cited a lack of "touch/feel" and limited ranges as key impediments to shopping there. This suggests Amazon's expansion in the fashion segment will take time. Perception and awareness of Super Retail's ((SUL)) Rebel brand and City Chic ((CCX)) were positive, while the apparel brands belonging to Premier Investments ((PMV)) were more mixed.

Telco/Fibre Infrastructure

Morgan Stanley believes recent M&A activity in the telco/fibre infrastructure sector highlights its strategic value and supports an Overweight rating for both Vocus Communications ((VOC)) and Superloop ((SLC)). The broker suspects interest from private equity and infrastructure investors in these assets highlights underlying strategic value. Both companies have received indicative bids in the last month.

Morgan Stanley considers fibre assets are attractive as they are leveraged to structural growth from data consumption, while there are high barriers to entry because of capital intensity. Other positive factors include recurring revenue, higher margins from vertical integration and lower competition, compared with consumer telco assets such as mobile & broadband in Australia. Morgan Stanley suggests both companies can increase enterprise market share organically, driving earnings/returns higher and leveraging their unique fibre assets.

Strong Growth Expected From Think Childcare

Brokers expect strong growth in returns from Think Childcare over the next few years.

-Investment in education, technology and site selection delivering favourable outlook -Softer occupancy rates in first half affected by Easter/Anzac Day -Nido roll-out expected to improve the quality of centres

By Eva Brocklehurst

Think Childcare ((TNK)) is moving to a higher-quality offering and has reaffirmed guidance. Limited commentary was provided on supply in the trading update but operating improvements, Wilsons suggests, reinforce the view that early investment in education, technology and site selection is having a favourable impact.

Moelis is also positive about the outlook for Think Childcare, expecting strong growth in margins and returns over the next three years as the centre network expands and allows supplier support costs to be shared.

The company is on track to complete 10 acquisitions and undertake two greenfield projects in 2019. Moelis has a Buy rating and $2.34 target and suggests thecompany's unique acquisition model provides the opportunity for compounding capital at high rates of return, at around 20%, without start-up operating risk.

2019 operating earnings (EBITDA) guidance was reaffirmed at $13.8-14.8m. Overall, Moelis reduces 2019 estimates by -5%, to reflect higher support costs versus expectations. However, this is seen being offset by the contribution from 2018 acquisitions as well as greenfield projects.

Wilsons believes the higher cost profile will abate as the centre acquisitions ramp up. The broker applies G8 Education's ((GEM)) five-year historical average multiples to add "vigour" to its valuation, arriving at a $1.95/share target/valuation, which is up 8.3% and reflects a 2020 enterprise value/operating earnings ratio of 7.2 x, -16.3% below G8 Education.

Think Childcare is well-placed, given the increase in demand for childcare services and easing supply growth that is expected in the second half of the year, Canaccord Genuity assesses, marginally increasing occupancy rates and fee assumptions for 2019.

Occupancy

The broker acknowledges the occupancy statement was softer than anticipated at first glance but forward assumptions appear bullish. As Easter and Anzac Day in 2019 were close together, an entire week was affected in terms of occupancy, which means the flat rate is slightly better than it appears. The company assumes occupancy over 2019 will increase by 3%. Canaccord Genuity maintains a Buy rating and $2.11 target.

Wilsons points to feedback which suggests closures are continuing, although this appears to represent just 1% of centres. Data from the Australian Department of Education and Training indicated a 0.3% increase in demand year-on-year in the September quarter of 2018. Wilsons maintains its Buy rating.

Nido

Moelis believes the company can deliver strong earnings growth and also undergo a step change in quality with the roll-out of Nido. Full integration is expected in 2020. The Nido brand is a higher quality service which has lower licensed places, average fees and historically generates better occupancy levels. This ensures a superior margin and earnings.

In the transition process so far, all centres have moved to the education curriculum, while there remains some training and practices to be implemented. Around 50% of centres have had the service model implemented. Capital improvements are ongoing and 14 sites have been identified as priorities for improvement. Two centres that were deemed incompatible with the Nido model have been closed.

In Quality We Trust

In this week's Weekly Insights (published in two parts):

-Conviction Calls, Part I -In Quality We Trust -Conviction Calls, Part II -Rudi On Tour

[Non-highlighted parts will appear in Part Two on Friday]

By Rudi Filapek-Vandyck, Editor FNArena

In Quality We Trust

About one year ago today there was virtually no one in the Australian share market who was interested in buying shares in TechnologyOne ((TNE)).

There was the occasional analyst who dared to point out the shares looked too cheap in light of the company's admirable track record, and ongoing buoyant growth prospects, but few only were paying attention.

One of the few was I because the FNArena/Vested Equities All-Weather Model Portfolio (see further below) owns shares in the company and I personally regard TechnologyOne the highest quality software company listed on the ASX, and one of the true all-weather performers locally.

But, as said, nobody wanted a bar of it. Upon persistent failure to move away from the $5 mark, the share price spent some time near $4.50 before turning back to around $5, where it still resided when I presented at the national conference of the Australian Investors Association (AIA) in early August.

There I was asked about my stock tip for the year ahead and I nominated TechnologyOne. More than ten years of growth in earnings per share averaging circa 15% per annum, and the decade ahead will most likely see more of the same, I explained at the conference. What exactly is there not to like? It's not a question many are asking about this same stock today. In between last year's AIA conference and the company's interim earnings report earlier this month the share price had rallied to near $9.50, or more than double the $4.50 it was languishing at a little over a year ago.

Yes, I am hopeful this stock might catapult me to last year's best stock picker at the upcoming AIA conference in late July, even though the share price has rapidly given back a chunk of that massive rally since the interim report was released. Truth is I never thought TechnologyOne shares would double from last year's too cheap sub-$5 price level, but I knew it would only be a matter of time before momentum would revisit this champion software company.

This is what I have learned from observing the Australian share market over nearly two decades: a great and high quality, reliable performer such as is TechnologyOne can fall temporarily out of favour, for all kinds of reasons, but it never lasts long. This is one key difference with shares in companies of a lesser quality and with a far less admirable track record; they can remain out of favour for far longer than you and I can keep our faith in a favourable ending.

Most investors get interested in a stock after it has fallen by what appears a ridiculous percentage, and then risk getting caught into temporary rallies, followed up by ongoing bad news and further share price weakness. EclipX Group ((ECX)) is one such fine example. iSentia ((ISD)) is another one.

Sure, Myer ((MYR)) shares doubled between early March and mid-April, so congratulations to everybody who was on board (conveniently forgetting all the money that was lost trying to pick the bottom in the Myer share price during the eight years prior).

As I have been highlighting over the years past, there is a viable, far less riskier strategy for long-term oriented investors and that is through buying high quality when the share market temporarily doesn't feel like it, rather than through scavenging through the rubble at the bottom of the beaten down dogs basket of the ASX.

One of the key factors as to why too many professional funds managers have found beating the market too difficult over the past five years is because most cheaply priced stocks revealed themselves as being traps for "value" seeking investors.

On the other hand, quality stocks including CSL ((CSL)), ResMed ((RMD)), REA Group ((REA)), Altium ((ALU)), Carsales ((CAR)), and TechnologyOne equally experience rallies and dips, but the dips are always an opportunity. Everyone can see this from opening up a price chart from the past ten years or so.

Admittedly, not every stock on my list of All-Weather Performers has this year managed to rise above peak share price levels recorded last year, but many have, and history suggests for the others it'll be simply a matter of time.

Unless, of course, something fundamentally changes the outlook for the company involved.

It happened to Ramsay Health Care ((RHC)) which saw its shares peak below $80 in 2016, then fall to mid-$50s last year. The shares are back near $70 this month as investors are starting to consider the potential implications of a turnaround in operational dynamics.

The story for InvoCare ((IVC)) looks pretty similar. InvoCare shares peaked in late 2017 around $17.40, then tumbled to near $11. They have rallied back to above $16 this month.

Both examples show us a lot of pain is inflicted on popular quality growth stocks when the future outlook becomes uncertain and investors start doubting which will be the way forward. But investors should keep in mind the punishment is not necessarily less for cheaper priced stocks. Of that an example such as EclipX Group can serve as a fresh reminder.

Most importantly, and this statement is backed up by historical evidence, high quality companies such as CSL, Altium, et al are far less likely to issue a profit warning, let alone one as severe a la EclipX Group and iSentia. And share prices tend to recover much quicker from a temporary draw down. Just look at what has happened to ResMed, REA Group, and the other stocks I just mentioned over the past year or so.

On my analysis, the biggest mistake made by investors is by treating every listed stock in the same manner, as if they are all the same, with relative value the only point of difference. In practice, however, stocks are not all similar. Quality commands, deserves and receives a premium. In particular when most sectors and listed companies are challenged and unable to deliver sustainable, uninterrupted growth.

This is one of such periods.

One of the stocks on my personal share market radar, Treasury Wine Estates ((TWE)), included in my domestic Prime Growth Stories selection, has this year somewhat fallen from grace as can be seen from the share price languishing around $15 when $18-$19 was not out of the question not that long ago.

Given the share price's track record since 2015, it is easy to suspect that investors might want to put this stock in the same basket with CSL, InvoCare, REA Group, and so forth but I have become a lot more circumspect about what goes on inside the global operations of this former market darling.

The reason is because market chatter about bloated distributor inventories in China for second tier wine from the producer of some of Australia's finest continues to resurface. This makes me anxious there possibly is some truth to it, regardless of company management's continued denials.

As the story goes, every distributor in China keen to stock up on Treasury Wine's high quality, prime wine products (such as Penfold's Grange) is forced by the company to also purchase volumes of lesser quality, cheaper wine. It is these second tier inventories that are reportedly hard to sell.

If the speculation is correct, none of this shows up in Treasury Wine's financial reporting, but common logic tells us this will become a serious problem at some point. Hence my reluctance.

Investors should be aware Treasure Wine Estates is essentially an 80/20 proposition whereby 80% of the profits stems from 20% of all wines sold (the prime priced quality section) but problems in the 80% of cheaper volumes can still cause havoc with the share price and its valuation.

A more attractive proposition, perhaps, was recently put forward by tech analysts at Bell Potter. Local technology company Integrated Research ((IRI)) has been on my personal radar for quite a while, but the company issued a sudden profit warning last year which explains the big tumble on the price chart from a peak in the share price as high as $4.

I don't like companies issuing profit warnings, for obvious reasons. I consider it a lack of management control and it certainly removes whatever was there beforehand in terms of "quality" label attached to the company.

Integrated Research's profit warning also reminded investors about how quickly fortunes can turn for smaller cap software and technology companies. A large number of peers have equally issued profit warnings, if not more recently then certainly over the years past.

Once again, this observation emphasises the true quality that resides with TechnologyOne; a fact I simply cannot repeat often enough. Consider this statistic for a moment: 99% retention of customers.

Back to Integrated Research. Bell Potter observes the company has experienced a good year post last year's debacle. The share price is back near $3, still nowhere near $4 but also a long way off from the bottom below $1.70. Bell Potter thinks the upcoming full year result should be strong, showcasing double digit percentage growth in both revenues and profits.

Of more importance, I would argue, is the fact that if Integrated Research is indeed back on track to continue the company's track record prior to last year, then the years forthcoming should see a resumption, and continuation, of double digit growth in earnings per share per annum. This is indeed the forecast put forward by Bell Potter.

Somewhat irresponsibly almost, Bell Potter argues both Integrated Research and TechnologyOne should grow at 15% on average per annum over the next three years. Of course, the two are not comparable just because both are wearing the label of "technology", and that's why the latter shares should trade at a hefty premium to the former.

Anyway, none of this means Integrated Research shares cannot be re-rated again on vast improvement of management's execution of the company's growth path. Investors who are prepared to give the company a second chance might want to have a closer look. Bell Potter thinks Integrated Research should provide positive guidance for the current fiscal year at some point in July and that this will act as a catalyst for the share price (all else remaining equal).

On Tuesday, as I am writing this story, I notice shares in TechnologyOne have stopped falling post interim report (whatever the exact disappointment was). After an initially timid move higher, they ultimately rallied in excess of 4% on the day.

It again reconfirms the observations I mentioned above. It also feeds my confidence that some of the resilient smaller cap quality stocks owned by the All-Weather Model Portfolio that have not been able to attract positive investor sentiment thus far in 2019 will eventually regain their prior mojo a la TechnologyOne and Aristocrat Leisure ((ALL)) post interim profit result last week.

I am specifically thinking about Orora ((ORA)), Bapcor ((BAP)) and GUD Holdings ((GUD)).

At a time when many an investor has fallen for the lure of jumping on, and staying on board, positive momentum stocks, it's great to be reminded that positive investment returns can still come from quality stocks, even when they are temporarily out of fashion.

As explained so often in "Reminiscences of a Stock Operator", it's the sitting and waiting that reaps the biggest rewards, at least for those that can withstand the mind's impatience when a share price is not moving, and all others, so it seems, are.

As long as investors don't confuse CSL with EclipX Group, or TechnologyOne with iSentia, of course.

****

Note: paying subscribers at FNArena have access to a dedicated section on All-Weather Performers on the website.

Note II: investors interested in attending this year's national AIA conference on Queensland's Gold Coast can still enjoy discount prices until May 31st.

https://administration.investors.asn.au/civicrm/?page=CiviCRM&q=civicrm%2Fcontribute%2Ftransact&reset=1&id=3

Note III: Reminiscences of a Stock Operator by Edwin Lefevre is one of the all-time classics about trading and speculating in US shares. I highly recommend reading it for those who haven't as yet

Also, for more information about the FNArena/Vested Equities All-Weather Model Portfolio send an email to info@fnarena.com, plus see further below.

Rudi On Tour In 2019

-AIA Adelaide, SA, June 11 -AIA National Conference, Gold Coast, Qld, 28-31 July -AIA and ASA, Perth, WA, October 1

(This story was written on Tuesday and Wednesday 28th & 29th May 2019. Part One was published on the day in the form of an email to paying subscribers, and again on Thursday as a story on the website. Part Two appears on the website on Friday).

(Do note that, in line with all my analyses, appearances and presentations, all of the above names and calculations are provided for educational purposes only. Investors should always consult with their licensed investment advisor first, before making any decisions. All views are mine and not by association FNArena's - see disclaimer on the website.

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

****

(Do note that, in line with all my analyses, appearances and presentations, all of the above names and calculations are provided for educational purposes only. Investors should always consult with their licensed investment advisor first, before making any decisions.)

Rudi's View: Citadel, Stockland & Expert Warnings

In this week's Weekly Insights (this is Part Two):

-Conviction Calls, Part I -In Quality We Trust -Conviction Calls, Part II -Rudi Talks -Rudi On Tour

[Non-highlighted parts appeared in Part One on Thursday]

By Rudi Filapek-Vandyck, Editor FNArena

Conviction Calls, Part I

Asset managers at AXA Investment Managers are touring Australia this week and their central message is that, maybe, investors should start preparing for more volatile, tougher times ahead.

AXA IM itself, which manages some EUR750bn globally both for the French headquartered insurer and for institutional and retail investors (institutions only in Australia), has adopted the view that the current economic expansion in the USA and elsewhere is getting long in the tooth. AXA suggests it's time to start positioning for a different context for equities globally.

While acknowledging the past years have been fairly atypical with bond yields at all-time lows (if not negative) and with central bankers actively supporting risk assets, AXA managers still maintain attention should be paid to the historical cycle for corporate earnings. The typical cycle framework below was presented during a briefing with the local press on Monday. It suggests that "value" investors might have to wait a whole lot longer until "low volatility", "positive momentum" and "quality" hand over the baton for leading performances in shares.

If AXA's assessment is correct, we are currently at an undefined point in the Late Cycle phase, implying at some point the economic cycle will turn for the worse, forcing investors to hide in stocks that look safer, carry less risks, are more reliable and robust, and less vulnerable to loss in economic momentum.

Interestingly, when asked about the observation that it might not have happened before that stocks of high quality are also trading on higher than usual valuations, Kathryn McDonald, Head of Sustainable Investing at AXA IM Rosenberg Equities, responded she still believes the underlying dynamics as represented on the stylised cycle overview should still prove valid.

If one looks closer into what is happening inside most of the world's quality companies, McDonald explained, one finds they are mostly not as expensive as they appear at face value. Even so, cheaper "value" stocks should prove more vulnerable when darker economic clouds announce themselves, so there's little use in trying to hide in cheaper valuation just for the sake of it.

****

AXA IM is not the type of manager who tries to put a precise timing on the next turn in the cycle, unlike strategists at investment bank Morgan Stanley whose view about the outlook for equities can be summarised as: see AXA IM's cycle assessment with exact timing being: now!

Two concerning observations stand out from the US strategy team's latest update: the Federal Reserve already has tightened a lot more than the average analyst/investor appreciates, and Morgan Stanley's proprietary, adjusted for QE and QT, US bonds yield curve implies the curve has been negative since November last year, and remains deep in the negative today.

Investors will be hoping the internal modeling at Morgan Stanley is not quite correct because history shows an inverted yield curve that stays inverted for this long is always followed by an economic recession. Which is why Morgan Stanley strategists warned their clientele this week not to get carried away by trade war hopes, Trump tweets, Q1 better-than-feared corporate profits and a Federal Reserve that has pressed the pause button in response to share market turmoil.

[Special note: since publication of Morgan Stanley's research note the US bond market has moved into an inverted yield curve without adjusting for QE/QT]

We are now officially on "recession watch", the strategists declared, explaining underlying momentum for the US economy had been weakening even before the current trade conflict with China captured newspaper headlines. One forecast stands tall: volatility is about to rise significantly. In addition: the next move from the Fed will be to cut interest rates, as implied by the bond market.

Economic data will get weaker. Corporate profits are poised to disappoint in the quarters ahead. Morgan Stanley's proprietary US Cycle Indicator is now, for the first time since late 2007, signalling a new downturn is emerging.

The strategists point out the early downturn assessment occurred on input data from April, which is before the Trump-China trade talks broke down. They add the OECD leading indicator has now fallen to its lowest level since the last recession. In addition, recent Market PMIs for the US are the lowest readings since the Great Recession.

A whole lot of confidence in the US is based on a general prediction the US economy and corporate profit growth should look a lot better in the second half of the calendar year. Morgan Stanley strategists believe this market confidence is about to be hit by a cold hard reality check.

Coincidentally, Emerging Markets analysts at Citi this week reversed their view now favouring risk to the downside on noted loss in economic momentum. A resolution in the trade spat between US and China can reverse this, as it would translate into a weaker USD, say the analysts.

Economic modeling by Morgan Stanley suggests continuation of US trade tariffs will pull both the economies in the USA and China on the verge of recession late in 2019. They also are concerned that it will take economic signalling, followed up by financial markets, to reignite negotiations with a stronger incentive to actually reach a concrete agreement between the two protagonist countries.

****

Fund managers at Wilsons Advisory and Stockbroking recently moved to reduce risk in respective model portfolios. Portfolio positioning is now underweight US equities, neutral Emerging Markets equities, underweight European equities, and with overweight positions in cash and fixed income (bonds).

Notably, Wilsons made no changes in positioning towards Australian equities, expecting the Australian share market from here onwards to perform better than offshore peers with a preference for domestic oriented business models.

The prime reason behind this change in preference is, of course, the fact that RBA and APRA are now in coordinated stimulus to stop the slide in the domestic housing market, while the freshly re-elected government should (at some point) join in with fiscal stimulus for low-to-middle income groups.

"Australia", notes Wilsons, "is in a fortunate position in that we have room to stimulate the economy through fiscal policy. Among the developed economies in the G20, Australia's fiscal balance as a percentage of GDP is the second best, beaten in our frugalness only by Germany."

Higher for longer iron ore prices are boosting the federal government's coffers, creating a rather large windfall that provides options for ScoMo's team in Canberra to ease the tax burden on income earners. On my observation, it has been a long while since asset managers preferenced Australian shares over international equities.

Investors would have noticed the Australian share market has outperformed overseas markets since that surprise outcome from the federal election.

****

Similar considerations are behind the decision by Australian strategists at Citi to raise their year-end target for the ASX200 to 6700, from 6500 previously, and to 6850 for mid next year. Citi's revised targets imply the ASX200 will finally break through the GFC high from late 2007. It will have been, by then, more than 12 years, and that's assuming Citi's projections will materialise.

Shorter term, Shaw Stockbroking chief investment officer Martin Crabb observes both US and Australian equities have outperformed the world index over the past twelve months with returns of 5.63% and 2.32% respectively. In comparison, Japan is down -11.5% over the period, while Europe ex-UK is down -4% and Emerging Markets have clocked losses of -9.4%.

Crabb highlights Australia's performance has not been backed by commensurate increases in earnings estimates, with iron ore producers pretty much the sole segment continuing to enjoy upgrades to forecasts. This makes the Australian share market "really expensive" on a global basis, suggests Crabb.

On a 12 month forward PE comparison Crabb believes Australian shares are now trading at an 8% premium vis a vis international equities. He thinks this is a time and context to be rather cautious.

Conviction Calls, Part II

Analysts at Wilsons don't like companies that issue profit warnings; in particular not when the company has been selected as a Conviction Buy for the year ahead.

And thus the only logical decision to make when Citadel Group ((CGL)) issued its surprise profit warning earlier in May was to downgrade its rating for the stock, while also removing it from its core model portfolio. The downgrade to Hold with a reduced price target of $4.50 implied the stock could not be maintained on Wilsons' Conviction Calls list either.

What irked Wilsons analysts most is they had been in contact with management recently, and guidance for the current year had been all but confirmed at an investor conference at the start of the month. The company's fall from grace comes with a stern warning there are now enough question marks to keep buyers at bay, putting the shares at risk of further de-rating.

In Wilsons' lingo this reads as follows: "We have seen this across the technology sector where surprise downgrades cause the stock to drift lower/underperform the market for multiple quarters post initial the downgrade." (sic)

Citadel Group had also been added to my personal selection of potential future All-Weather Performers. It has equally lost that spot too.

****

Portfolio managers at Macquarie have made several changes post Coalition re-election in anticipation of an improving housing market. They added Stockland ((SGP)) but removed Mirvac ((MGR)) while focusing the exposure to local banks on National Australia Bank ((NAB)) and Westpac ((WBC)).

Investment returns from the construction materials sector have been the worst in decades, notes Macquarie, but with RBA rate cuts on the agenda it is time to increase exposure. Macquarie has added CSR ((CSR)) on top of its existing position in James Hardie ((JHX)).

Macquarie also decided to take profits in (reduce exposure to) Aristocrat Leisure ((ALL)), BHP Group ((BHP)) and Rio Tinto ((RIO)).

****

Over at Citi, the surprise federal election result has encouraged recommended portfolio managers to increase the overweight position in banks, while also adding Harvey Norman ((HVN)) and Boral ((BLD)).

Citi also increased its exposure to Downer EDI ((DOW)) which just goes to show not everything can be foreseen and contractors in general remain a fickle industry to invest in. Downer shares tanked more than -9% on Wednesday after the company flagged it might be financially responsible for the Murra Warra windfarm project, now its German partner in the project has called in the administrators.

****

Brian Johnson and Christopher Kightley, banking analysts at CLSA, refuse to budge from their Underweight sector recommendation irrespective of a number of positives occurring that have triggered a rally in bank share prices in the second half of May.

Both analysts maintain, despite the positives from RBA, APRA and Coalition government, operating profits across the sector are growing at insipid pace at best, which means share prices will at some point probably trade weaker too.

Banking sector analysts at stockbroker Morgans is of a similar view, arguing one month ago or so Australian banks seemed to offer good value, but now that underlying dynamics have received a boost, and post share prices rallying, the sector looks a lot closer to fully valued, suggest Morgans' analysts.

Morgans likes Westpac ((WBC)) the most, and National Australia Bank ((NAB)) the least.

****

However, not everybody is singing from the same hymn sheet when it involves Australian banks, or even the Australian share market in general.

Market strategists at Deutsche Bank are keeping a bullish outlook and their suggestion to investors is to "let it run hot". Against a darkening international backdrop, stimulatory measurements locally will translate into outperformance for domestic companies and shares, Tim Baker and David Jennings predict.

Their recommendation is to stay Overweight Australian banks, as more RBA cuts will keep bad debts low, as well as Overweight offshore cyclicals as the weakening AUD should further support them, while Aussie yield continues to look attractive on a global scale.

Having said so, Deutsche Bank does believe the Australian share market has overdone it in the short term, so as a whole Baker and Jennings believe the major indices are probably looking at lower levels in the months ahead.

Deutsche Bank's model portfolio is Underweight resources. Recent changes made include adding Atlas Arteria ((ALX)), Harvey Norman ((HVN)), JB Hi-Fi ((JBH)), Medibank Private ((MPL)), Evolution Mining ((EVN)), and ResMed ((RMD)).

Stocks that have been removed from the model portfolio include Insurance Australia Group ((IAG)), Oil Search ((OSH)), Flight Centre ((FLT)), Downer EDI, Incitec Pivot ((IPL)), and Ansell ((ANN)).

The combination of APRA-RBA stimulus and a general reversal in sentiment throughout the general populace in Australia, with soon a stabilisation in property prices to follow, is making the managers at the Auscap Long Short Australian Equities Fund equally positive.

As a matter of fact, having attended Auscap's annual roadshow meetings for quite a while, this week's presentation in Sydney was by far the most bullish in the history of Auscap roadshow presentations on both my observation and on the manager's own admission.

Auscap is so bullish on the Australian economy, it doesn't understand why the RBA is cutting interest rates! (But they will).

The fund's current top ten holdings are Adelaide Brighton ((ABC)), Blackmores ((BKL)), Centuria Metropolitan REIT ((CMA)), CYBG ((CYB)), GDI Property Group ((GDI)), JB Hi-Fi, Mineral Resources ((MIN)), Nine Entertainment ((NEC)), Super Retail Group ((SUL)), and Unibail-Rodamco-Westfield ((URW)).

Auscap has this month been buying bank shares, for the first time in years, with Westpac shortly to enter the fund's top ten holdings.

Being a typical value-oriented investor, Auscap sees most opportunities among domestic oriented old economy stocks that are trading near post-GFC lows in terms of valuations, with the added requirement these companies are adjusting to the threat of modern interruptive technology-driven competitors.

Contrary to rising cash levels elsewhere, Auscap co-founder, principal and portfolio manager Tim Carleton gleefully declared the fund is fully invested (zero in cash), being indicative of how "genuinely excited" Auscap is about the outlook.

****

Adding a final twist to the domestic investment story: on Friday, banking analysts at Deutsche Bank (not the same guys as those manning the market strategy desk) reiterated to Deutsche Bank clientele lower interest rates domestically are not helpful for the banks. They are creating more powerful headwinds for the sector.

Brian Johnson & Co would say "told you".

Rudi Talks

Audio interview about investing in high quality stocks in the Australian share market:

https://www.youtube.com/watch?v=f9pTAV4TPJA&t=16s

Rudi On Tour In 2019

-AIA Adelaide, SA, June 11 -AIA National Conference, Gold Coast, Qld, 28-31 July -AIA and ASA, Perth, WA, October 1

(This story was written on Tuesday and Wednesday 28th & 29th May 2019. Part One was published on the day in the form of an email to paying subscribers, and again on Thursday as a story on the website. Part Two appears on the website on Friday).

(Do note that, in line with all my analyses, appearances and presentations, all of the above names and calculations are provided for educational purposes only. Investors should always consult with their licensed investment advisor first, before making any decisions. All views are mine and not by association FNArena's - see disclaimer on the website.

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

****

BONUS PUBLICATIONS FOR FNARENA SUBSCRIBERS

Paid subscribers to FNArena (6 and 12 mnths) receive several bonus publications, at no extra cost, including:

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

Subscriptions cost $420 (incl GST) for twelve months or $235 for six and can be purchased here (depending on your status, a subscription to FNArena might be tax deductible): http://www.fnarena.com/index2.cfm?type=dsp_signup

(Do note that, in line with all my analyses, appearances and presentations, all of the above names and calculations are provided for educational purposes only. Investors should always consult with their licensed investment advisor first, before making any decisions.)

(Do note that, in line with all my analyses, appearances and presentations, all of the above names and calculations are provided for educational purposes only. Investors should always consult with their licensed investment advisor first, before making any decisions.)

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

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

Find out why FNArena subscribers like the service so much: "Your Feedback (Thank You)" - Warning this story contains unashamedly positive feedback on the service provided.

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

TERMS AND CONDITIONS OF USE, AND DISCLAIMERS

These Terms and Conditions of Use, and Disclaimers constitutes your agreement with News Network with respect to your use of its FN Arena website, its weekday news periodical, Australian Broker Call, as well as it's monthly periodical Australian Super Stock Report, as well as any other publications (including articles) News Network may publish on its website, or anywhere else, from time to time. Please read the contents of this page carefully as it contains important legal information and disclaimers. By entering and perusing the website, reading the Australian Broker Call or the Australian Super Stock Report, or, if you are subscriber, by entering the password protected part of the website, you acknowledge that you have read, understood and accept this agreement.

By accepting this agreement you acknowledge, understand and accept the following:

1. Reference to "FN Arena" and "News Network" means reference to News Network Ltd, its journalists, directors, other employees, affiliates, agents, associates and subsidiaries.

2. News Network Ltd is the owner of the FN Arena website and brand name.

3. Reference to "we" or "us" is reference to News Network.

4. Reference to "this website" or the "FN Arena website" means reference to www.fnarena.com, and includes reference to News Network's weekday news periodical, Australian Broker Call, as well as its monthly periodical Australian Super Stock Report, as well as any other publications (including articles) News Network may publish on this website, or anywhere else, from time to time.

5. Reference to "news periodicals" means reference to News Network's weekday periodical, Australian Broker Call, as well as it's monthly periodical Australian Super Stock Report, as well as any other periodicals News Network may publish from time to time on this website, or anywhere else, from time to time.

6. Reference to "publications" in this agreement means any material, including articles, published or put in print on the FNArena website, or anywhere else, whatsoever, and includes News Network's weekday periodical, Australian Broker Call, as well as it's monthly periodical Australian Super Stock Report, and any other periodicals News Network may publish from time to time.

7. Reference to a "visitor" means, you, a visitor to this website, and includes a subscriber to Australian Broker Call and the Australian Super Stock Report, as well as any other publications or periodicals News Network may, from time to time, publish on this website.

8. News Network is a media company which employs financial journalists to report financial news. News Network's journalists perform the required research and collect the information that is, ultimately, each day, published on this website and in News Network's news periodicals. As is obvious, the process by which the information is collected and delivered to you is a purely journalistic one and, therefore, the comments, opinions and recommendations News Network reports on this website are not the opinions of News Network or any of its journalist or other employees. News Network is ONLY and specifically a matter-of-fact reporter of industry signals suggesting price direction probability of some shares. News Network simply delivers the information – it does not create it.

9. Although News Network obtains the information published herein from sources deemed to be reliable, and given and received in good faith, it cannot and does not guarantee its accuracy. News Network does not take any responsibility either for the financial soundness or for the correctness of statement made or opinion expressed in the data or content reported by News Network, and cannot and does not guarantee the reliability and accuracy of the opinions of the brokers whose opinions, recommendations and forecasts it reports.

10. News Network publishes this website, all publications and its periodicals strictly for convenient personal, non-commercial, educational and informational purposes of its subscribers only. Our goal is to provide the subscribers with a convenient starting point of potentially useful, but not comprehensive, content that can educate or otherwise enhance a visitor's knowledge base and frame of reference.

11. News Network is NOT a stock broker or financial or trading advisor, nor is it an advisory service of any kind, and no advice or recommendations on investments or trading are made nor implied on this website. Nothing contained in this website is intended to be, nor shall it be construed as, advice or recommendation. Any investment or other decisions made by you must be based solely on your own evaluation of the targeted subject for investment, and your financial circumstances and investment objectives, and News Network will not be held liable for any such investments and decisions.

12. It is distinctly understood and accepted that the shares referred to in the FN Arena website, News Network's publications and/or periodicals have not been recommended by News Network. The content and or any comments found of this website, including the content and/or comments published in any publication and/or periodicals published by News Network, do not constitute a recommendation or endorsement by News Network with respect to any company, security, share or investment or any financial or investment product.

13. This website makes no representations, and, to the extent allowed by the law, specifically disclaims all warranties, express, implied or statutory, regarding the accuracy, timeliness, completeness, merchantability or fitness for any particular purpose of any material contained in the website.

14. Before making an investment decision, you must do your own research and rely on your own examination of the share, and the risk involved, and not on what you read on the FN Arena website, or in any publication or periodical. The content of this website is provided strictly for convenient personal, non-commercial educational and informational purposes only and News Network shall not be held liable for any investment decisions, sales or purchase decisions, which you may have made based on what you have read on this website or in the periodicals published by News Network from time to time, or in any other publications News Network may publish on its website, or anywhere else, from time to time. Anyone who makes investment decisions based on what they read on this website does so at their own risk, and agrees that they cannot hold News Network responsible and/or liable for any loss whatsoever.

15. It is your responsibility to evaluate the completeness, accuracy and usefulness of any content made available on this website. If you are unsure, or in doubt about the meaning of any information, you should consult your financial advisor.

16. News Network does not guarantee any returns on investments made in any share mentioned on this website by the visitors. As any investor well knows, any investment opportunity, strategy or concept involves a degree of risk and investors should not invest any funds unless they can afford to take the risk of losing their investment. News Network strongly suggests that you consult your own financial advisors regarding the soundness of any intended investments, strategies or concepts, and discuss with such advisor your individual investment needs and goals. You may also wish to consult the broker who expressed the opinion we have reported on in the news periodicals we publish.

17. News Network shall not be held liable to any visitor of the FN Arena website, or any reader of its periodicals and/or publications, or anyone else who may have relied on this website, directly or indirectly, for any inaccuracies in the printed material found on the FN Arena website, in the periodicals and/or other publications, any typing errors, omissions, interruptions, timeliness, completeness, deletions, defects, failure of performance, computer virus, communication line failures, alterations of, or use of any content herein, regardless of cause, for any loss or damage resulting therefrom.

18. Under no circumstances, including, but not limited to negligence, shall News Network be liable for any direct, indirect, incidental, special or consequential damages that result from the use of, or the inability to use, the FN Arena website, and any or the News Network's publications and/or periodicals.

19. As a condition of use of the FN Arena Website, News Network's publications and periodicals, you agree to indemnify News Network and all those affiliated with it from and against any and all liabilities, expenses (including legal costs) and damages arising out of claims resulting from your use of the FN Arena website, News Network's publications and periodicals. If you are uncertain about this agreement or the contents of the FN Arena's website, or are dissatisfied in any shape or from, with the content of the FN Arena website, or any of the publications or periodicals, or you do not agree with these terms and conditions, your sole and exclusive remedy is to discontinue using the FN Arena website, News Network's publications and periodicals.

20. News Network may, from time to time, publish advice, opinions and statements of various third parties, other then the ten stock brokers, and various other information and content providers. News Network does not represent or endorse the accuracy or reliability of any advice, opinion, statement or other information provided by these third parties. Reliance upon any such opinion, advice, statement, or other information is at your own risk.

21. The FN Arena website may contain links and pointers to websites maintained by third parties. News Network does not operate or control in any respect any information, products or services on such third-party websites. Third party links are included solely for the convenience of visitors, and do not constitute any endorsement by News Network of any products or services provided by the third party link owners or operators. News Network has no control over any websites that we might link to and does not take responsibility for their quality, content or suitability.

22. News Network is not responsible for claims made by advertisers on the FN Arena website or in any of its periodicals. Such advertisements are included solely for the convenience of visitors, and do not constitute any endorsement by News Network of any products or services advertised. News Network does not check the accuracy of the statements made by the advertisers. You assume sole responsibility for the access and use of third party links and pointers from the FN Arena website, as well as any purchases you may make from those third parties (including advertisers).

23. All the content, information and material made available on this website are provided to you "as is" and without warranty of any kind from News Network whether express or implied, including, but not limited to, implied warranties of merchantability and fitness for a particular purpose, title, non-infringement, security or accuracy, nor does News Network endorse or take any responsibility for the accuracy or reliability of any opinion, advise or statement made through the FN Arena website, its periodicals, or for making good all or part of any loss and/or damage that may have been caused by the visitor's reliance on any information, advise, product or service obtained from a linked website.

24. News Network is not liable for any copyright infringements incurred by any outside content or information contributors, or by third parties who have links to this website, or advertise on this website.

25. News Network reserves the right to make any and all changes to the FN Arena website, including the publications and periodicals, at its sole discretion without notice to you. News Network reserves the right to deny access to this website or its information to anyone at any time.

26. This agreement shall be deemed to include all other notices, policies, disclaimers, and other terms contained in the FN Arena website, provided, however, that in the event of a conflict between such other terms and the terms of this agreement, the terms of this agreement shall prevail.

27. News Network shall have the right, at its discretion, to change, modify, add or remove terms of this agreement at any time. Changes shall be effective immediately. Notification of any such changes shall be made herein, therefore, you are strongly advised to read these terms each time you wish to access the FN Arena website or any periodical.