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Stories To Read From FNArena

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GPO Box 3145
Sydney NSW 2001

info@fnarena.com

Your editor
Rudi Filapek-Vandyck

Your dedicated team of
journo's
Greg Peel
Eva Brocklehurst

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BT Investment Outlook A Little Less Rosy

BT Investment Management's business made a solid start to FY18 although net outflows, largely from previously disclosed mandate losses, raise a few concerns regarding the outlook.

-Downside risk enhanced if outflows persist -Business supported by diversified exposure -Some uncertainty persisting in UK business

By Eva Brocklehurst

After a strong performance over the last several years the December (first) quarter has revealed a more mixed outlook for BT Investment Management's ((BTT)) JO Hambro business. BT Investment's funds under management (FUM) of \$98.1m were 2.4% higher in the quarter, although below some broker estimates. The miss was largely driven by net outflows, which can be explained by the realisation of \$2.7bn of Westpac ((WBC)) MySuper redemptions in addition to negative net flows for JO Hambro.

JO Hambro recorded a performance fee of \$47.5m that will contribute around \$17.8m to cash net profit, or 9% of earnings. Morgans calculates that nine investment strategies contributed to the fee but estimates the UK Equity Income fund contributed around 85%. UBS suggests future flow and performance fee prospects at JO Hambro are highly reliant on a handful of funds performing well and this risk is not fully reflected in consensus earnings estimates.

The broker believes the stock is fair value, both in absolute terms and relative to peers, but continues to envisage downside risks to outer year expectations. Analysis suggests only three of the JO Hambro retail funds generated performance fees and the remainder, which now account for 70% of performance fee assets under management (AUM), are trailing high watermarks by -5.9% on average.

Outflows were expected during the quarter because of the Westpac MySuper transition and a pre-announced institutional mandate loss for JO Hambro. Credit Suisse notes this is the first quarter of outflows for JO Hambro under BT Investment Management's ownership. The broker is not too concerned, noting the stock is trading on a forward earnings profile that is broadly in line with UK peers and this appears fair given the quality of the core franchise. Therefore, outflows during the quarter were probably one-off in nature but if they were to persist this would pose downside risk.

Credit Suisse has factored in more conservative forecasts and considers the risk is now skewed to the upside from a beat on performance fees. Given the near-term uncertainty regarding the outlook for flows, and the impact of MiFID2 implementation on the company's business model, Ord Minnett is also retaining a Hold rating on the stock. The broker notes flows have started to slow in recent quarters for JO Hambro, given significant growth over the past four years.

While acknowledging one-offs played a part, with the implementation of MiFID2 this month - and the impact on the company and industry not yet quantified - the broker believes the outlook for flows in the UK business remains uncertain. MiFID is the framework of European Union legislation for investment intermediaries that provide services to clients around financial instruments.

Morgans returns to an Add rating and asserts the company's diversified markets exposure supports a solid outlook for the medium term. The previous Hold rating was based on a short-term view to assess the first quarter flows. The outflows for JO Hambro were largely concentrated in previously disclosed mandate losses and therefore the broker considers the outlook unimpeded.

Morgans expects further retail redemptions in the UK Opportunities fund are likely but this impact will recede over the next two quarters. In the medium term equity markets remain constructive, with the company having a diversified exposure across global markets. The main downside risk, in Morgan's view, is a sustained underperformance of the company's major funds and material outflows as a result of market uncertainty.

Macquarie is encouraged by the strong FUM performance and the underlying \$1.1bn of inflows. The broker still expects a further \$800m to \$1.0bn of redemptions from Westpac in the next two quarters as the reconfiguration of My Super is finalised but, besides this, considers the underlying momentum remains positive.

There are three Buy ratings and three Hold on FNArena's database. The consensus target is \$12.03, suggesting 4.8% upside to the last share price. Targets range from \$11.10 (Credit Suisse) to \$13.20 (Morgan Stanley). The dividend yield on FY18 and FY19 forecasts is 4.4% and 4.9% respectively.

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Potential For Further Returns At South32

South32 has upgraded production guidance for South African manganese by 8% as it flexes output to take advantage of higher prices. The December quarter also revealed weakness at Worsley and Cannington.

-Relying on higher grade stopes in the second half to ensure guidance at Cannington -Strong balance sheet provides potential for further returns -Stock generally seen trading around fair value estimates

By Eva Brocklehurst

Manganese ore production was the highlight in the December quarter for South32 ((S32)), offset by weaker production from the company's Worsley (alumina) and Cannington (silver, lead and zinc) mines.

The company maintains FY18 guidance, although lifts forecast for South African manganese by 8%. Maintenance activities at Worsley and an electric arc incident at the aluminium smelter in South Africa resulted in weaker production at both sites. UBS suggests it may be challenging for these assets to hit FY18 guidance.

The December quarter was expected to be about mending operating issues at Illawarra (coal) and Cannington. At Illawarra, production has improved by 200,000t but a full recovery is expected to take 12 months.

Still, Ord Minnett expects achieved prices will likely reflect the benchmark. Illawarra production was broadly in line with Macquarie's estimates and the product mix included a positive skew to coking coal relative to its forecasts.

Meanwhile, Cannington is currently mining lower grades and has reduced the mill throughput, lowering production. UBS points out the company is relying on higher grade stopes in the second half as well as a commissioning of the crusher in March to ensure guidance is achieved.

Brokers note the lower grade has now pressured the asset to lift its performance substantially in the second half. First half silver production was equivalent to just 36% of the full year guidance. Credit Suisse suggests, as Cannington moves into its last decade, variable grades and production should not come as a surprise.

South African and Australian production of manganese were the highlights in the report, exceeding broker estimates substantially, and increasing 28% and 11% quarter on quarter, respectively.

Macquarie estimates the company ended the first half with a net cash position of US\$1.9bn. Net distributions of US\$238m received from equity accounted investments in the first half were significantly higher than Macquarie's base case estimates.

South African coal production was flat, although export volumes were up 13% because of a reduction in domestic demand. The company has stated this may imply downside risk to FY18 production guidance.

In turn, Deutsche Bank suggests it implies more exports of higher margin coal. Nickel production was -14% lower quarter on quarter but still well ahead of the broker's forecast.

Deutsche Bank expects the company to finish the December half with a flat cash position, despite a better dividend from manganese. The main negative is higher working capital because of the build up in inventory and receivables. The company expects the build up in working capital to unwind in the second half.

Shareholder Returns

Citi downgrades to Neutral from Buy believing that, although the company has a strong balance sheet that will provide the potential for further returns to shareholders, it offers limited growth from the existing portfolio.

If spot prices were maintained, the broker's FY19 estimates for operating earnings (EBITDA) would be 45% higher, at US\$3.5bn, and the company would generate US\$2.2bn in free cash flow that could further top up returns to shareholders through either buybacks or dividends.

Credit Suisse also elects to downgrade the stock, to Underperform from Neutral, given continued strength in commodity prices has meant the stock has rallied almost 17% since Christmas.

The broker looks for a lower entry point but concedes that, if commodity prices hold up for longer than currently assumed, value will remain compelling because of the state of the balance sheet and the capacity for further shareholder returns.

The company has committed to return US\$750m to shareholders by the end of October. UBS suspects the on-market buyback program is unlikely to meet this timetable and assumes a higher dividend payout ratio for FY18, at 70% versus 50%, to take up the shortfall.

While the company has completed \$305m of the \$750m capital return, Ord Minnett does not expect a top up and forecasts a US7c interim dividend. As the stock is trading around the broker's fair value estimate, a Hold rating is maintained.

FNArena's database has two Sell ratings, five Hold and one Buy (Morgan Stanley, yet to comment on the report). The consensus target is \$3.50, signalling -8.0% in downside to the last share price. Targets range from \$3.08 (Morgans, yet to comment on the report) to \$3.85 (Ord Minnett).

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How China Is Locking Up Critical Resources

How China Is Locking Up Critical Resources In The US's Own Backyard

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.

In the 1800's the United States under President James Monroe invoked the Monroe Doctrine, which stated that any effort by European nations to control any independent state in North or South America would be viewed as "an unfriendly disposition towards the United States."

The intent of the Monroe Doctrine was to free the newly independent colonies of Latin America from mostly Spain and Portugal, so that the States could exert its influence undisturbed. "The Monroe Doctrine, first articulated in 1823 as a means of blocking external interference in the Western Hemisphere, was the central pillar of US policy toward Latin America until Barack Obama's secretary of State, John Kerry, told a roomful of Latin American diplomats in 2013 that "the era of the Monroe Doctrine is over."

The statement was part of an effort to rehabilitate the US image in a region long accustomed to seeing the United States as seeking to control it through persuasion when possible, and force when necessary. In a policy paper published last December, Craig Deare, a dean at the US National Defense University and now Mr. Trump's top Latin America advisor on the National Security Council staff, denounced Kerry's statement "as a clear invitation to those extra-regional actors looking for opportunities to increase their influence. He specifically mentioned China." Is Trump resurrecting the Monroe Doctrine? Max Paul Friedman

The point of mentioning the Monroe Doctrine is to illustrate just how far the United States has moved away from it. Now, the real influencer in Latin America is China, evidenced by the billions worth of investment either through the purchase of mining and energy company stakes, or outright mine acquisitions.

The reason, of course, is to feed China's insatiable appetite for commodities. As an example, the Chinese are both the largest producers and consumers of aluminum and iron ore, with iron ore imports exceeding the 100-million-tonne threshold for the first time in September 2017.

The enormous political, economic and cultural shift in China, from a developing agrarian society to a modern, urban one, has led to some remarkable developments, all of which are good for commodities.

China's New Silk Road is a \$900 billion initiative meant to open channels between China and its neighbors, mostly through infrastructure investments. China, long ago put a lock on much of Africa's vast resources.

Last April President Xi Jinping announced a grand scheme to transform a backwater called Xiongan, south of Beijing, into a city triple the size of New York. Consulting firm Wood Mackenzie estimates that building the city will call for around 20 million tonnes of steel, 400,000 tonnes of aluminum, and 250,000 tonnes of copper during the first 10 years of construction.

The Made in China 2025 initiative, which aims to make China's copper industry more efficient, is expected to grow Chinese copper demand by an additional 232,000 tonnes by 2025. This isn't counting the need for more copper for railways, electric vehicles, car motors and power transformers.

While iron ore and copper have been the hot targets of overseas acquisitions by Chinese firms as they seek to feed an economy that up until 2015 was growing at double digits, the Chinese have also gone after gold, nickel, tin and coking coal. More recently the most desired metals are those that feed into a tectonic global shift from fossil fuels to the electrification of vehicles. This has meant a hunt for lithium, cobalt, graphite, copper and rare earths - metals that are used in electric vehicles, of which China has become the world leader.

The most interesting part of this trend is not that China is acquiring mines and mining company stakes abroad - that has been going on for at least a decade - but that the overt attempts to lock up the world's mining and energy resources, some of which are critical to the future world economy, are happening under the nose of the United States in Latin America, in countries previously subject to the Monroe Doctrine and in one case, right in their own front yard.

Rare earth robbery

In 2016 Molycorp's Mountain Pass Mine in California was shut down because it couldn't compete with the low rare earth oxide prices coming out of China - which has cornered the market in REOs with about 95% of the world's production. The timing was bad because Molycorp had just invested \$1.25 billion to expand the light rare earths facility. It was forced into bankruptcy, until last summer when an investor group with ties to the Chinese government bought the mine for \$20.5 million, beating out American bidders including ERP Strategic Minerals.

While this purchase likely flew under many radars (rare earths haven't been in vogue among investors for years), it should be greeted with considerable alarm. The Coalition for a Prosperous America is calling on the US government to block the sale on national security and economic grounds. Why? Because rare earths are critical to US military technology, and Mountain Pass was the only rare earths mine in the country. Electric systems in manned and unmanned aircraft, atomic batteries that power guided missiles, and lightweight materials used to make jet engines and rocket noses, all rely on REEs. Without a domestic supply, the Americans must rely on Chinese sources of rare earths to build "made in America" military and space equipment.

Mission critical for "the big four"

Rare earths aren't the only minerals that the United States is woefully dependent on foreign mines. While the US has consistently maintained that a strong domestic metals industry is an essential contributor to the nation's economic and security interests, the fact remains that since the 1990s the US has lost control of several critical mined commodities. Written about in a previous *Ahead of the Herd* post, chromium, cobalt, manganese and platinum group metals represent the metallurgical Achilles' heel of the United States because of their widespread role and vulnerability to supply disruptions. Six of the world's top 10 cobalt mines are in the DRC, hardly a stable jurisdiction for mining, where resource nationalism - the tendency of governments to grab control of their own natural resources - is a continuous threat.

Manganese is another striking example. Most of the world's manganese comes from South Africa, Gabon and China. There are no producing manganese mines in North America. Aside from iron ore, manganese is the most essential mineral in the production of steel. If manganese imports were suddenly stopped, there would be no US steel industry - making this one of the most critical, and vulnerable, supply chains for the nation. The US gets most of its electrolytic manganese from China. EM is used as an aluminum and copper alloy, but its most important application is in lithium-ion-manganese batteries. If the US can't access competitively priced and reliable supplies of EM, a host of high-tech new applications will be lost to foreign competitors.

While much of the rest of the world is scrambling to tie up control of strategic minerals, America has deliberately hamstrung itself. After World War II the US set up the National Defense Stockpile to acquire and store strategic minerals for national defense purposes, but in 1992, the bulk of these stored commodities were sold off. In 1985 the secretary of the US Army testified before Congress that America was more than 50 percent dependent on foreign sources for 23 of 40 critical materials essential to US security.

Trump gets it

In December Donald Trump issued a directive that aims to identify new domestic sources of strategic metals. The thrust of the directive is to reduce US dependence of foreign supplies of these materials. "The United States must not remain reliant on foreign competitors like Russia and China for the critical minerals needed to keep our economy and our country safe," Reuters quoted President Trump saying.

While this is certainly a step in the right direction, the United States appears to be doing little to gain access, through acquisitions, joint ventures or off-take agreements, to the materials of the future that are essential in the making of smart phones, computers, military equipment and renewable energy technologies.

The Chinese, on the other hand, are way ahead in foreign mine acquisitions and off-takes. So far ahead that it is unlikely that the United States will ever be able to catch up, and break free of their current state of critical metal dependence. Below are just a few examples.

Argentine gold tie-up

Last summer Shandong Gold partnered with Barrick, the world's biggest gold producer, to purchase a 50% stake in the Veladero gold mine on the Chile-Argentina border. The \$960 million deal included Shandong, China's top gold miner, studying the possibility of building the massive Pascua Lama gold deposit Barrick has been trying to develop on the same border. The Chinese firm could also work with Barrick to explore other mines in the El Indio gold belt of Chile.

Brazil's vulnerability is China's gain

Brazil, one of the best mining jurisdictions with a wealth of minerals including iron ore, gold, copper, manganese and bauxite, should be tightening control of its mineral riches as it struggles through a major recession fueled by a corruption scandal. Instead the country has opened its doors to foreign investment: namely, Chinese.

According to Dealogic Chinese M&A of Brazilian companies totalled \$10.8 billion in 2017 and \$11.9 billion in 2016. Chinese banks and investment groups have committed \$15 billion of a \$20-billion China-Brazil Fund, a Beijing-managed fund to finance infrastructure projects that was launched in 2016. The fund is to speed resource development, including rail projects. There's also the \$10 billion "dollars for oil" loan between China Development Bank and Petrobras, the Brazilian state oil company. In return for paying off Petrobras' debts, China gets oil supply commitments for Chinese buyers.

Next door in Venezuela, despite the basketcase of an economy run under President Nicolas Maduro, China is also investing heavily, hoping to cash in on the country's natural resources that were plundered by the late dictator Hugo Chavez. In July the government signed agreements totaling just over \$1 billion to expand mining in the country gripped by low oil prices and hyperinflation. Venezuelan state-owned CARBOZULIA will partner with Chinese state mining giant Yuankuang Group, as well as a Colombian engineering firm, to renovate mining and port infrastructure in Zulia state to the tune of \$400 million. A second \$180 million deal has the Venezuelan government working with Yuankuang and China CAMC to jumpstart nickel mining. In a third agreement, Defense Ministry-owned CAMIMPEG signed a \$580 million deal backed by joint Chinese and Venezuelan investment to provide services in the areas of mining and gas production, reports Venezuelananalysis.com.

The great lithium grab

Speculation of a lithium shortage, led by Tesla which is helping to drive demand for EVs, almost tripled the price of lithium carbonate to over \$20,000 a ton in 10 months. The burgeoning energy storage market for intermittent wind and solar power is also poised to become a major demand driver for lithium.

It is no surprise then that China, where the market for EVs is booming, wants to lock up lithium supply contracts before the price shoots up any further, and to meet the government's ambitious plans to expand EV production.

Last July, among the bidders interested in Potash Corp's 32% position in Chilean major lithium producer SQM, was Chinese private equity firm GSR Capital. A few months later Sinochem, China's state chemical firm, joined the race for the \$4-billion stake. In August GSR bought Nissan's electric vehicle battery business and last fall Chinese carmaker Great Wall Motor signed an agreement with Pilbara Minerals, the Australian lithium miner, to secure supplies for the next five years, the Financial Times reported.

China Molybdenum bought the Tenke copper and cobalt mine in the Democratic Republic of Congo last year for \$2.65 billion in an effort to secure a supply of cobalt for EV batteries. In November Chinese battery maker Contemporary Amperex Technology Co Ltd (CATL) said it is "looking into upstream investments in raw materials, mostly cobalt" to ensure stable supply as demand for electric vehicles (EVs) soars, according to Reuters.

The Chinese are also investing in early-stage lithium plays. In December Bacanora Minerals, which has a lithium project in Mexico, announced that NextView Capital, a Chinese institutional fund manager, has acquired a 19.89% equity interest, in exchange for a lithium battery offtake agreement.

While most North American EV enthusiasts are focused on Tesla and its Nevada gigafactory, experts see the real growth happening in China. According to a report by Bloomberg Intelligence, Chinese gigafactories will pump out 120 gigawatt hours annually worth of electric batteries by 2021, compared to Tesla's 35.

That's enough to supply batteries for around 1.5 million Tesla Model S vehicles or 13.7 million Toyota Prius Plug-in Hybrids per year according to Bloomberg New Energy Finance.

Warming up to South American copper

Electric vehicles use a lot of copper, and China hasn't been shy about orchestrating a major increase in copper imports to meet the expected demand. Geologist and newsletter writer Dave Forest noticed that Chinese imports of copper concentrate from both world-leading copper nation Chile and less prolific red metal producer Peru, have both increased in the past couple of years.

He notes that together, Chile and Peru accounted for 55% of China's total copper concentrate imports of 17.05 million tonnes in 2016. The next-biggest supplier, Mongolia, only shipped 1.50 million tonnes.

Two large Peruvian copper mines are owned by Chinese companies. Chinese state-run Chinalco owns the Toromocha copper mine, while the La Bambas mine is a joint venture between operator MMG (62.5%), a subsidiary of Guoxin International Investment Co. Ltd (22.5%) and CITIC Metal Co. Ltd (15.0%). The Chinese-backed Mirador mine in Ecuador is slated to open in 2018.

Most of the metal produced under these off-take agreements will NEVER come to the market anyplace other than in China. Those metals that do can have their China to U.S. supply shut down any time the Chinese want.

Rise of the petro-yuan

There is one more important development set to increase China's global commodities dominance, and that is the recent announcement that China is shaking up the oil futures market. Because most commodities are traded in USD, the greenback has a huge advantage over other currencies.

China has long wanted to reduce the dominance of the USD in commodities markets, and its strategy is to launch a crude oil futures contract priced in yuan and convertible into gold. Crude oil futures, either Brent or WTI, are currently priced in USD.

The yuan-denominated oil futures will allow exporters like Russia and Iran to avoid US economic sanctions and circumvent the US dollar. Zero hedge quotes Adam Levinson, CEO at Graticule Management Asia, warning Washington that besides allowing Chinese companies to hedge oil prices, the futures contract will also increase the use of the yuan, "and thus the acceleration of de-dollarization and the rise of the petro-yuan. "I don't think there's any doubt we're going to see use of the renminbi in reserves go up substantially," says Levinson.

Conclusion

It's hard to escape the conclusion that China, both through its enormous purchasing power, and its financial muscle that allows it to make substantial investments in mining and energy resources overseas, is assuming a position of world dominance in the commodities markets. Credit must be given to Chinese leadership for forward-thinking in developing its EV industry and for making strategic acquisitions of commodities like copper, manganese, vanadium, lithium and other battery metals that will provide a steady feedstock for the new electrified economy. But scorn must also be heaped on the United States and other countries that have failed to prepare. In the US, public infrastructure is crumbling, the automobile is still king in most states, few cities have decent transit, and many still consider global warming to be a hoax. The situation isn't much better in Canada.

North American politicians really need to get with the program; to invest in and facilitate the mining of critical metals in North America; to scour the globe for mines that can provide the feedstock for the industries of the future, and invest in them; and to block the sale of strategic mineral assets like Mountain Pass to foreign buyers. If none of this is done, we are quickly heading into a two-tier world of haves and have-nots. Where the haves are countries like China that seized the opportunity to acquire the world's finite resources while they were still available, and the have-nots are forced to bow to the victors who will control and set the prices of the spoils.

China's global resource grab, and the ramifications for the rest of the world, are on my radar screen.

Are they on yours?

If not, maybe they should be.

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](http://WallStreetJournal.com), [USA Today](http://USA Today.com), [NationalPost](http://NationalPost.com), [LewRockwell](http://LewRockwell.com), [MontrealGazette](http://MontrealGazette.com), [VancouverSun](http://VancouverSun.com), [CBSnews](http://CBSnews.com), [HuffingtonPost](http://HuffingtonPost.com), [LondonTheNews](http://LondonTheNews.com), [WealthWire](http://WealthWire.com), [CalgaryHerald](http://CalgaryHerald.com), [Forbes](http://Forbes.com), [DallasNews](http://DallasNews.com), [SGTReport](http://SGTReport.com), [VantageWire](http://VantageWire.com), [IndiaTimes](http://IndiaTimes.com), [NineMSN](http://NineMSN.com), [iBtimes](http://iBtimes.com) and the Association of Mining Analysts.

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Material Matters: Zinc, Iron Ore And Oil

A glance through the latest expert views and predictions about commodities. 2018 outlook; zinc; iron ore & steel; coal; aluminium; nickel; oil; and Australian miners.

-Mining and energy commodities expected to peak in current quarter -Zinc market should become more balanced towards end 2018 -Iron ore and steel prices expected to retrace from March -China likely to boost local production of coal -Crude prices expected to head lower over 2018

By Eva Brocklehurst

Commodity prices have continued to rally into 2018 amid a synchronised improvement in the global economy and re-accelerating demand in China, but appear set to retrace as the year gets underway.

Commonwealth Bank analysts observe demand conditions are presenting better than many predicted, in spite of the reduction in industrial activity from the northern winter. This has supported iron ore and coal to a much greater extent than the metals.

The analysts suspect most mining and energy commodities will experience a peak in the current quarter before sliding lower once the Chinese New Year holiday is over in March.

The main upside risk to forecasts, the analysts believe, is another year of aggressive supply-side reform in China, which would affect aluminium, alumina and steel the most. Oil prices are expected to fall as the OPEC-led deal fails to draw down stockpiles to the five-year average.

Deutsche Bank expects global demand to improve, even with a softening Chinese property market. The broker also envisages 2018 as a year in which M&A accelerates in the mining sector. Base metals appear more attractive to the broker versus the bulks.

There appears to be upside risk to demand from China and Southeast Asia in terms of infrastructure and machinery and a weaker US dollar is also expected to be positive for commodities because of upward pressure on marginal costs.

Deutsche Bank retains a preference for aluminium, nickel, zinc and copper miners. The CBA analysts expect most mining and energy commodities will peak this quarter. Supply is expected to respond to higher prices, while demand will slow slightly in China.

Zinc

Zinc prices have retreated on the London Metal Exchange, breaking a month-long run to the upside, and Macquarie, having flagged the current quarter as the peak for zinc prices for some time, assumes demand destruction and new mine supply will confront the structural deficit.

Fresh 10-year highs were hit briefly, at US\$3400/t, accompanied by a steady draining of LME warehouses, although the broker points out that the LME is not the only location for zinc stockpiles globally.

The latest data signal that a large percentage of recent Chinese imports came from Spain, from what the broker suggests is a re-positioning of some of Glencore's Asturianas material to the bonded arena. Hence, a short-term pullback for zinc is seen becoming more likely, before a renewed pick up in Chinese galvanising activity and seasonal demand in March.

Timing is critical, the broker warns, and later in the year an orderly unwinding of fundamentals on either side of the supply/demand equation should ensure the market becomes more balanced.

Glencore appears committed to reintroducing tonnage carefully, while Chinese mine supply has struggled to grow. Macquarie observes many other new entrants have challenges which may result in weak initial output.

On the demand side, galvanising (60% of demand) appears undisturbed by price levels and there are few appropriate substitutes for chemicals (9%), while brass demand (11%) remains more a function of copper prices and fashion.

Iron Ore & Steel

Deutsche Bank's base case in 2018 is for flat steel demand and a modest -1% reduction in seaborne demand for iron ore. Seaborne supply is expected to increase by around 2%, mostly stemming from increases in production from the major miners.

This should increase the market surplus to around 65mt, even with further reductions in Chinese domestic iron ore production. Chinese steel production is expected to increase from March, and both steel and iron ore prices are expected to retrace from current levels.

Deutsche Bank lifts its 2018 benchmark iron ore price forecasts to US\$66/t but reduces lump forecasts to US\$78/t.

The CBA analysts anticipate iron ore prices will ease later on this year amid concerns about a surplus. Chinese iron ore supply, the most expensive in the world because of its low-grade, will be key to this outcome. If prices stay as high as they did in 2017, the analysts suspect China's iron ore output may lift again.

With the seaborne market expected at 30-50mt in 2018, global steel production would need to rise 2-3% to absorb the additional tonnage. This may not be impossible, but the analysts anticipate China's steel demand will slow and weigh on expectations for global steel output to increase this year.

The analysts believe steel margins will dictate the price action for iron ore, once output restrictions for steel are lifted by mid-March. They expect the premium being paid for higher grade ore will ease from current levels but emphasise that the broad preference for higher grade ore is a structural change to the market.

Coal

The CBA analysts expect import demand for coking coal in China to wane, amid a recovery in local production. With spot prices at US\$260/t, the Chinese steel mills are expected to look for cheaper domestic product, and this will incentivise new production. The analysts expect coking coal prices will weaken in 2018 while they upgrade near-term forecasts to reflect the recent surge in prices.

Meanwhile, thermal coal prices have also picked up in response to strong heating demand in China during a cold winter, but should reverse once the weather subsides. Thermal prices are expected to average US\$82/t, above the price level that policy makers are targeting but below spot levels. The analysts suggest the impetus remains strong for China to boost its domestic supply.

Aluminium

CBA analysts find enough evidence to suggest the supply of aluminium is adequate, despite the risk of significant cuts to production. They expect prices will trend lower from current levels as Chinese demand weakens and the market realises there is enough physical aluminium in the market.

Nickel

Downside pressure is seen building on nickel prices in 2018 because of surpluses in the nickel ore and nickel pig iron market. The CBA analysts expect battery demand to be an important driver at some point for nickel but consider it too early for this to affect nickel prices, and the shortage story is likely to be one for the next decade.

Australian miners

Deutsche Bank considers the Australian mining sector fairly valued, given its commodity prices outlook, but attractive on a enterprise value/EBITDA and free cash flow yield basis versus historical averages. The broker is positive for both Rio Tinto ((RIO)) and BHP Billiton ((BHP)), citing improving shareholder and group returns along with production growth.

For base and precious metals the broker flags Sandfire Resources ((SFR)), OceanaGold ((OGC)), Alacer Gold ((AQG)) and Dacian Gold ((DCN)). Deutsche Bank has a Sell rating for Newcrest Mining ((NCM)), Northern Star ((NST)), Regis Resources ((RRL)), Independence Group ((IGO)) and Western Areas ((WSA)).

OceanaGold is upgraded to Buy while St Barbara ((SBM)) and Independence Group are downgraded to Hold and to Sell respectively, on valuation.

Oil

The CBA analysts upgrade crude forecasts to reflect the sharp rise in prices, as Brent recently touched a three-year high of US\$70/bbl. Nevertheless, they believe prices are likely to head south from here.

Compliance among OPEC and allied countries in terms of production cuts may falter at current prices. Moreover, despite the US shale sector promising to focus on returns and developing assets, the availability of capital and rising

prices could mean production grows strongly. The analysts suggest US supply may surprise on the upside if prices remain near spot levels.

The main bullish risk for oil prices this year are geopolitical tensions. A dispute between the Iraqi Kurds and the local government has already sidelined some oil. Friction between Iran and Saudi Arabia and growing anti-Iran sentiment in the West are also issues. Re-instating sanctions on Iran would put at risk nearly 4% of global oil supply.

The analysts suggest the only hope for oil prices to rally further is demand growth but remain sceptical as to whether this will save the market from a surplus by the year's end.

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Analysts Predict More Resilient Oil Sector In 2018

As oil prices show resilience above US\$60/bbl several brokers are confident that 2018 will be a more positive year for the energy sector.

-Asian LNG demand to be a key feature of 2018 -Production growth should lead to a more balanced market in 2019/20 -Investors now appear more willing to pay for risk

By Eva Brocklehurst

Deutsche Bank enters 2018 constructive about the potential for the oil sector. The broker's positive tone reflects a view that, after three challenging years, major oil and gas companies have re-positioned businesses to work in a US\$50/bbl environment and the cash flow from projects will start to accelerate.

The broker expects Asian LNG demand to be a feature of 2018. The improved outlook emerging in the Pacific Basin is, in part, driven by seasonal factors but also reflects wider structural changes, particularly in China.

Deutsche Bank believes this will be a transition year for LNG, moving to a seller's market from a buyer's market and potentially bringing forward from 2023-24 the commonly-accepted inflection point where demand overtakes supply.

Sector analysts at Extreme Petroleum Technology are not so enthusiastic and suggest Saudi Arabia is draining US crude inventory to manipulate the higher price of oil and the market should not get too comfortable with West Texas Intermediate in the mid US\$60 price range.

When OPEC meets in June production cuts are likely to end and another downturn in prices ensue as the market re-establishes stability. Demand may be trending higher but so is US shale production, and the analysts at Extreme Petroleum Technology suggests these trends should be watched carefully.

Morgan Stanley, on the other hand, suggests the oil market is likely to be undersupplied in 2018 and prices should remain resilient this year. The broker asserts that financial flows matter and the return prospects from oil futures are sharply improved with a market in backwardation.

Brent, WTI and Dubai futures all moved into backwardation late last year (further out futures are higher priced) and this curve has become steeper subsequently. Backwardation is likely to remain intact in the Brent and WTI curves and this, Morgan Stanley believes, will attract capital into oil futures and drive the price higher.

While oil prices have rallied beyond levels required for long-term supply/demand matching, and a correction is certainly possible at some point, Morgan Stanley believes prices will be higher towards the end of the year than they are today. The broker raises its Brent oil price forecast for the September quarter to US\$75/bbl.

Oil prices in line with forecasts should drive an acceleration of production growth, particular from US shale, and this should lead to a more balanced market in 2019/20. The broker expects oil prices in those years in line with long run marginal costs, at around US\$65/bbl.

As oil prices have recovered much faster than most analysts expected, UBS anticipates significant improvements to broker price targets and estimates for earnings per share. OPEC is expected to be successful in bringing oil inventories back to 5-year averages this year, although a re-balanced inventory will make oil more susceptible to geopolitical effects.

In the longer term the broker believes the Brent oil price will return to US\$70/bbl, a level required to incentivise sufficient new supply. UBS has a 2018 Brent forecast of US\$60/bbl, if Middle East concerns abate and US shale activity accelerates. LNG demand growth will continue to surprise to the upside but the broker suggests new supply in 2018 could dampen spot pricing.

Australian Energy Stocks

Despite the strong rally in oil, UBS expects the increase in revenue for Australian major stocks will be more muted because of lower contracted LNG prices, given the three-month lagged Japanese customs-cleared oil price in the December quarter fell -7.0% versus the preceding quarter.

A strong rally in spot LNG prices in the December quarter will only partly offset the impact of lower oil-linked contract prices. The broker believes Beach Energy ((BPT)), unlike the other majors, is the best positioned from the

rally in oil as it is not exposed to contracted LNG prices.

Macquarie envisages the sector will rally hard from strong oil and LNG prices and investors are now willing to pay for what they have avoided since the oil price slumped in 2014 - risk. In the broker's coverage, the biggest beneficiary should be Oil Search ((OSH)), with 20% spot cargoes that typically receive a premium to reported spot prices.

The broker suspects companies will attempt to maximise volumes early in 2018 as many operations have major outages that are scheduled. Santos ((STO)) is expected to try lift Fairview volumes after a disappointing finish to 2017.

Woodside ((WPL)) is expected to minimise T2 start up maintenance at Wheatstone and avoid unplanned outages after a lacklustre 2017. The broker suggests Woodside has rallied into territory that could set it up for disappointment.

Senex Energy ((SXY)) remains a preference in the mid to small caps space, with the full field development of the WSG project expected this year.

Macquarie is also more positive on Sino Gas & Energy ((SEH)) but, with Chinese gas prices expected to fall after the winter, remains cautious about buying the stock ahead of the quarterly result, because the company has been bought as a China gas proxy.

Citi credits Oil Search as the only major energy stock which screens positively regarding capital discipline, believing Santos, Beach Energy and Origin Energy ((ORG)) have all destroyed value in various ways, although resulting changes in management provide hope for better discipline going forward.

Oil Search has done best through exploration over the last six years, appearing to break even after Muruk, which shows how one good well can move results to feast from famine.

The broker asserts Woodside, which singled out exploration as a key strategy for growth, has destroyed value through exploration over the last six years. The company has done well historically as a top tier operator and Citi suggests money should be returned to shareholders in the absence of exploration growth.

Citi removes "exploration upside" value from its target prices, reducing these by around -5-15% across the sector.

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Uranium Week: In Limbo

-Kazatomprom uncertainty dominates spot uranium market activity -Overall trading volumes thin -Analysts maintain uranium prices remain too low

By Rudi Filapek-Vandyck

The global uranium market remains in limbo with market participants trying to figure out what exactly are the plans at Kazatomprom regarding an announced -20% cut in uranium production for the next three years, and what will be the consequences worldwide?

Kazatomprom is the national operator of Kazakhstan for import and export of uranium, rare and rare-earth metals, and nuclear fuel components for power plants. Kazakhstan is the world's largest source of uranium, roughly supplying twice as much as Canada and 4.5 times as much as Australia per annum.

On 4 December last year, the Kazakh producer announced it will reduce production by -20% for the next three years. Common perception suggested this meant -20% less from 2017 output, but the company later clarified the reduction will be from previous "projections". Nobody outside Kazakhstan knows what these prior projections were.

Industry consultant TradeTech reports such confusion is keeping potential buyers on the sidelines. The direct result, as one would expect, has been sluggish volumes in spot market activity as the calendar switched 2017 for 2018.

Tepid Volumes Into 2018

For the week ending Friday, January 12th, TradeTech registered a total of five transactions involving less than 500,000 pounds U3O8. Buyers included utilities and traders, with traders acting as sellers. According to the consultant, sellers are convinced market fundamentals are strong and the Kazakh reduction will further strengthen fundamentals, irrespective of exact details.

Analysts have been suggesting for a while that uranium prices are simply too low and, in order to keep a well-supplied market longer term, the price must move substantially higher.

For the week, TradeTech's weekly spot price indicator fell by -10c to US\$23.65 per pound U3O8. Last time we updated in mid-December, the reference price was US\$0.95 higher at US\$24.60. On January 5th, the corresponding price stood at US\$23.75. In early December, the spot price reached as "high" as US\$26.50. Back in 2006 it peaked at US\$236-238 per pound.

Since the Fukushima disaster in 2011 the price of uranium has fallen by -65%.

In the term uranium market, TradeTech reports one non-US utility is now evaluating offers received on December 28, in response to a request seeking offers for approximately 1m pounds U3O8 per year for two, five-year periods beginning in 2020 and extending through 2029.

TradeTech's mid-term U3O8 price indicator sits at US\$28/lb, unchanged from December 31st, while the long-term price indicator sits at US\$31/lb, also unchanged from late December.

Note the latest price changes are not reflected in the chart below.

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The Wrap: Health, Banks & Salary Packaging

Weekly Broker Wrap: Private health insurance; housing; banking; online; and salary packaging

-Pressure on private health insurer margins likely to grow -High levels of new dwelling completions expected to weigh on prices -Lack of leverage to growth but banks still benefiting from favourable margin trends -Rise of online takeaway food aggregators pressure urban shopping centres -Valuation discount still required to capture the risk for salary packaging operators

By Eva Brocklehurst

Private Health Insurance

Ord Minnett suggests the tougher approach from the government on insurer price rises may lead to margin pressures in FY19 and nib Holdings ((NHF)) may suffer less than Medibank Private ((MPL)). Approaching an election year, the broker expects there will be pressure to achieve increases below 4%.

Both companies experienced margin expansion in FY17, with inflation running behind premiums. This gap is likely to disappear, or even reverse in FY18, as below-industry increases from April 2017 for both listed companies are reflected in FY18 results, while both insurers have some cost reduction programs that could partially offset this.

Macquarie's analysis suggests claims growth is tracking below historical levels. The broker expects a weighted average premium increase of 3.85% for Medibank Private and 3.80% for nib versus a sector increase of around 4%.

The broker expects the industry to receive ongoing support from government policy to ensure that sufficient young people retain private health insurance and support sustainability. The expectation for continued below-trend claims growth supports the broker's estimates for a Medibank Private margin for FY18 of 8% and nib of 6.1%.

Premium rate increases signal as much about claims volatility as the direction of profits, in the broker's opinion, and a narrowing of premium rate variation supports the view that claims volatility is reducing for the sector.

Housing

Recent data signal that house prices in Sydney as well as at the national level have already stopped falling. Macquarie suggests it very likely that prices at the national level are now again rising modestly.

As always, there are large differences between locations and the type of housing. The broker does not expect a repeat of the bounce that occurred in 2016, as that year witnessed 50 basis points of reductions to the official cash rate, while this year there is likely to be speculation regarding the timing of eventual rate rises.

Banks have also become more discriminatory in terms of their lending. The broker believes rising interest rates will eventually be a major stumbling block for housing prices and periods of broad-based falls in dwelling prices are much more likely in the medium term.

UBS observes the size of the retraction in housing activity and price growth, particularly dwelling commencements, is less than previously expected. This suggests that the full impact of macro prudential tightening is having more of a negative impact on lending and prices for established housing than for new housing. The broker agrees the historical trigger for a sharp reduction in housing activity are increases in official rates.

As UBS expects the Reserve Bank to maintain steady rates until 2019. Amid the expected rebound in approvals, forecasts for dwelling commencements are upgraded to 200,000 in 2018 and 185,000 in 2019. Nevertheless, with activity concentrated in high-rise developments, GDP-basis dwelling investment is still expected to fall. The broker calculates that, even under its base case, the high ongoing level of completions/supply in coming years should weigh on prices.

Banking

The banks will have a challenging outlook as the housing market slows, UBS adds. Net interest margins will come under pressure from competition as well as from switching. Moreover, the impending Royal Commission is an area of material uncertainty while mortgage mis-selling and responsible lending risks are a growing concern. The broker expects Australian banks to continue to lag peers given the regulatory risks and lack of leverage to global rates and growth.

While the underlying earnings growth profile is subdued, Macquarie expects the banks to return capital to shareholders via special dividends and buybacks. The bank sector is now trading at around a -30% discount to the industrials and the broker envisages relative value at current levels.

Macquarie upgrades Westpac ((WBC)) to Outperform and elevates the stock to its preferred exposure. Growth will be constrained by the highly leveraged household sector while margin will be affected by competition, the broker acknowledges. Yet, on a short-term view there is relative value as banks continue to benefit from favourable margin trends and benign credit conditions. Macquarie also envisages scope for banks to reduce expenses.

Online

Citi has a cautious outlook for the online media sector, concerns over rising costs and the potential for the reversal of volume growth trends. The sector is also trading near-record price/earnings multiples. The broker downgrades forecasts for earnings per share for Domain ((DHG)) and REA Group ((REA)), pushing back listings growth assumptions, and factoring in higher costs growth for Domain.

Estimates for Carsales.com ((CAR)) have been upgraded on expectations of stronger growth from Korea. The broker's only Buy rating in the sector is Trade Me ((TME)). Seek ((SEK)), after benefiting from four years of strong cyclical volume growth, is expected to slow.

Online takeaway food aggregators are growing rapidly in Australia, providing convenience and choice. Morgan Stanley examines the economics for aggregators, restaurants, consumers and drivers and concludes that efficient integrated operators such as Domino's Pizza ((DMP)) will remain relevant.

Australia is a relatively underdeveloped market for online delivery, with penetration at 10% versus the UK at 34%. The market remains fragmented, unlike other industries such as online classifieds which tend to be dominated by one major player. The broker's analysis of the economics shows restaurants need more than 50% of sales to be incremental or they suffer lower profits after signing up with an aggregator.

The economics of online aggregators and delivery suggests there is pressure on shopping centres in dense urban areas. These typically have a lower scope to host delivery services, being multi storey, site-constrained assets. In contrast, more convenience-based assets in remote areas are less exposed to the threats. In this way Stockland ((SGP)) may be benefiting via its food "pad" sites located outside of its malls. The broker notes Scentre Group ((SCG)) is not as defensive in this regard.

Salary Packaging

McMillan Shakespeare ((MMS)) and Smartgroup ((SIQ)) were supported in 2017 by a strong operating environment and Credit Suisse notes the stocks were up 60% and 86% respectively for the year. Hence, the broker wonders whether enough risk has been priced in. While acknowledging it may have been too quick to downgrade long-standing Outperform ratings, valuations are still recognised to be at a level where it is appropriate to ask the question.

Credit Suisse accepts traditional regulatory risk remains low and the political appetite for change is weak. Nevertheless, the broker points out there is a difference between no risk and low risk. These companies have a monoline dependency on one part of the tax code and carry inherent risk. In the broker's opinion a valuation discount is needed to capture this risk.

There is a chance the high profitability which these two enjoy attracts attention, either from a regulator or from an employer seeking greater benefits for employees. The broker asks whether novated leasing, being extremely profitable, is perhaps overly so, given it relies on tax legislation. While expecting a positive outlook the broker believes valuations are fair and retains Neutral ratings on both stocks.

McMillan Shakespeare offers slightly better valuation support whilst Smartgroup has greater scope for upgrade.

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Treasure Chest: Time to Sell Fortescue?

RBC Capital Markets suspects Fortescue Metals will find it hard to achieve a broad uplift in iron ore grades and cost savings will also be difficult to obtain.

-Widening discount for low-grade iron ore a critical issue -FY21 before a meaningful uplift in product grade can be maintained? -Robust Chinese growth and supply-side reform should be supportive

By Eva Brocklehurst

Fortescue Metals ((FMG)) has made progress in reducing its costs and debt, but should investors be wary of the impact of iron ore price realisation on cash flow and earnings? The company has provided consistent production and cost management from its iron ore assets in Western Australia's Pilbara but now RBC Capital Markets believes further cost savings will be more difficult to achieve. This view stems from increasing strip ratios and the need for sustaining capital expenditure across the asset base.

Also, the market has witnessed a widening discount for low-grade iron ore, which Fortescue markets, and this has become a critical issue for the company, RBC declares, estimating a -1% decline in price realisation would require a further -5% in cost savings.

The analysts also warn investors not to use the Platts 62% index as a proxy for the stock, noting increases to this benchmark index are not necessarily reflected in the prices that Fortescue receives for its product. This observation is based on the shift in demand towards higher quality products.

The company has signalled it would like the majority of its iron ore product to be greater than 60% iron and whatever project replaces Firetail should provide the majority of an uplift in grade. The analysts suggest achieving this will be difficult, given a mineral resource of 875mt at 58.8% iron. Either an increase in cut-off grade is required or additional upgrading.

The analysts believe that, given the early nature of the preferred option at Eliwana, it may be after FY21 before a meaningful uplift in product grade can be maintained.

The company is also diversifying its product base and exploring for copper and gold opportunities. Again, the analysts suggest such a move may require M&A and an expansion of the exploration budget, as well as adding complexity to a simple investment proposition. RBC warns this portfolio expansion may lead to a de-rating of the stock and considers the balance of risks weighted to the downside, downgrading its investment rating to Underperform.

RBC Capital Markets, not one of the eight stockbrokers monitored daily on the FNArena database, has a revised price target of \$4.25. CLSA, also not one of the eight, is on the same page and advises selling iron ore exposure on an expected pullback in the market.

The broker considers Fortescue Metals the obvious way to play the theme. CLSA remains constructive regarding steel prices in China but finds it hard from a trading perspective to envisage how iron ore prices can hold up in the near term.

Several other brokers are more positive, maintaining or upgrading to Buy in the last few weeks. UBS upgraded to Buy from Neutral in December as part of a broader update on its commodities outlook for 2018. The broker remains attracted to the elevated price levels in iron ore and finds value in the stock amid prospects of surplus cash being generated.

Citi also believes that better-than-expected Chinese growth and supply-side reforms provide the support for bulk commodities, upgrading Fortescue to Buy from Neutral last month. Macquarie, in maintaining an Outperform rating, suggests, even if softer demand emerges this year, unlike the previous downturn in 2011, the supply-side response, generally, is likely to be more subdued.

The broker acknowledges low-grade discounting continues to affect Fortescue but believes its price target of \$6.00 factors in a realised price of US\$50/t that is broadly in line with the average for the September quarter. Macquarie remains positive on the pure-play iron ore stocks. Deutsche Bank, with a Hold rating, prefers base metal commodities to the bulks.

There are five Buy ratings on FNArena's database, two Hold and one Sell (Morgan Stanley). The consensus target is \$5.50, suggesting 3.7% upside to the last share price. The dividend yield on FY18 and FY19 forecasts is 6.1% and 5.4% respectively.

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