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INTERNATIONAL

China's Trade With US: Down But Not Broken

While further trade decoupling between China and US/rest-of-world would hurt China the most, there's no corporate or political appetite for the costs or disruption associated with severing trade with the world's second largest economy.

-Asia/ROW key beneficiaries of further trade decoupling with China
-US imports from China remain around a fifth below pre-2019 trend projections
-China has most to lose if trade with US/ROW decouples further

By Mark Story

In light of recent speculation of a new cold war between China and the US and its allies, Oxford Economics has explored situations that could potentially lead to deeper economic decoupling between today's two global superpowers.

There is no shortage of evidence to suggest the US-China trade war has had a major negative impact on bilateral trade.

Fuelling further speculation that China-US trade was decoupling were US tariffs on imposed China in 2018 that led to both trade diversion and import substitution. What's noteworthy here, adds Oxford Economics, is import substitution in sectors like electronics, where it was initially thought such switching of suppliers might be difficult.

Declining trade was restored somewhat by the Economic and Trade Agreement reached between the two sides in late 2019 (known as phase one) and by the coronavirus crisis, which has boosted US imports from China.

However, despite this improvement Oxford notes the losses remain substantial, with US imports from China around -20% down on where they might have been based on the 2009-2018 trend.

<u>Two scenarios point to major trade structure shifts</u>

To pressure-test the notion that the declining China/US trade trend could escalate continued decoupling between China and the US, Oxford Economics developed two scenarios.

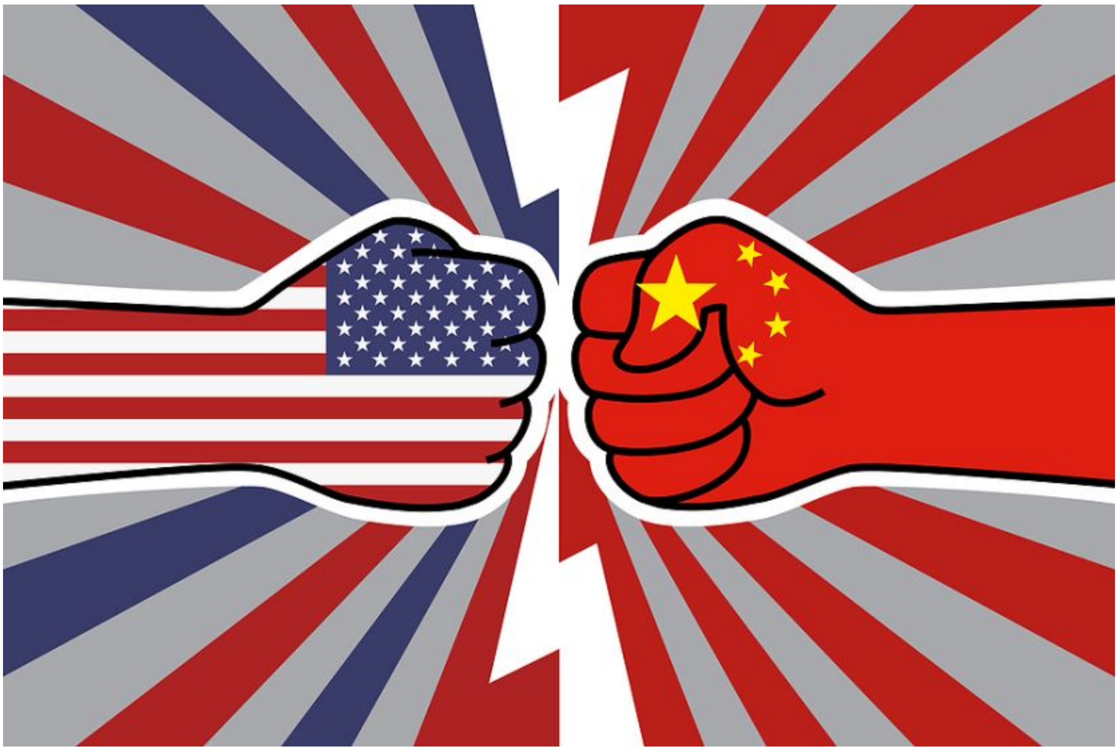
Firstly, there's a 'US-centric' scenario, in which existing trade and geopolitical tensions worsen. This would lead to a further sharp rise in trade barriers against China on the part of the US and a lesser rise involving other US allies.

Within this scenario, trade barriers are raised on around 11% of China's imports and 25% of its exports.

Then there's a broader decoupling scenario in which the economies of US-Canada-Mexico, Japan, South Korea, Taiwan, and Europe all raise trade barriers against China dramatically in an attempt to cut China off economically. Within this scenario, trade barriers increase on around 55% of China's imports and 63% of its exports.

In summary, Oxford Economics' analysis suggests US-China trade decoupling would lead to major shifts in trade patterns. On the US side, in both scenarios China's share in US imports falls from 16% to 4%-5%, with gains spread among the other regions.

The forecaster found that both scenarios point to major shifts in US and Chinese trade structures.



China the bigger casualty

The forecaster's analysis also reveals that US-China trade decoupling would have a significantly greater impact on China's GDP than on the US.

In the US-centric decoupling scenario China's GDP falls by just under -1% in the long run, and in the broader decoupling scenario by around -2.5%. However, Oxford Economics assumes short-run losses would likely be considerably bigger, at up to -2% and -5% respectively.

In both scenarios, trade barriers rise on around 16% of US imports and 7% of exports, which to the forecaster also suggests bigger economic impacts on China than in the US, and more so in scenario two.

While China's total exports fall -7% in the US-centric scenario, within the broader scenario they fall by as much as -22%. By comparison, in both scenarios the share of China's exports going to the US drops from 20% to 7%-8%.

Overall, the net effect of the forecaster's scenarios reveals that higher trade barriers would cut trade between China and key trading partners. This would lead to trade diversion to other Asian economies and the rest of the world.

US total exports fall by -3%-4% in both scenarios. Elsewhere the forecaster notes the North East Asian group - Japan, Korea, and Taiwan - sees the biggest falls in total exports, mostly due to lost intermediate exports to China.

In the US-centric scenario the share going to other Asian and rest-of-world destinations rises from 37% to over 50% and in the broader decoupling scenario to 70%.

Broader decoupling: Neither proof nor desire

While the economic impacts from deeper trade decoupling of China and the advanced economies would be substantial, Oxford Economics found no proof of a broader decoupling process involving China's other major trade partners.

Given that many US firms are keen on such engagement, and with governments of most advanced economies -the biggest allies of the US- equally reluctant to curtail economic engagement with China, the forecaster's analysis concludes the **likelihood of a broad decoupling scenario is low**.

While some commentators have linked decoupling to a 'new cold war', the forecaster thinks this analogy is inappropriate, especially given China is far greater integrated into the world economy than the USSR was in the 1950s.

This makes large-scale decoupling much more expensive, which Oxford Economics concludes greatly reduces its likelihood.

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INTERNATIONAL

Investment Strategies For Inflation and Tapering

As equity markets continue to rise, investment managers scan the world for opportunity with an eye on inflation and the commencement of tapering by the US Federal Reserve.

-Front-loaded US fiscal policy may drag on second half growth
-Fund managers offer preferences by sector and style
-The shift towards ESG strategies looks structural
-Citi expects the ASX200 to reach 7,700 by mid-2022
-Preferred Australian stocks

By Mark Woodruff

The reopening trade can be dated from the first week of November 2020, when the first successful covid-19 vaccine was announced. Since then, the best performing asset classes have been small-cap and non-US equities, global real estate investment trusts and commodities, while the Value style of investing has outperformed.

More recently, US equity markets have continued to rally with the S&P500 rising 0.5% in May and 2.2% in June.

In June, that strength was driven primarily by a strong move in the stocks making up the latest acronym, namely FAAMG (Facebook, Apple, Amazon, Microsoft and Google). These stocks account for over 20% of the S&P500's market capitalisation.

Other markets have fared less well, as the strength/momentum of the uptrend in global equity markets has diminished. For example, Chinese equities are largely unchanged since the start of 2021, German equities have continued to edge modestly higher, while Japanese and Korean equity markets have been trending lower since February this year.

In Australia, the stock market is currently around 4.8% above its pre-covid peak, lagging behind other global markets with the MSCI AC World index 28.5% above the peak.

Globally, many assets have increased more than normal in the acceleration phase of the economic cycle. Cyclicals and growth stocks are 46% and 26% above their ten-year trend, respectively, which suggests they are vulnerable to negative surprises.

Where to from here? Naturally, the topic du jour remains the likely timing and magnitude of interest rate rises across the globe.

In the US, speculation continues as to when the Federal Reserve will start to taper the asset purchasing program. Some fund managers believe the situation is in hand, and trust the Fed is cognisant of how tapering impacted markets in 2013, and will proceed in such a way this time so as to avoid too much turbulence.

While risk assets could become volatile temporarily on the announcement of tapering, it's thought this may not have a long-lasting impact.

Of course this looks easy in print, but at the time markets will have to assess the Fed's average inflation-targeting framework, which by design looks past initial price increases.

Back in Australia, the Reserve Bank recently reiterated its commitment to "highly supportive monetary conditions" and suggests the target cash rate is unlikely to increase from its current level of 0.10% until 2024 at the earliest.

Before looking at how portfolio managers worldwide are adjusting their asset class exposures, let's first examine the dynamics of this current cycle and how that may affect expectations for growth and inflation.

Dynamics of the current cycle

The current cycle has been driven by pandemic effects and explains why the manufacturing recovery was underestimated, explains Dankse Bank. As consumers could not buy services, they bought a lot more goods.

However, the easing of the pandemic leaves a lot of uncertainty about what will drive the economy. As the market underestimated the increase in goods consumption, there is a risk the market will also underestimate the reversal and see a bigger decline in goods demand than expected.

Such reversals are currently evident in the US housing market, where pandemic effects have previously dominated. There is now a sharp cooling in activity, despite rising consumer confidence and a strengthening jobs market.

Going forward, a driver for overall growth may be the higher-than-normal savings, along with the reduction in consumer debt during the pandemic.

Additionally, stronger services should underpin overall growth, as the sector has been lagging with lots of pent-up demand. Normally the manufacturing and service sectors move in accord, explains Danske B, but this time there has been quite a big divergence.

However, fiscal policy has been front-loaded in the US, which will turn into a drag on growth in the second half as the temporary income spike from stimulus cheques and enhanced benefits fades.

Inflation and tapering

After upgrades to all major regions over the last few months, Citi economists expect global real GDP to grow by an impressive 6% in 2021 and 4.2% in 2022, following the -3.5% contraction in 2020.

Rising energy prices in 2021 are expected to keep headline inflation running well above 2% in many economies, but should unwind into 2022.

However, a couple of factors will help put a lid on inflation expectations going forward, according to Dankse Bank. Firstly, we are approaching the peak in the economic cycle, which has historically mostly led to lower inflation expectations. Secondly, this peak now coincides with an expected decline in headline inflation in both the US and Germany over the next year. Finally, a more hawkish Fed during the second half should help anchor inflation expectations.

On the flipside, an upside risk is that US wage growth moves up more than expected due to labour shortages, and that the Fed falls behind the curve. However, while a tapering of bond purchases should contribute to higher yields, Dankse Bank does not expect a new "taper tantrum".

Morgan Stanley also believes the rate of change in terms of year-on-year inflation is peaking. While inflation should remain above the Fed's 2% personal consumption expenditure (PCE) target in the next two years, it should normalise from current levels.

Inflation in Europe and Japan is less pronounced, and will undershoot targets for longer, suggesting to the investment bank that any tightening from the European Central Bank and Bank of Japan will be well behind the Fed.

Sectors and styles

Dankse Bank believes we will face 'twin peaks' in both inflation and the manufacturing cycle over the coming quarters. This has important implications for performance across assets and within asset classes.

The bank believes this will occur when we move from the current acceleration phase of the business cycle (easy liquidity and lagging job gains, leading to muted wage pressure) to a more mature late cycle phase (central banks start a path of withdrawing liquidity, job markets gain strength and wage pressure builds).

In this latter phase, corporates also face lower growth in revenue. Nonetheless, equities should continue to rise after the peak, assures Danske.

More interestingly, it will likely be a matter of tilting the equity exposure to benefit from the (average) shift in markets, as borne out by a historical analysis performed by the bank. That is, the curve flattens and commodities pause or outright decline. Inflation expectations then co-move with commodities, the US dollar strengthens and liquidity tightens.

Largely, such cross asset moves would be consistent with a tilt to Quality and Technology in styles and sectors. The Value factor would probably underperform jointly with the commodity space.

Russell Investments, on the other hand, still likes the pandemic-recovery trade that favours equities over bonds, Value over the Growth and non-US over US stocks.

The investment advisor believes the inflation spike is mostly transitory, a combination of base effect (from when the Consumer Price Index fell during the initial lockdown last year), and temporary supply bottlenecks. It's thought it will take until the middle of 2022 for the US economy to recover the lost output from the lockdowns and longer in other economies. Broad-based inflation pressures are unlikely until then.

Alternatively, Citi strategists think the recent pull-back in bond yields will prove temporary and they still expect the ten-year US Treasury yield to hit 2.0% into 2022, as the economic recovery gathers momentum and markets contemplate Fed tightening.

Rising yields are usually accompanied by cyclical sector outperformance, especially Financials. Technology-related stocks are also expected to hold their own if real yields stay low.

Finally, Morgan Stanley recommends investors begin to blend Value with Quality, particularly in the US and Europe, as this blended approach tends to outperform in the mid-cycle phase.

In particular, there's a preference for Quality stocks with relatively more stable earnings along with reasonably priced Growth stocks. These both offer dependable performance in mid-cycle transitions.

In this regard, the investment bank prefers international (and Australian) healthcare stocks as opposed to technology stocks for which valuations remain rich.

Timing of tapering

Morgan Stanley expects the Fed to wait until the September FOMC meeting to signal its intention to taper asset purchases, whilst formally announcing tapering in March 2022.

The investment bank forecasts tapering to then start from April 2022 and rate hikes are likely to begin in the third quarter of 2023. This will occur after the inflation rate has been sustained at or above 2% for some time and the labour market has reached maximum employment. These moves to normalise policy are expected to come at a later stage in the recovery compared to previous cycles.

As long as the Fed retains balance sheet expansion, technical corrections in the market (not related to a downgrade in the macro outlook) will likely be bought as investors believe the "Fed put option" remains. This term encapsulates the widespread belief that the Fed will always rescue the economy and financial markets.

Morgan Stanley believes the Fed is very cognisant of how tapering impacted markets in 2013, and will do so in such a way as to avoid too much turbulence. Risk assets could become volatile temporarily on the announcement of tapering, but it's not seen as having a long-lasting impact. The Fed is only expected to proceed once inflation and growth have sufficient momentum to allow a change in policy.

Citi expects an announcement this September of -$15bn/month worth of tapering (from US$120bn/m), to start in December this year, five months earlier than the April date envisaged by Morgan Stanley. The first US rate hike is expected by Citi in December 2022.

Overshoot?

While Morgan Stanley's base case remains a moderate overshoot of inflation, their economists see a very real risk that inflation could enter the acceleration phase, (i.e. threaten to breach 2.5%, the Fed's implicit tolerance threshold, from the second half of 2022).

This would likely be driven by higher wage costs. This could play out either from a faster-than-expected job market improvement or uncertainty around the natural rate of unemployment. It's conceivable that the natural rate of unemployment has risen and sits higher than commonly perceived.

A shorter timeline of the current labour market recovery may not give workers enough time to be re-skilled and reallocated across industries. This is especially the case if the structural shifts in the labour market persist due to the pandemic. This would mean that a lower decline in unemployment would be needed to start generating noticeable wage inflation.

Global Equities

The combination of a neutral short-term/positive long-term view leads Morgan Stanley to continue to recommend a mild overweight to risk assets. The style preference shifts somewhat towards Quality as the cycle matures but a preference remains for Value over Growth, and overweight sectors and countries most levered to reflation on a longer-term view.

Earnings growth is expected to continue, but at a much slower pace. Valuations will also remain elevated, particularly in the US. However, risk premiums (the amount by which the return of a risky asset is expected to outperform the known return on a risk-free asset) remains relatively appealing. This is even more so now that the investment bank expects a limited rise in bond yields moving forward and cash rates are expected to remain steady for a sustained period.

Morgan Stanley considers tapering in US monetary policy as the key trigger for a correction in the short term, particularly given current elevated valuations and artificially low bond yields.

Nevertheless, with substantial cash sitting on the sidelines and a positive macro outlook, it's believed this could potentially create a good opportunity for investors to add to equities in the medium to longer term.

Russell Investments believes global equities remain expensive, with the very expensive US market offsetting better value elsewhere. While sentiment is close to overbought, it is not near dangerous levels of euphoria. The strong cycle delivers a preference for equities over bonds for at least the next 12 months, despite expensive valuations.

Financial stocks are the largest sector in the MSCI World Value Index, and these should benefit from further yield-curve steepening, which boosts the profitability of banks. Russell expects long-term interest rates will have modest upside over the next few months as global growth continues to improve.

In terms of regions, Morgan Stanley believes the US market will likely lag in the second half of the year. The 'strong winds' of the economic recovery will create risks to margins, tax policy and high valuations.

Europe and Japan are expected to perform better, with still-strong earnings growth, less extreme valuations and less risk associated with a "hotter economy".

Emerging Markets

Emerging markets (EM) equities sit somewhere in the middle of Morgan Stanley's scenarios for the US (earnings growth, but at a slower pace) and Europe and Japan (still-strong earnings growth with less extreme valuations than the US).

EM equities have been laggards so far this year and Russell Investments believes they have been held back by the high weighting toward technology stocks in the emerging markets benchmark.

Additionally, there have been concerns about slowing credit growth in China and the slow rollout of covid-19 vaccines across some regions has contributed. It's believed this should start to reverse later in the year as Chinese credit growth stabilises and vaccines become more available across emerging markets.

Citi suggests the shift towards ESG strategies is structural, and this favours Growth over Value and Europe over EM equities.

ESG inputs are becoming increasingly important for equity fund managers. Flows into ESG-focused funds are increasing and right now it is the most important theme for European equities, and becoming more important elsewhere.

Australian economy and the sharemarket

Morningstar notes the Australian economy continues to exhibit solid growth, and there are now more people employed than before the covid-19 outbreak. The slow vaccine rollout is expected to ramp up, and early signs of this are more evident following the recent lockdowns.

The RBA has maintained its accommodative stance and the investment management firm believes it will continue the quantitative easing program until the Fed begins to taper. Hence, a rise in the cash rate is still considered some way away.

The Australian economic recovery is reflected in the rapidly improving unemployment rate. It fell to 5.1% in May, its lowest level since December 2019. This is despite the federal government's JobKeeper scheme ending in March. Unemployment is already below the Federal Budget forecasts, released in May, which envisaged an unemployment rate of 5.5% for the June 2021 quarter.

The equity market as a whole currently looks overvalued, according to Morningstar, and investors should be particularly selective when investing new capital. Nonetheless, Morningstar makes several sector and individual stock suggestions (below).

Australian equities also look fairly expensive to Citi though the ASX200 is expected to reach 7,700 by mid-2022, 4.6% above current levels.

Economists at the investment bank have upgraded their GDP growth forecasts for Australia by 1.3 percentage points (ppt) to 5.6% in 2021 and by 0.7ppt to 3.2% in 2022. The upgrades reflect strong growth in domestic demand, which has offset weaker net-exports.

With less than 6% of the population fully vaccinated, Australia lags other advanced economies and remains vulnerable to future outbreaks. Notwithstanding these risks, fundamental factors are considered supportive of continued domestic growth, particularly from household and housing-exposed sectors. The investment bank also likes the Resources sector, which should be supported by commodity prices remaining higher.

With limited upside for the ASX200, Morgan Stanley feels there is more value in rotation. Similar to international equities, this means retaining leverage to mid-cycle expansion whilst embracing Quality as a hedge to later cycle risks that attach to rising inflation and higher yields.

Australian sectors and stocks

Longer-term, as the cash rate increases, Morningstar expects the banks to reprice loan books and generate attractive returns on equity. Westpac ((WBC)) is the only major bank still estimated to be trading below fair value. While the earnings outlook is more volatile, general insurers such as Suncorp Group ((SUN)) and Insurance Australia Group ((IAG)) still appear undervalued despite being strong performers in the June quarter. Magellan Financial Group ((MFG)) and Challenger ((CGF)) also are considered to look attractive at current prices.

Pure-play BNPL firms will cede share as the banks fight back. Most could see slimmer margins and higher bad debts in time, having to boost marketing, loosen lending standards, and trim fees. Consensus is ignoring their capital intensity and cost demands, which will likely result in a de-rating if these hefty expectations aren't met, explains Morningstar.

Chemical firms, including Incitec Pivot ((IPL)), Nufarm ((NUF)) and Orica ((ORI)) are considered -21% undervalued on average. For Orica and Incitec Pivot, global mining volumes are expected to improve as the covid-19-related restrictions on supply ease. For Nufarm, margins are expected to improve as headwinds from raw materials costs, weather effects and covid-19-related restrictions ease.

In what is an overvalued sector generally, Newcrest Mining ((NCM)) remains one of the better-value picks, trading at just over a -10% discount to Morningstar's fair value estimate. This is considered to reflect market concerns around the outlook for gold as the world recovers from covid, which has the potential to reduce gold's appeal as a safe haven asset. In addition, the spectre of inflation could increase the opportunity cost to hold gold and lessen its relative appeal. The company has also faced production challenges at Lihir and imminent grade decline at Cadia. However, the assets are considered to remain much better than average.

The investment manager continues to see limited buying opportunities in Healthcare, with approximately 70% of stocks under coverage seen as overvalued. Avita Medical ((AVH)) remains one of the favoured picks in the sector.

The June quarter technology stock rebound only made the overvalued sector even more expensive, in Morningstar's view. Computershare ((CPU)) rose 15% on no news yet remains relatively cheap. Link Administration ((LNK)) tracked sideways during the quarter, despite positive pricing for the Pexa Group ((PXA)) IPO and remains the cheapest stock in the sector.

Technology One ((TNE)), with a long track record of profitability and franked dividends, is the new Morningstar top pick for the sector. The company is often unfairly perceived as "old tech". Its share price tends to be inversely correlated with movements in "new tech" names, despite its rapid transition to a "new tech" SaaS business model.

Commodities

The ongoing Chinese intervention to curb commodity prices is expected to have only a temporary effect and Citi is bullish on commodity demand as the global recovery pushes on.

All-time high free cash flow, de-geared balance sheets and ever-increasing ESG pressures against growth have meant very high shareholder returns in the sector. We are reminded that most of the metals are enablers of the energy transition and will benefit from it.

However, JP Morgan is much less constructive on the price outlook for industrial metals. China accounts for 55-60% of base metals end-use demand, and the country's credit cycle has peaked, supporting a bearish bias for base metals over the course of 2021.

The Agricultural outlook remains bright, according to Citi, supported by rising grain prices and higher fertiliser pricing compared to last season.

Morgan Stanley's strategists believe current commodity share prices are overshooting fair value, though is looking for a better opportunity to sell, focusing instead on relative value. Here, aluminium and copper are favoured over nickel and zinc.

The commodities team forecasts a lower iron ore price through the second half of 2021 as market tightness recedes, due to slowing property and infrastructure demand in China. Also, it's expected that monetary tightening will likely start weighing on prices in the months ahead.

A neutral view on oil is maintained, with Brent to remain in the US$65-70/bbl range as demand recovery accelerates while OPEC supply remains constrained. JP Morgan, on the other hand, predicts oil prices are set to break US$80/bbl in the second half on strong demand.

Morgan Stanley remains negative on gold, with prices likely to drift lower as real yields are expected to bottom out, with the risk of a sharper sell-off in 2022 as the trend accelerates.

Meanwhile, Dankse Bank is forecasting that metal prices will be broadly stable over the next six months, as the decline in manufacturing momentum will ease demand for metals, in line with historical patterns. This time around, the cooling of the Chinese business cycle is set to underpin these patterns, as the slowdown is driven mostly by commodity-intensive sectors such as construction and infrastructure.

Credit and government bonds

As long as recession risks are low, Dankse Bank sees a rather benign environment for credit, as the low-yield environment drives a hunt for yield.

For government bonds, the bank expects a catch-up in US jobs growth and looks for US ten-year treasury yields to rise to 2% by year-end.

Government bonds are expensive in Russell Investments' view, and yields should come under upward pressure as output gaps close and central banks look to taper back asset purchases.

The global investments solutions firm expects the US ten-year Treasury yield to trade in a range of 1.5%-2.0% range over the second half of the year.

High yield and investment grade credit are considered expensive on a spread basis yet benefit from a positive cycle view that supports corporate profits growth and keeps default rates low.

Credit as an asset class has had an outstanding run to date, and Morgan Stanley sees limited value left. While moving to underweight on investment grade credit, the investment manager still likes the sub-investment grade segment (loans in particular) given the lower duration, higher yield and low default rates.

As a general statement Russell Investments thinks Australian government bond rates will largely track the US, given the RBA's quantitative easing program and focus on the exchange rate.

Currencies

Morgan Stanley expects a modest yet fairly broad-based US dollar strength over the next 12 months, bringing the US dollar index (DXY) from the bottom to the top of the around 5% range it's been trading in since mid-2020.

As Fed normalisation is signalled and US policy divergence is underscored versus the rest of the world, the US dollar should gradually move higher, with the DXY potentially reaching 93 by mid-2022.

JP Morgan agrees and suggests staying long the US dollar versus other reserve currencies, as the Fed's hawkish pivot is seen as bullish.

The Australian dollar will be around US$0.75 by mid-2022, according to Morgan Stanley, as RBA dovishness will increasingly contrast with other central banks that will have begun to normalise.

The normalisation in iron ore prices will be a headwind as well, though the interest rate differential will likely play a greater role in the currency price.

Russell Investments notes the US dollar typically gains during global downturns and declines in the recovery phase, and hence takes the opposite stance to Morgan Stanley on the currency's trajectory. The main beneficiary is likely to be the euro, which is still undervalued. British sterling and the economically sensitive commodity currencies (the Australian dollar, New Zealand dollar and the Canadian dollar) are expected to climb further, although these currencies are no longer considered undervalued from a longer-term perspective.

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AUSTRALIA

Viva Energy Revives Hopes Of Dividends

Despite the various city lockdowns and restrictions on travel, Viva Energy has grown its fuel volumes, underpinned by agriculture, resources and the regional retail network

-Total fuel sales volumes now ahead of pre-pandemic levels
-Viva Energy grew market share while fuel margins improved
-Upside likely from the “future fuels” options at Geelong

By Eva Brocklehurst

The agriculture, resources and regional transport sector have provided Viva Energy ((VEA)) with strong commercial fuel sales, while additions to the retail network have also lent support despite the various city lockdowns.

In the company's update, retail and commercial fuel volumes were well ahead of forecasts as were refining margins. The commercial segment appeared to benefit from new contracts as well as contract retention, Credit Suisse observes, along with retail fuel from the regionally-oriented Liberty network.

Retail margins have outperformed the industry, falling just -2c per litre year-on-year on the broker's estimates which compares with a -6c per litre decline for the industry based on Australian Institute of Petroleum data.

Guidance for operating earnings (EBITDA) of $390-410m in the first half was also well ahead of broker forecasts. Macquarie points out this would be a record result since the company listed in 2018.

The broker is also impressed by Viva's ability to capture market share in both retail and commercial fuel. Retail markets, the company pointed out, have absorbed price increases while returns have been solid.

Macquarie believes the beat to earnings expectations has been largely driven by a material capture of market share as well as better fuel margins. Penetration into premium fuel should also continue to support earnings growth, UBS adds.

The broker notes total fuel volumes are now above pre-pandemic levels amid strong diesel demand in regional

Australia, particularly from agriculture and resource industries. This offset weak metro fuel sales that have been affected by lockdowns.

UBS envisages upside from improving refining margins and transport fuel demand as travel restrictions ease, yet does not expect jet fuel to recover to pre-pandemic levels until 2025. As the stock is trading at 18.3x 2021 earnings (EBIT) compared with Ampol ((ALD)) at 13.5x the broker finds more value in the latter.

Dividends

The near-term implication from the update is the likely reinstatement of dividend payments at the first half result in August, and Credit Suisse assumes a 50% pay-out. In addition, Macquarie anticipates a return of up to $100m in capital arising from the proceeds arising from the divestment of the company's service station portfolio to form the listed Waypoint REIT ((WPR)).

Goldman Sachs also believes a return to ordinary dividends is increasingly likely for the first half and expects an interim 2.9c per share. The broker expects **performance will be supported in the second half by a recovery in macro conditions and improving returns on equity**, including a $100m capital management program.

Refining

Refining margins were US$6.60/bbl for the first half and averaged US$7.30/bbl for the second quarter and UBS forecasts a 2021 refining margin of US$6.90/bbl. Viva received $40.6m from the federal government and due to the refinery subsidy, Credit Suisse calculates the margin would need to exceed US$7.70/bbl to provide a net positive contribution to operating earnings.

Macquarie assesses, following the government's deal to fund 50%, the upgrade work to the refinery's clean fuels will be brought forward to 2022 from 2024. The Commonwealth subsidy for refining, intended to secure the country's refining capacity, was passed into law on June 29.

This fuel security package is expected to last to June 30, 2027, and mitigate some of the downside risk to refining margins, providing payments when the margin environment falls below the long-term cash break-even level of the Geelong operations.

Viva Energy has highlighted preliminary studies are being undertaken to commence necessary upgrades to the refinery in order to manufacture low-sulphur gasoline. The company is also proceeding in the third quarter with a hydrofluoric acid alkylation plant, with an expected investment of $25-35m.

An update on the LNG terminal and hydrogen plants are expected in August and Macquarie ascertains Geelong should now be consistently positive in terms of cash flow, except during any clean fuels upgrades.

The broker envisages upside from fuel marketing and the options for future fuels at Geelong while Goldman Sachs believes t**he refining subsidy will lower the risk profile of Australian refiners and provide stronger corporate appeal**.

UBS also expects Viva Energy will execute on its strategy to lift its alliance with Coles ((COL)) to 70-75m litres over the next 3-5 years and any faster volume growth could mean upside to valuation.

Goldman Sachs, not one of the seven stockbrokers monitored daily on the FNArena database, has a Buy rating and $2.70 target while the database has four Buy ratings and two Hold. The consensus target is $2.32, suggesting 11.8% upside to the last share price.

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AUSTRALIA

Turnaround In Live Events Boosts Audinate

The outlook for Audinate's market leading AV technology has improved amid a global turnaround in live sound and events

-Sentiment in the live sound/events industry is improving
-Sourcing of silicon chips remains the greatest obstacle to fulfillment
-Audinate has a record backlog of committed sales orders

By Eva Brocklehurst

Audinate Group ((AD8)) has fired up expectations for FY22, with underlying growth in its audiovisual products (AV) back at historical levels and the order backlog tracking at record highs.

Shaw and Partners notes the professional AV tide is turning in the company's favour amid increasingly positive commentary that points to confidence in the global AV space and a recovery in 2022.

The most notable is the turnaround in live sound/events which means an earnings inflection point has likely emerged for the business. Moreover, Audinate continues to extend its lead over competing offerings. The broker cites independent research into the professional AV market, industry surveys and discussions with a major system integrator that all suggest sentiment is improving.

The company has guided for FY21 revenue of US$25m, implying fourth quarter revenue of US$6.9m which appears almost flat compared with the prior quarter. R**evenue is expected to return to growth in historical percentages i.e. 26-31%**.

This is consistent with market expectations in FY22, UBS observes, noting over the last year the importance of a solid digital AV offering has been strengthened.

Morgan Stanley considers Audinate a key stock heading into the August results, with the latest guidance underscoring its view and, while supply issues may be a concern, ultimately demand is the key driver of the business.

Furthermore, that demand is improving as Shaw notes the US, a key market, has been lagging, given the extent and duration of the pandemic, but the quicker-than-expected roll-out of vaccines has meant it is now on the upturn.

Obstacles

The sourcing of silicon chips remains the greatest obstacle. If original equipment manufacturers (OEMs) have shortages of other chips required within their products it will impact on Audinate's sales.

There has been a record backlog of committed sales orders as ordering patterns from OEMs have changed since the pandemic, with increased lead times for components and chip manufacturers requesting up to 12 months visibility.

The company has indicated a global supply of chips and electronic components remains uncertain. This is the point on which Morgan Stanley would like further clarity, such as the extent to which OEMs are struggling to obtain components along the implications on underlying demand.

Shaw agrees the struggle to procure critical components could have a negative impact and constrain revenue growth, but highlights this as one reason why Audinate set up an alternative supply/manufacturing hub in Malaysia.

To date, the company has managed fulfillments and has sustained minimal, albeit not zero, impact on orders from the shortages, despite some downtime in Malaysia. Another milestone, the broker highlights, is the recent commercial release of both Bolin and Patton Dante AV-enabled video over IP cameras, encoders and decoders.

The prices are lower yet have higher specifications compared with competitive offerings that are already in the market. Recent product launches are a major positive UBS concedes but would like the product range to be broadened further.

The stock continues to be a key picks in the small cap space for Shaw. Over the longer term the broker describes the stock as a “ripper of a story” with a **clear earnings trajectory and technology that is the default global standard**.

The main risk is any macro downturn in the AV space, exacerbated by the prolonged pandemic. On the other hand, the company is well capitalised post the 2020 capital raising and has gross margins of 77%.

Shaw And Partners, not one of the seven stockbrokers monitored daily on the FNArena database, has a Buy rating with a $12 target. There are three Buy ratings on the database with a consensus target of $10.33 that suggests 6.0% upside to the last share price.

See also, Resounding Comeback For Audinate on February 23, 2021.

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AUSTRALIA

Wesfarmers On Drugs?

Wesfarmers has flagged its planned expansion into the personal care, health and well-being sector with a surprise bid for Australian Pharmaceutical Industries

-A strategic acquisition to expand opportunities post the pandemic
-Yet Australian Pharmaceutical has downgraded FY21 guidance
-Will the Wesfarmers bid be a catalyst for the personal care, health sector?

By Eva Brocklehurst

Not content being a hardware, discount department store and office retail conglomerate, Wesfarmers ((WES)) is planning to expand its territory into the personal care, health and well-being sector, seeking growth opportunities post the pandemic.

The company has submitted a non-binding indicative offer to acquire Australian Pharmaceutical Industries ((API)) for $1.38/share, a 21% premium to the prior close. Major shareholder Washington H Soul Pattinson ((SOL)), which has a 19.3% interest, has already indicated it will vote for the proposal, granting a call option in favour of Wesfarmers.

In the view of several brokers, this is a strategic acquisition, more about successfully executing a transaction rather than the specific quality aspects of the business being acquired. There is heightened competition in retail pharmacy from Chemist Warehouse as well as other online health & beauty platforms and more investment is required to turn API around.

Morgans believes the personal care sector can provide long-term growth opportunities although asserts Wesfarmers will need to invest in supply chain, systems and product range to improve competitiveness and operating efficiency.

This may be possible, given the strong retail and supply chain capability of Wesfarmers, but could take some years. Morgans accepts Wesfarmers' rationale because of the defensive growth qualities but points out **industry margins are low and API has been negatively affected by store closures over the past 15 months**.

Downgraded Guidance

In tandem with the bid, API has downgraded FY21 guidance and now expects underlying earnings (EBIT) to be $66-68m, as opposed to the previous guidance of $75m. This is largely because of the pandemic and the impact of the current restrictions in Sydney. If restrictions are not lifted as of July 31, this is expected to impact on earnings by -$1m per week.

API will also exit manufacturing in New Zealand by the second half of FY23 to focus on pharmacy distribution and its retailing businesses, Priceline and Clear Skincare.

Goldman Sachs has no view on whether the proposal will be completed but in the event it is successful believes API offers Wesfarmers exposure to another staple retail business. This would be a relatively small addition, with the broker calculating API would represent just 1.9% of Wesfarmers' FY21 earnings based on the mid point of the latest guidance.

CLSA considers the bid "uncertain" while suspecting it will be supported by shareholders because API is focused on the consumer rather than the industrial segment.

The transaction is unlikely to have a material influence on the valuation of Wesfarmers and the company does not appear to be paying a significant premium, in Credit Suisse's view. Still there are questions the broker poses for Wesfarmers, not to mention an unsuccessful foray with Homebase and struggle to right-size Target. Is this really the right vehicle to expand?

Citi had expected Wesfarmers to deploy its excess capital via acquisitions in the absence of tax effective ways to return capital yet envisages few synergies from this acquisition, estimating the transaction will be 1.7% accretive to earnings per share.

Higher Bid/Counter Bid

Credit Suisse suspects Wesfarmers may need to raise its offer in order to be accepted by API, as it is currently in line with where the shares traded in April 2021. Counter bids? The broker also points out speculation has always existed around an API/Sigma Healthcare ((SIG)) merger, given the recent underperformance in the latter's share price.

Yet, Credit Suisse does not anticipate Sigma will emerge with a counter bid for API, given it is a higher quality business and unlikely to pay a premium.

Sigma is also well into its turnaround strategy, has excess capacity in distribution centres and a strong balance sheet. Nevertheless, Credit Suisse considers the Wesfarmers bid can be a catalyst for Sigma to re-rate.

Goldman Sachs, not one of the seven stockbrokers monitored daily on the FNArena database, has a Buy rating for Wesfarmers with a $59.70 target. The database has one Buy (Macquarie), five Hold and one Sell (Citi) rating for Wesfarmers. The consensus target is $53.45, signalling -8.7% downside to the last share price.

For API there are three Hold ratings and the consensus target is $1.33, suggesting -3.2% downside to the last share price.

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AUSTRALIA

Patent Dispute Shrouds Nearmap's US Expansion

While the US is the real growth engine driving Nearmap forward, potentially costly US legal action, which could also impact sales momentum, gives the market cause for caution

-Overhang on Nearmap remains until US litigation resolved
-Brokers fear potential court case damages could be unduly large
-ACV momentum in the US expected to grow 50%-plus

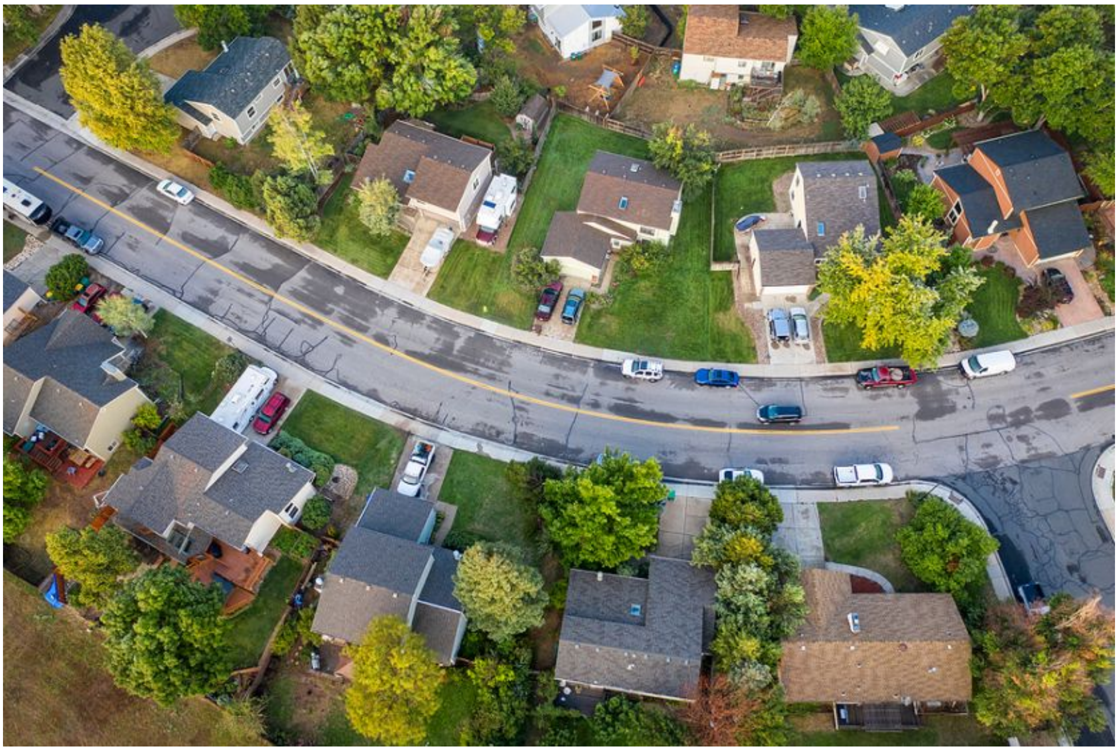
By Mark Story

Due to increased investment in sales, marketing, and product, plus improving economic conditions, Nearmap's ((NEA)) three key verticals, insurance, government, and roofing, delivered another record half of annual contract value guidance (ACV) growth in the US.

In light of strong ACV momentum in the US, which is expected to grow by 50%-plus year-on-year, the Australian aerial imaging company upgraded its FY21 ACV guidance to $128.2m.

Given the maturing sales productivity in A&NZ, where growth continues to below historical levels, the company is planning to step up investment in operational expenditure (opex) and capital expenditure (capex) materially in FY22 and FY23 to accelerate momentum in North American growth.

Jefferies Equity Research regards the roll-out of the now complete Hypercamera 3 as the most important piece of IP in Nearmap's kitbag, which will help to expand the company's coverage across the US.



Litigation overhang

News of strong US growth momentum is welcome news for shareholders who watched the company's share price tank -20%-plus earlier this year following revelations rival Eagleview was suing the company for alleged patent infringement.

Eagleview, along with another rival, Pictometry International, accused Nearmap of infringing their patents covering roof estimation software. This technology was brought into the business when Nearmap acquired Pushpin in December 2019.

Since then, Nearmap, which maintains allegations are fundamentally without merit, has also lodged a motion to dismiss two of Eagleview's eight claims due to lack of patent eligibility.

But while Nearmap believes the business will be able to successfully defend the patent infringement, brokers are considerably more cautious about the outcome, and the potential impact on the business.

While the potential impact on Nearmap’s North American operations may be small, brokers are concerned that potential damages could be disproportionately large. Citi, which has a Neutral recommendation on the stock and a price target of $2.35, continues to rate Nearmap as high-risk given the nature of these legal proceedings.

What concerns Citi the most is the potential impact the legal case could have on growth in the US. Should the company be unsuccessful in defending against the legal allegations, the broker suspects a higher-than-expected churn, customers downgrading contracts and/or lower than expected new sales.

At face value, Morgan Stanley, which has an Overweight rating and a $3.20 price target, cannot see strong US sales being impacted by the legal dispute. The broker assumes legal proceedings by Eagleview - eight years after Nearmap's US entry -were partly triggered by Australian company’s clear success on the US rival’s home turf, with ACV in North America up circa 2x in two years and growing.

However, the broker also believes that while roof estimation software is not a core part of the business, customer uncertainty due to this legal action is a lingering risk for Nearmap.

Encouragingly, Jefferies Equity Research cannot see any obvious signs that the litigation is having any client impact, with cash flows appearing to be better than the broker forecast for second half FY21.

Commenting on the legal dispute, Jefferies notes Nearmap has deep pockets to defend its position. Given that patent infringement litigation has been used tactically across other sectors, notably healthcare, Jefferies suspects the case with Nearmap will more than likely resolve in the company's favour.

Based on Macquarie’s initial reading of the filing, Nearmap is trying to strike out the claim on the basis that the patent is too broad-based.

While Macquarie is not a law firm, the broker is also incrementally comfortable with the legal case based on the recent defence filings. The broker points investors to consider differences to other successful claims by EagleView which incurred punitive payouts – where there was unmistakable evidence of information/IP sharing - in a downside/loss scenario.

Outlook

While the legal case may create an overhang until it is finally resolved, upgraded guidance by Nearmap suggests it has not yet impacted sales momentum or perception with existing customers. Macquarie, which has a Neutral rating, and a price target of $2.60, has it forecasts currently under review pending release of finalised FY21 result.

Due to the US growth trajectory, Citi is forecasting group ACV growth of 24% in FY22, and 40% growth over the medium term. The broker expects cash burn to step up materially in FY22 as the company rolls out Hyper Camera 3.

The broker has also upgraded ACV forecasts by 4% to 5% but lower FY21 earnings by -$1.6 million and -$3.1 million in FY22 to reflect higher costs.

Morgan Stanley expects mid-20% compound organic sales growth, with scope for 40%-plus cash earnings margins over the longer term. The broker expects Nearmap to step up investment in opex and capex materially in FY22 and FY23 and is now forecasting cash burn of -$28m and- $14m respectively.

However, with a gross profit payback of less than 12 months in North America in first half FY21, the broker believes Nearmap should push hard on investing in capture footprint, frequency, R&D, and sales team expansion.

There are two Neutral and one Overweight ratings on the database with a consensus target of $2.71 that suggests 19.7% upside to the last share price.

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AUSTRALIA

Is It All The Way With Ford For ARB?

ARB Corp, having unveiled a substantially strong FY21 performance, is shaping up for the growth opportunity presented by the US truck accessory market

-Underlying profitability strong despite cost pressures from freight and raw material prices
-Risk that sales activity in export markets decreases as travel restrictions unwind
-ARB Corp's association with Ford increases brand awareness

By Eva Brocklehurst

A strong surge in new vehicle sales has propelled ARB Corp ((ARB)) to flag a profit outcome that is well ahead of forecasts for FY21. Moreover, the relationship with Ford could shape up to be a game changer.

The order book is also robust, having increased to 10-12 weeks from 6-8 weeks in the first half. FY21 pre-tax profit is guided at $145-150m, up 86-92%. Revenue guidance for FY21 of $623m is also around 8% above consensus forecasts.

The highlights included improving US trading conditions and momentum in 4WD sales in Australia. The mid point of guidance implies a second-half pre-tax margin of 22.2%, around 30 basis points ahead of the first half, albeit Citi notes this is adjusted to exclude the first half JobKeeper subsidy.

Hence, the broker concludes underlying profitability is strong despite cost pressures from higher freight and raw material prices. Yet Macquarie assesses the pre-tax margin, including the subsidy, was down -240 basis points half on half, as manufacturing was scaled, although this may also reflect higher investment in growth opportunities and higher costs.

The company is intent on managing input costs and global supply chain pressures and while the order book is consistently strong the outlook is clouded by the pandemic. Macquarie suspects firm trading conditions in the Australian vehicle aftermarket are likely to continue while the international border is shut and the focus is on domestic getaways.

Hence, there is some risk that sales activity in key export markets such as the US, which comprises 35% of sales, decreases as travel restrictions are unwound. This could be a leading indicator for the Australian business when travel normalises.

Adventure Market

Citi believes there are multiple growth drivers, including the Ford partnership and export opportunities in the UK following the acquisition of Truckman. There is also signs the consumer is increasingly attracted to SUVs and 4WDs.

The Federal Chamber of Automotive Industries has indicated new vehicle sales rose 28.3% in the June half and, critically, key segments are outpacing the more traditional passenger market. Sports utility vehicles (SUV) increased 37.6% and light commercial vehicles (LCV) increased 32.7%.

Ord Minnett agrees future sales will be driven by demand from these segments as well as further expansion of the store network in Australia, along with penetration of offshore markets. The stock remains its top pick in the automotive parts sector.

Nevertheless, the broker agrees the opening of international borders, potentially in the second half of FY22, is a possible offset as well as a lack of benefit from superannuation withdrawals. On the other hand, Ord Minnett expects growth opportunities could include the expansion of the company's Thai manufacturing facility as well as other acquisitions.

The next catalyst is the FY21 results on August 17 where there should be more detail on the drivers of the result, acquisitions and growth opportunities.

US Opportunity

Wilsons reiterates its view that **recent developments in the US market have sufficient commercial relevance to ARB for the company to consider complementing wholesale operations with a retail store network**.

ARB is supplying Ford with product for accessory packages on its Bronco and Ranger models and first sales are expected shortly. The US truck accessory market, therefore, represents a significant growth opportunity.

The association with Ford will also increase ARB brand awareness. The broker models a scenario where the US segment sales will increase to $737m by FY35. Wilsons, not one of the seven stockbrokers monitored daily on the FNArena database has an Overweight rating and $48.40 target.

FNArena's database has two Buy and two Hold ratings. The consensus target is $42.01, signalling 1.5% upside to the last share price.

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AUSTRALIA

Consolidation In The Wings As BNPL Heats Up

Competition is intense among the BNPL operators, leading to the prospect of the industry struggling for direction before a timely consolidation

-Apple Pay Later could potentially increase the size of the BNPL market
-Main impact may be felt by smaller participants in the BNPL industry
-PayPal may be the biggest threat to established BNPL options

By Eva Brocklehurst

The BNPL sector has ridden a wave of popularity yet there are signs it will be a choppy ride to shore. Competition is intense and will become more so. This leads to the prospect that the industry may struggle for direction before a period of consolidation.

The trend towards instalment payments has been validated and Citi looks forward to a future period when the ability to pay this way will become a commodity. Early listed operators **Afterpay** ((APT)) and **Zip Co** ((Z1P)) will be successful through owning the consumer shopping experience via their apps and website.

Increased competition should also bring forward the adoption of BNPL, Jarden asserts. The market appears to be viewing the prospect of recently announced Apple Pay Later as negative for the major operators, based on the reaction in their share prices, instead the broker wonders whether this is a positive, as a Apple could increase the size of the market.

The broker believes the competitive advantage and a concerted drive to establish economies of scale should bode well for Afterpay, less so for Zip Co, and possibly negatively for **Sezzle** ((SZL)). Sezzle recently obtained a three-year contract with Target Corp in the US, adding to its retail base.

Given the size and scale of Apple, Citi agrees Afterpay will be in a comparatively stronger position than Zip, although it will need to continue to invest and innovate to hold the consumer's interest.

There's Afterpay, Zip Co's QuadPay and now there is Apple Pay Later. Apple is partnering with Golden Sachs to launch the service, which is a short-term loan option and a payment made every fortnight. This opens the BNPL functions to credit cards available on Apple Pay.

This is another consumer-side offering which does not compete with Afterpay or Zip Co directly on the merchant side. **As currently understood, Apple Pay Later is to be linked to a credit card** and, as Macquarie assesses, is more of a direct competitor to **Splitit** ((SPT)) than other BNPL products.

Splitit sources revenue via transaction fees, paid by the retailer when a customer uses the payment option via an existing credit card online or in-store. There are no late fees.

If Apple Pay Later repayments are limited to credit cards then the potential impact on Afterpay and QuadPay is limited, in Citi's view, as around 90% of Afterpay transactions use a debit card.

On the other hand, it is a larger threat than the offerings from the banks and credit companies, such as **Commonwealth Bank**'s ((CBA)) Step Pay, as Apple Pay has a wide consumer reach, with Citi noting there are 43.9m users in the US.

The main threat appears to be to the in-store take-up of Afterpay and QuadPay, given the consumer experience of using Apple Pay on a mobile website or in-store is also superior. In the case of QuadPay, UBS asserts Step Pay, along with others of a similar nature, is indeed a threat.

Jarden expects the impact will be felt by the smaller participants in the BNPL industry as larger players have more engaged users and a more developed ecosystem. In the case of Afterpay there are loyalty, promotions and greater lending options for repeat customers.

Fee Versus No Late Fee

The main competitive threat to the two established BNPL options comes from PayPal, Citi asserts. PayPal has switched on its Pay in 4 in Australia, offering no late fees.

Macquarie suspects this is good way to encourage adoption of the product compared with other offerings, most of which include just lower merchant fees. Both Afterpay and PayPal, in the case of missed payments, would suspend the users account yet recoup missed payments differently.

Afterpay would send texts and emails but eventually write off the bad debt whereas PayPal would defer to a third-party debt collector. The actual impact on the consumer of either of these choices is yet to be seen, Macquarie points out.

Removing late fees from its valuation of Afterpay results in in a small downgrade to the broker's target while **the lack of disclosure makes it difficult to quantify the proportion of revenue Zip Co generates from late fees**.

Yet, Macquarie observes Zip Co's account-based product shows a willingness to incur ongoing fees and thus appears to be less sensitive to the potential for an alternative "no late fee" product.

PayPal has 9m users in Australia compared with Afterpay's 3.5m, although PayPal has no presence off-line in Australia. Afterpay's Australasian in-store:online ratio was 22:78 as of the first half of FY21.

More Minnows

The market in Australia may be dominated by Afterpay and Zip Co but there are myriad others jostling for a space in the sector. **Layby Group** ((LBY)) is one, taking its name from the very old concept of instalment payments.

For those not old enough to remember, this was a time before credit cards when instalments for goods were paid to the retailer and the item kept behind the counter until you paid up fully. Layby Group has a strong presence in the UK which Canaccord Genuity believes is its biggest market for expansion.

Latitude Group ((LFS)) provides a variety of services across personal loans, credit cards as well as interest-free retail finance. Macquarie emphasises it assigns no value to the Latitude Group BNPL product.

In the case of **Smartpay Holdings** ((SMP)), CCZ Equities expects Australia will be the main focus while noting the company has been successful in taking customers from the big four banks.

Then there is **Zebit** ((ZBT)), which is an online retailer that allows a customer to purchase items online in instalments without interest and fees, and **Openpay Group** ((OPY)), for which the main differentiator is its flexible plans and transaction sizes.

Humm Group ((HUM)) also has variable plans, allowing the customer to make fortnightly payments for small items and providing up to 60 months interest-free for large items.

How are all these stocks rated? Most of those on the FNArena database carry Buy ratings. UBS is the key exception and has stood out with its contrary view point on Afterpay, believing whichever way you cut it the stock is way overvalued, despite the positive developments in the industry.

UBS has a $42.00 target for Afterpay while the consensus target is $122.57. Macquarie recently adjusted its target on Afterpay slightly lower, to $130 from $140, to account for market share loss in Australia and to reflect the competitive landscape. The broker also retains a Sell rating on Zip Co (as does UBS). Zip Co has a consensus target on the database of $8.69.

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AUSTRALIA

Lockdown Impacts On Growth And Equities

While Sydney endures an extended lockdown, economists are invoking recent history to ascertain the potential fallout for both the economy and sectors within the share market.

-Will Sydney's current lockdown impact as Melbourne's did in 2020?
-Downside risks for the consumer sector
-Will provision releases still proceed as planned for the banking sector?
-The major bank most affected by the Sydney lockdown

By Mark Woodruff

Economists at leading brokerages have examined past lockdown data in an attempt to draw conclusions regarding the impact of current lockdowns on economic growth, and upon ASX sectors and stocks.

This has raised a few interesting questions: Will extended lockdowns have the same impact as those during 2020? What is the difference in impact between a whole nation in extended lockdown and individual states?

As Oscar Wilde noted, sometimes comparisons are odious. The uncertain length of Sydney's lockdown, the less severe restrictions and the different levels of fiscal support certainly make comparisons more difficult to draw though potential impacts may still be gleaned.

Before looking at potential impacts upon different sectors, let's first examine how the wider economy may be affected by the Sydney lockdown.

Impact on the macroeconomic scene

The current lockdown shouldn't impact upon Jarden's forecast of an initial interest rate hike in mid-2023.

However, **it could potentially delay the tapering of quantitative easing**, given the likely impact on the labour market of extended restrictions. Jarden's economists had expected tapering to commence in November.

Melbourne's extended 2020 lockdown, lasting almost four months, saw a -15% peak to trough fall in retail sales, costing around -$4bn, and led to a -2.5% or -85,000 fall in employment. If Sydney were to experience similar moves, Jarden estimates a potential -$11bn or -2% hit to quarterly GDP, a loss of -$5bn in retail sales and potentially -100,000 job losses or -0.8% of total employment.

Without JobKeeper the broker sees **potentially greater downside risk for employment** though this may be partially mitigated by greater staff retention, due to labour market tightness and the difficulty for many businesses in finding staff.

Melbourne's experience also suggests that once lockdowns end, economic activity rebounds rapidly. Thus a near-term hit should be partially offset by a subsequent rebound.

Wilsons thinks the Sydney lockdown is likely to be measured in weeks, not months. Based on this, Australian growth prospects still look good for the coming year. Australia's vaccine rollout has disappointed, but is steadily progressing and should pick up significantly in the final quarter of 2021 as vaccine supplies accelerate.

National Australia Bank's business survey results for June showed a drop from the extreme highs of May, with confidence down -9 points and conditions down -12 points, with the latter now back in line with the average for this year.

The survey was taken from June 18-30, and does not incorporate the most recent information on the likelihood of an extended lockdown in Sydney. JP Morgan highlights that previously the link between business confidence/conditions and mobility has been relatively strong, and thus expects a further decline in next month's survey, as stay-at-home orders persist.

While the link to economic activity from these numbers may be tenuous, the broker had been expecting growth to step down several gears from the second quarter onward, now that the pre-covid level has been recovered, and the survey's results are at least qualitatively consistent.

Meanwhile, as a preliminary estimate for Sydney, the broker ascribes roughly a third of the hit incurred in the 2020 Melbourne lockdown, weighted by the affected areas' share of GDP. While a meaningful change, it feels small relative to the variation in the last year and the broker expects the drag in July will be gradually won back in August, and to a larger extent in September.

What sectors are impacted?

Jarden sees **downside risk to the Consumer sector** (particularly Discretionary Retail), mixed effects for REITs (negative for retail and office, marginally positive for industrial) and a near-term negative for the Bank sector (delaying the unwinding of bad and doubtful debt provisions and capital management).

Hospitality, arts and recreation, retail and other services are industries most impacted by lockdowns. These sectors represent around 21% of employment in Greater Sydney, or 4% of national employment.

As an indication, Victorian retail sales for clothing fell -55%, department stores -46% and cafes, restaurants and takeaway fell by -38.5%. Meanwhile, food/supermarket spending was broadly flat.

It's believed the Sydney lockdown will see similar negative impacts across discretionary retail, and online traffic is not expected to be sufficient to offset the collapse in footfall.

The Jarden retail analysts remain **cautious on the outlook for household goods retailers**, given significant pulled forward demand over 2020 and increasing competitive pressures.

Will lockdowns have the same effect second time around?

Data show JP Morgan that **activity restrictions are having less effect on mobility and the economy overall recently, compared to last year.**

Sectors that are the most affected by the pandemic are still below normal. This is because the border constraint was never relieved. Additionally, some of the earlier behavioural/mobility changes (eg work from home) haven't as yet normalised during the reopening.

Underperforming sectors simply can't suffer as much from incremental restrictions as they did last year. This applies to tourism and consumer services in the CBD, for example.

It's all in the relativities

Last year Melbourne was in localised lock-down for an extended period through the third and fourth quarters. The difference with Sydney's lockdown is that the rest of the country is relatively unrestricted and is no longer in its initial rebound phase from the nationwide shuttering.

The explosive surge last year, as most of the economy reopened, could easily carry a localised shutdown, even in a large city. However, the recovery is now more mature, and against a baseline of moderate growth, the drag from Sydney will be somewhat more obvious.

Effect upon the banking sector

Overall for the banking sector, JP Morgan suggests **provision releases are still more likely than not over the next six months, despite the lockdown**. The broker thinks it's too early to revise second half FY21 and FY22 forecasts.

While Morgan Stanley expects the banks to take a more conservative approach to provision releases, **the Sydney lockdown is not expected to lead to higher individual provision charges in the June quarter.**

National Australia Bank ((NAB)) is likely to be most impacted by a prolonged lockdown in NSW, given its larger SME franchise, suggests JP Morgan.

In concluding comments, the broker feels the trajectory for medium-term major bank impairment expenses rests on whether current lockdown restrictions are successful in suppressing community transmission of the covid-19 delta strain, and the progress of the vaccine rollout.

COMMODITIES

Material Matters: Iron Ore, Coal & Battery Elements

A glance through the latest expert views and predictions about commodities: iron ore; coal; palladium; and lithium

-Iron ore teetering at fresh highs, expected to move to a downtrend
-A hot northern summer signals strong demand for thermal coal
-Higher prices for alternative seaborne coking coal boosting Australian product
-Palladium price likely to have hit a peak, major loser from energy transition
-Demand for EV battery materials showing no sign of ebbing

By Eva Brocklehurst

Iron Ore

Credit Suisse expects the **iron ore** price to fall over the second half of 2021 as a record price is incentivising supply. Moreover, the increased supply is coming from China, with the broker noting statistics show only 10mt of seaborne iron ore was required to produce an additional 63mt of steel in the first five months of the year.

Rio Tinto's ((RIO)) shipments were particularly weak in April and May and as a consequence, Credit Suisse notes the Pilbara Blend hit eight-year lows at China's ports, which supported prices despite the steel price declining.

The shortfall should be corrected in the second half and rising port stocks are then likely to cause prices to unwind. Furthermore, Chinese authorities are unhappy with iron ore pricing and appear to be seeking to stem demand for **steel**. Infrastructure expenditure has started to decline and property construction may also be easing, although the broker notes manufacturing remains buoyant.

In its iron ore coverage, Credit Suisse upgrades estimates for earnings by more than 20% for 2021/22 based on the latest bulk update. The broker retains a preference for Rio Tinto over **BHP Group** ((BHP)) based on its larger exposure to iron ore as well as **aluminium** for which an upcoming structural deficit is anticipated.

Despite China's efforts to curb steel production, Credit Suisse believes its crude steel production in 2021 will exceed 2020 levels and, into 2022, the global iron ore market will remain reasonably tight, anticipating US$179/t in 2021 and then US$144/t in 2022. From there a downward trajectory is assumed.

Morgan Stanley also considers iron ore will track lower, noting China's port stocks have declined -12mt since late April down to just 28 days of consumption. Restocking could support the iron ore price during the quieter summer period but the broker is aware of a reversal in low-margin, scrap-based electric arc furnace output, with utilisation rates down to 66% compared with 77% back in May.

This is cushioning the impact of easing steel output on iron ore demand. Healthier margins could drive some short-term upside to iron ore before the seaborne iron ore market becomes more liquid and prices decline.

Meanwhile, Australia shipments improved in June albeit still below last year's levels because of Rio Tinto's interruptions. Shipments from BHP and **Fortescue Metals** ((FMG)) increased over the quarter and the broker notes Brazil's Vale is continuing to fare better compared with the June quarter 2020.

Coal

On the coal front, despite moves to eliminate its use, particularly **thermal coal**, prices remain resilient. Credit Suisse points out a perverse result of the activism regarding coal is the tightness of supply and strong prices, because of a lack of investment in production.

Despite decarbonisation initiatives, replacing power plants takes time and green steel is still in the experimental stage. The broker expects coal will remain in high demand over the next five years. Soaring spot LNG prices are also helping demand for thermal coal.

Continued support for thermal coal should also come from soaring energy demand in China as the economy emerges from the pandemic. Macquarie is witnessing an increasing number of media reports regarding the peak-load shifting in China as well as rationing because of shortages.

Moreover a hot summer in the northern hemisphere could also offer additional upside to thermal coal as the broker notes, while most analysts look to China for clues on the price, it could be the rest of the world that shifts the market balance.

A higher thermal coal demand induced by elevated energy requirements could support thermal prices in the short to medium term while longer term a shift to an alternative remains the key risk.

Meanwhile, Credit Suisse points out Australia's **coking (metallurgical) coal** is experiencing an "updraft" from the extreme prices that China is offering for non-Australian seaborne material.

Macquarie agrees a reshuffling is taking place in the seaborne market for coking coal as Canadian exports to China hit multi-year highs in May. The broker notes coal has been the best performing commodity over the year to date with prices up by 93% and 62% for metallurgical and thermal coal, respectively.

Palladium

Macquarie is increasingly confident that high prices for **palladium** are now a signal to the current bull market. Beyond the supply/demand disruptions of the pandemic and the loss of 400,000 ounces because of flooding at Norilsk's mine, the broker believes the market is on a path back to balance.

Positive structural trends that have occurred over the past decade are likely to now go into reverse and palladium will be also a major loser from the energy transition, amid increased recycling and the penetration of electric vehicles.

Tighter emissions standards are likely to incentivise increased adoption of zero emission vehicles. While the broker does not believe the tightness will unwind "in a hurry", 2021 should mark the high point.

Further volatility is likely in the short term, especially given South African cases of coronavirus are running at around 25,000/day. Car manufacturers are also working through supply chain disruptions to catch up with a recovery in sales and replenish inventory.

Therefore, Macquarie expects progressively narrower deficits in palladium and a return to surplus by 2025 that should result in prices retreating towards US$1200/oz.

Lithium

China and Europe have driven the strong demand for electric vehicles, with sales up 224% and 153% in the year to date respectively. This is despite a global chip shortage. Average raw material costs in the industry for **nickel, cobalt** and **lithium** rose by around US$10/kilowatt hour to just over US$35/kilowatt hour in the first half of 2021.

Spodumene concentrate bound for China increased by 44% in the year to date and inventory declined from March to May, which led to material price gains. Macquarie also points out major contributions to falling EV costs in coming years will likely come from platform costs because of economies of scale, rather than falling battery costs.

Macquarie has recently initiated coverage of **Liontown Resources** ((LTR)), with a $1.05 target and Outperform rating. Liontown has one of the largest undeveloped JORC-compliant spodumene projects globally.

The broker believes Kathleen Valley, in Western Australia, has potential to produce 700,000tpa of spodumene, large enough to underpin a fully integrated lithium hydroxide refinery.

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COMMODITIES

Energy Sector Ripe For Re-Rating

While energy might be ‘on the nose' for many investors, all brokers expect rapidly changing supply dynamics, fuelled by an unwillingness to invest in large and expensive projects, is likely to support the sector

-Australian energy sector has significantly underperformed global peers
-Rising oil/LNG prices to drive energy stocks higher
-Sharp valuation discounts expected to close

By Mark Story

Given the long overhang cast by covid, carbon concerns and heightened considerations around ESG investing, it’s hardly surprising that the energy sector, both here and globally, has been regarded as something of a pariah by investors.

While stocks in general are seen as overvalued with prices returning to normal following the worst of the pandemic, the Australian energy sector has been left behind by both the broader market and global peers alike.

The ASX Australian Energy Index (XEJ) has seriously underperformed the US Energy Index to the tune of around -22% since they both collapsed in first quarter 2020.

Despite being pushed higher on the back of declining oil inventories, Australia’s energy sector has significantly underperformed the oil price over the last seven months. In light of the lingering covid threat, the market has clearly struggled with the notion that oil prices can sustain levels north of US$55/bbl.

The sector-wide de-rating across oil and gas in 2021 saw earnings multiples drop by as much as -30% on average. But while forward earnings continue to strengthen, share prices have continued to tread water.

Environmental considerations aside, what has also taken its toll on equity valuations have been revelations several global energy super-majors, including Shell, Exxon, and Chevron, plan to exit oil completely and pivot further into gas and renewables.

Also taking its toll on sentiment and share prices has been investor uncertainty around major equity raisings. As well as being share price dilutive, it also worries investors that large investments needed to fund carbon-hungry projects have by nature lengthy payback periods.

Value on offer

But despite recent share price rises, and the equity market's unwillingness to price in recent oil strength, brokers are united in their conclusion that value remains on offer right across the energy sector.

The average price to fair value (P/FV) across Morningstar's A&NZ coverage has risen from 1.10 at the end of March to 1.15, implying the market is 15% overvalued. By comparison, with constituents trading on an average price to fair value ratio of 0.77 - as the higher spot oil price is yet to be factored into share prices - Morningstar assesses the energy sector as -20% undervalued.

But unlike years past, Morgans does not view the current underperformance of oil stocks as structural. The broker expects equities to re-rate during the second half as numerous short-term factors reverse.

As a base case, Morgans sees oil prices well supported by the rapidly changing supply dynamics, which the broker thinks are also dampening the current required supply response.

The broker suspects this is creating short-term potential for exceptional oil price upside, which means stocks are unlikely to remain at sharp discounts for very long. With this view in mind, Morgans maintains an Overweight recommendation on energy, assuming covid does not further impact demand in the near term.

Forecast upgrades

While Morgans has been bullish on oil's prospects for a significant rise, the broker remains conservative in its price deck assumptions. Despite the case building for lifting long-term oil price assumptions, the broker has at this stage left its long-term Brent oil price forecast unchanged at US$62/bbl, around 7% above consensus.

All brokers unanimously conclude that the short-term price risk is tilted to the upside as producers hesitate to add capacity to meet the temporary shortfall, knowing the energy transition will limit future demand growth.

Based on strong post-covid recovery in key markets, Citi now expects demand to surpass the record 100.8mbdp set in August 2019 by August this year. As a result, the broker upgrades its Brent oil price forecast for 2021 and 2022 by 4% and 13% to US$71 and US$67/bbl.

Standouts

With most energy-exposed stocks trading well below fair value, Ord Minnett believes M&A could be the spark for equity performance and remains positive on most stocks in the sector. In Ord Minnett's view, M&A could be a strong catalyst to close the gap between stock prices and valuations.

Potential M&A scenarios postulated by Ord Minnett include Santos ((STO)) buying Oil Search ((OSH)), Woodside Petroleum ((WPL)) acquiring an additional interest in the North West Shelf joint venture, and Beach Energy ((BPT)) targeting Cooper Energy ((COE)) and others.

Ord Minnett has also upgraded its recommendation on Carnarvon Petroleum ((CVN)) to Buy from Hold based on valuation.

The broker's preferences among the small caps are Senex Energy ((SYX)) due to its growth and exposure to east coast gas prices, and Cooper Energy due to its strong balance sheet and attractive valuation.

UBS also retains Buy ratings across the sector in the expectation that Australia's energy equity market will eventually catch up on the recovery in oil prices. The broker has lifted its price targets for Santos and Oil Search by up to 2% to reflect higher spot LNG prices from a tightening LNG market.

The broker expects higher realised prices to translate to higher revenues in the second quarter FY21 for Australian energy names, by 1-6% quarter-on-quarter.

While Morgans also maintains an Overweight recommendation on energy, the broker sees the most attractive sector value on offer as being amongst some of the small- and mid-cap producers.

The broker's top picks are Karoon Energy ((KAR)) up 120% and Senex Energy up 83%: Two of the only energy stocks to have posted better or similar share price performances relative to oil prices, up 90% over the last 12 months.

The broker also expects these two stocks to boast the best balance sheets in the sector next year.

Meantime, JP Morgan's large commodity Overweight is focused on energy as a hedge for rising inflation. JP Morgan's outlook is also based on the broker's expectations of a commodity up-cycle driven by the post-pandemic recovery.

The broker has Overweight ratings on eight of the ten energy stocks in its coverage.

Given Oil Search is the most fundamentally levered to oil price, relative to its peers, Citi's 2021-23 earnings forecasts have risen 8%, 34%, 12% respectively on upgraded commodity prices.

Citi has highlighted three key production numbers to pay attention to during this quarterly reporting season. The first of these is Senex, which may report its first quarter-on-quarter production decline since 2019.

The broker also expects Woodside to surprise on North West Shelf production given earlier concerns about water breakthrough in wells.

Then there's Beach Energy's Western Flank production, for which Citi notes the market has severely questioned forecasts following last quarter's reserves downgrades.

Future investment in question

Morgans believes the re-rating of energy stocks is likely to erode the desire for the investment necessary to avoid future oil market instability. However, from Citi's perspective, Australian companies look set to grow investment in upstream oil and gas at a much faster rate than their US counterparts.

But with ESG and lengthy payback concerns now heightened, the broker suspects investors may be preferencing companies with lower re-investment rates in the space, and higher returns of capital to shareholders.

Citi concedes there is an element of "lack of control of destiny" concerning the major Australian names. For example, with the likes of Woodside and Oil Search wired to JV partners to execute on growth strategies, the broker believes a pessimistic argument can be mounted for the difficulty of getting these projects off the ground.

ESG FOCUS

ESG Focus: It's Easy Being Green - For Now (Part 2)

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ESG focus: It's easy being green - for now

Carbon intensity is set to emerge as the benchmark hero in the global push to create a fungible green bond market.

-The green bar is set "deceptively" low
-Standardisation is a global hot topic
-Carbon intensity to become the green common denominator

By Sarah Mills

Welcome to Part 2 of our green bond story, one of several articles on the ESG bond market.

Part 1 discussed the state of the green, sustainable and social (GSS) use-of-proceeds bond market; green bond basics and pricing; and developments in the international criminal courts. [Link below]

It notes that green bonds, in particular, have created a bridgehead for sustainability finance to transform traditional vanilla non-bond financial markets over the next two decades.

This article focuses purely on the green bond market and regulatory attempts to improve fungibility of green bonds to draw them into mainstream investment.

It's easy being green, but not for long

At the moment, nearly any corporation and its dog can issue a green bond and expect very little scrutiny.

Failing to direct the proceeds as agreed in the loan's terms does not trigger a default, and as long as the loan is financial, the issuer is good to go.

The International Accounting Standards Board has stated publicly that "greenwashing is rampant".

The market's critics cite inadequate green contractual protection for investors, poor quality of reporting metrics and transparency, greenwashing and pricing issues.

Evidence also overwhelmingly suggests that green bond issuance is not associated with falling or even comparatively low carbon emissions at the company level, and critics argue therefore green issuance has had limited impact save as a transition subsidy (at best).

Green deception, or eco-fraud as some have described it, can have serious implications for ESG-specific fund managers.

Failure of an instrument to meet a fund's standards can result in loss of funding approval, a need to sell the bonds potentially at a loss, or, in extreme cases, dissolution of the fund.

If failed instruments are included in sustainability indices, it can also impact on the integrity of the indices, as was the case with Mexico Airport's failed green bond, which lost its green ratings from Moody's Investors Service and S&P Ratings.

It may also mean the taxpayer might end up subsidising a vanilla bond and result in back-ended tax benefits.

These claims are largely true.

The policing of the green bond market is loose, but that is forecast to change as certification and other credentialing improve.

Already green loans more frequently have enforceable green covenants.

Similarly, over time, penalties for non-conformance are likely to rise, and at some time in the distant future could trigger a default.

The EU, announcing its sustainable finance strategy this month, promised a crackdown on greenwashing and improved ratings systems.

Baker McKenzie suggests incorporating reporting provisions into contracts, making them actionable via an agreed put event, and introducing margin incentives as a penalty for non-compliance (which really makes them sustainability linked).

In return, the firm argues that investors should reward issuers with increased appetite and lower pricing.

Tax incentives for good performance have also been discussed

Flouting green bond agreements can incur reputational damage but at this stage, even that is fairly low.

But given primary market pricing is comparable with vanilla bonds, most issuers are doing so partly to gain credentialing for the future, most at least pay lip service.

The de-rating of Mexico Airport's green bond has also directed efforts to ensuring a green bond remains a green bond until the end of its maturity; and this will become a requirement for issuers and a subject for due diligence, according to *On Point*.

What happens to the non-conformers?

So not surprising, non-conformance of bonds has attracted some attention, and steps are being taken to ramp up the reputational consequences of green “default”.

Under the Climate Board Initiative’s (CBI’s) Standard of Certification, green defaults must be declared to the CBI within one month of becoming aware of non-conformance.

The CBI may recommend corrective action but if conformance is not restored, the board can revoke its green bond certification, remove the bond from the Climate Bond listing; and inform bondholders, exchanges and other market participants of the loss of certification.

This process is discretionary and uncertain.

The CBI actions affect the issuer’s credentialing, which at present is nothing more than a slap on the wrist given pricing supplements often include express statements that a loss of certification does not constitute and event of default and bondholders cannot exercise redemption rights or take any other action.

But moves are afoot to standardise reputational and financial consequences.

Until then, investors are left holding the baby so due diligence is important, particularly for funds whose mandates require the investment to meet certain green targets.

Regulators are also expected to incorporate oversight into the supervisory process and the prudential treatment of balance sheet assets; and brown penalties may be introduced in the medium term.

<u>Standardised measurement is a hot topic</u>

Perhaps the biggest challenge facing the green bond market is lack of standardisation, which hampers liquidity, transparency and comparability.

Typically, green bonds are not fungible, in that they apply to different projects, in different industries from corporations or countries with different risk profiles and ratings, and for different reasons.

They are not comparable and regulators are seeking to address this issue.

According to Baker Mackenzie, on top of the above, there is no universally accepted legal and commercial definition of a green bond:

“Imitating the International Capital Market Association’s (ICMA) Green Bond Principles, elements common across many standards include:

(i) use of proceeds disclosure stating the cash raised will finance new or existing projects that have positive environmental or climate benefits;

(ii) ongoing reporting on the foregoing green use of proceeds; and

(iii) the provision of a second opinion by an independent third party reviewer certifying the green aspects of the bond.

The four main providers of green bond data tend to be the arbiters of “kosherness” and include CBI, Dealogic, Bloomberg and Environmental Finance Bond Database.

But even this data has gaps wide enough to drive a horse and cart through.

Tracking the banks’ usage of green proceeds is also hard given the fungible nature of cash and loose labelling by banks, according to Fitch ratings.

Because green bond issuance is used for standalone projects rather than company-wide emissions, this can confuse some equity investors in terms of the likely forward credentialing/rating for the issuing companies.

Not only that, projects promising carbon reductions can be offset by carbon increases elsewhere.

<u>The thorny issue of verification</u>

This takes us to another major challenge for the market – verification that environmental benefits are delivered.

When it comes to certification, the Climate Bond Standard aims to establish a platform for assessing climate-friendly attributes of projects but doesn’t try to assess the credit worthiness of the instrument, nor compliance with laws or other environmental obligations. This is up to the investor to determine.

Sustainable Finance Disclosure Regulation (SFDR) and Non-Financial Reporting Directive (NFDR) are expected to step in to the breach, requiring institutions to disclose the extent to which they are taxonomy-aligned and the strength of their green asset ratio.

The green certification platform is preparing to include enforceable contractual arrangements protecting investors from “green” default.

According to Corrs Chambers Westgarth, these may include:

- “an assurance process during the tenor of the green bond with regular reporting required to be made available to investors;

- “requirements for application of proceeds to the intended green purposes;

- “the ring-fencing of proceeds into a separate account so that any unallocated issuance proceeds form a green tranche are not applied to other non-green purposes;

- “linking green failures to put events to enable bondholders to accelerate or redeem their bonds, or linking green failures to a margin ratchet requiring the issuer to pay an increased coupon if there is green non-compliance.

“With these arrangements, we expect margin ratchets will be the most popular. This is due to the clarity margin ratchets provide green bond investors and issuers with respect to enforcement … ;

- “the green bond market may further evolve to include a full “green default” regime and rights recourse. However, at this stage, the market is not ready.”

<u>Carbon intensity – the green common denominator</u>

So the push is on to create a ratings system for green project issuance based on an issuer's total group carbon emissions, using carbon intensity as the common denominator for all issuance.

This will increase pressure on green issuers to publish standardised impact reports.

Carbon intensity is favoured as a benchmark because of its relative ease of measurement and ease of verification.

Carbon-intensity performance is measured as emissions relative to revenue.

According to the Bank for International Settlements (BIS), there is no evidence that green bond issuance is associated with any reduction in carbon intensities over time at the firm level.

In fact, about half of green bond issuers have the highest carbon intensity (and are usually energy producers).

Trucost data shows that while carbon intensities fell on average in the two years after issuance, carbon intensities rose afterwards.

According to BIS, Scope 1 green issuers post a 60% fall in intensity after three years but only 30% firm-wide for Scope 1-3 emissions (see previous article for Scope 1, 2 and 3 definitions).

Median changes across firm before and after are minimal. Also, results are not statistically significant so no clear pattern emerges.

But the BIS believes that carbon intensity can be used to create fungibility by classifying green bonds into “buckets” – a concept already well understood in the industry.

For example, the bonds could be sorted according to project types within industry buckets based on a carbon-intensity ratings systems.

BIS has this to say:

“A firm-level (organisational level) green rating system should have three high-level objectives:”

- It should provide extra incentives for the rated companies to contribute to the attainment of climate goals;

- It should help investors in their decision-making processes, particularly those investors without resources to conduct their own green due diligence; and

- The system should allow investors and other stakeholders such as auditors, regulators and policymakers, to check an organisation’s improvement and verify that the desired climate mitigation effects are achieve.

By rating an organisation, rather than the bond, on its overall carbon intensity, it also encourages the organisation to increase its carbon efficiency; and help investors sort the wheat from the chaff in the quest for the sustainability premium.

It would also provide extra incentives for large carbon emitters to battle climate change.

We will offer an edited version of BIS's free complementary musings on the subject in a separate article for real enthusiasts.

Green bond certification for treasury bonds on cards

Denmark's central bank, Nationalbank, and the Danish Ministry of Finance announced in May that they were considering a new model for sovereign green bonds that separates financial commitments from green commitments.

Denmark has the fifth-lowest government debt-to-GDP in the EU and the central bank notes that green bond issuance drains liquidity from pre-existing bond series, raising the cost of funds.

Under the proposed model, the Danish government's "green" bonds would be traditional vanilla bonds, complemented by a green certificate.

This certificate separates the commitment to provide a coupon payment and the principle on maturity from the use-of-proceeds commitment.

In essence, the bonds can be issued in the primary market alongside traditional bonds, but the green certificates can be traded separately (a zero-coupon bond with zero redemption at maturity).

"Owning both the conventional government bond and the green certificate is equivalent to owning a sovereign green bond," according to the Danish central bank.

Denmark's liquidity problem is one faced by many other small sovereign issuers and, if successful, could be adopted more widely with interesting broader market consequences.

According to IP, four of Denmark's biggest pension funds have said they are receptive to the idea.

While experimental, it is just one example of the potential for innovation in the green bond market and the likely augur of many new instruments to come.

The EU will likely be entertaining many options given its ambitious 2050 targets are off to a slow start.

The challenge for investors

As noted, green bonds don't always come from the most carbon-efficient firms, creating challenges for investors.

On the fixed-income side, backing the wrong carbon horse could cause investors to lose bang for buck.

Failure could also affect the green credentials and financial positions of investment funds, resulting in fund re-ratings, forced sales and possible dissolution.

But once regulations tighten, investors may gain a financial windfall from step-up rates and penalties, adding some reward into the equation.

On the equity side, if investors conflate green issuance with green credentialing, they may invest in a company that is on a losing rather than a winning carbon streak.

Those with hedged portfolios will be seeing the best performers regardless as this is where the long-term investment sweet spot lies.

There are those that suggest that true "green" intent is as good a barometer as any financial litmus test, given it is likely to guide investors with a moral barometer towards the most ethical choices in the absence of proper regulation and financial metrics.

As with most ESG investment, the best GSS bonds are likely to be forward looking, as leaning into impact during a period of dramatic change is being pitched as safer than sitting on the edges.

In the words of the transition architects, it's a game of "Who Cares Wins".

It's Easy Being Green -- For Now (Part 1):
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ESG Focus: A Green Revolution Made In Germany

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A Green Revolution Made In Germany

Widespread vaccine rollouts are seeing European markets open up and pathways to the global recovery become clearer. Saxo Markets predicts a transition to a greener economy in a post-covid world is set to be the defining feature of the upcoming third quarter.

-All eyes are on Europe as green energy looks to be a decider in the German elections and UK markets offer global investment potential
-Europe taking a lead in the green revolution may improve the euro, but Asia investors are being pointed towards the UK market for investment potential
-The US dollar may weaken in a high inflation, post-stimulus economy
-Commodities continue to make a play for long-term investor interest into the third quarter

By Danielle Austin

Green agendas continue to dominate global government decisions and dictate future trends and equity market movements.

According to Saxo Markets, the federal German election could be a catalyst for Europe to define itself as a global leader in the green energy movement and give it an edge over the US and China.

Investors from Asia looking to invest in European markets are being steered towards the smaller UK market subset, offering more predictability and a more defined focus on shareholder interests.

The US dollar has continued to see-saw in recent months thanks to increased liquidity off the back of stimulus packages, while commodities are predicted to continue with their recent growth streak as infrastructure spend increases.

German Green Party set to start a revolution

It is Saxo Markets' observation that young voters appear to be taking the wheel and steering to a likely win for a Green-Black alliance in the upcoming September German election, with a lesser chance of the Green Party scoring enough votes to take singular control.

It is Saxo's view that a win for the Green Party is indicative of the generational shift in political agendas occurring not only in Germany but in wider Europe. The increasingly left-leaning younger generations are casting their votes for a political agenda that focuses on mitigating climate change and reducing carbon emissions in a climate of equality and social justice.

Current Chancellor Angela Merkel has largely disappointed climate-focused voters, with the country failing to enact change to reach its 2020 emissions goals and only reaching targets as a result of covid impacts.

According to Saxo, the German Green Party has managed to capture the current zeitgeist of youth climate and social justice movements that have propelled the party's popularity in recent years.

Recommitment to the EU could equal euro recovery

Saxo notes a recommitment to the European Union from all members to deal with legacy bank issues, reform harmonisation and make significant fiscal commitments could result in a remarkable recovery for the euro post-election.

While the EUR750bn recovery fund will not be sufficient for many periphery-EU members to recover from excess debt, an in-power German Green Party could pave a path to wider recommitment to the EU through increased financial commitment.

Saxo Chief Economist and CIO Steen Jakobsen describes the German Green Party as pro-EU and anti-Russia and China and a win by the Green Party is expected to drive movement on the EU project through a mutualised, climate-driven agenda and significant fiscal stimulus.

The EU Emissions Trading Systems could further be a catalyst for a green revolution globally, forcing countries outside of Europe to undertake green measures to complete production for European companies.

Asian investors narrow in on UK market

While Europe is offering interesting long-term investment opportunities for investors looking to sustainability, climate crisis and ESG initiatives, Saxo recommends Asia investors would be well served to focus on the smaller UK market.

As a spin-off of the wider European market, the UK offers the ability to focus its own objectives and the needs of its stakeholders, while the EU remains fragmented on policy and fiscal matter.

Saxo experts highlight the post-Brexit UK market as one of the most underweighted currently in global portfolios, but the UK offers reduced uncertainty having made it through Brexit contentions and being one of the leading countries globally in the vaccine rollout.

According to Saxo, the FTSE100 has exposure to cyclicals including financials and commodities that are likely to perform well in an inflation and rates-rising period.

US stimulus impacts take hold

Saxo expects an increasing focus shift to the impacts of the US stimulus to roll out over the third quarter.

The US dollar could weaken in a post-stimulus economy, with Saxo experts pointing out since November 2020 European equities have begun to outperform US equities for the first time in more than a decade.

Following increased liquidity of the US dollar caused by stimulus packages, Saxo’s number one surprise is the US dollar didn’t devalue further in recent months.

Commodity rally to continue into the third quarter

It is Saxo's view the commodity sector appears geared to continue to rally into the third quarter, after five consecutive quarterly gains, although the growth rate is expected to slow.

The Bloomberg Commodity Spot index has now increased by 75% since March 2020, recently reaching a ten-year high. Strong, stimulus-driven demand for key commodities may be driving a super-cycle, but Saxo expects rising demand to be longer lasting.

Saxo predicts the likes of gold, silver, copper, iron ore, aluminium, zinc and platinum to continue to attract demand from a combination of increased government spend on infrastructure and decarbonisation.

Additionally, increasingly unpredictable weather patterns are driving a need for a stock build of agricultural commodities.

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ESG Focus: It's Easy Being Green - For Now (Part 3)

BIS Pursues Green Bond Rating System.

Part 2 of our green bond story *It's Easy Being Green – For Now* (link below), touches on the steps to make carbon intensity the common denominator for a green-bond ratings system, to aid fungibility and liquidity, and reduce greenwashing and other abuse.

Here, FNArena has included a heavily edited version of the Bank for International Settlements' (BIS) complimentary discussion on the subject for bond enthusiasts.

BIS says ideally:

"A firm-level green rating system should have three high-level objectives":

- It should provide extra incentives for the rated companies to contribute to the attainment of climate goals;
- It should help investors in their decision-making processes, particularly those investors without resources to conduct their own green due diligence; and
- The system should allow investors and other stakeholders such as auditors, regulators and policymakers, to check an organisation's improvement and verify that the desired climate mitigation effects are achieved.

By way of solutions for point 1 (incentives), BIS suggests:

- an organisational level rating for green issuance;
- the right measures (BIS suggests carbon intensity);
- ratings buckets (divided by industry) to make comparison between companies easier, and to motivate corporate competition; and
- the rating placement on a finer grid for organisations with a higher carbon intensity.

For point 2 (simplifying investor decision-making), BIS suggests:

-Taking a simple approach to ratings that relies on a backward measure of climate attainment;
- transparency; and
- granularity (so that investors know if the projects fit with their investment strategy) to determine likely performance over time;
- and again use the bucket concept, which is already familiar to investors.

On the subject of verification (point 3), BIS suggests:

- adopting the carbon intensity as the standard measurement as it is easily verifiable and is based on outcomes;
- basing verification on scope 1, 2 and 3 emissions (at present, they may be based on just 1 and 2, which ignores company wide emissions) and the broadest types of emissions available, in order to capture the emissions for an organisation's entire value chain;
- adopting mandatory audits of emissions data and mandatory reporting based on legal standards (which are already being developed); and
- emanding data on broader emission scopes from third-party to help assess an organisation's overall carbon footprint.

In summary, existing ratings for green bonds are not a good measure for a corporation's carbon-intensity performance, measured as emissions relative to revenue.

By rating firms, rather than bonds, on their overall carbon intensity could encourage them to increase their carbon efficiency and help investors sort the wheat from the chaff.

It would provide extra incentives for large carbon emitters to battle climate changes.

For further reading:

It's Easy Being Green - For Now: https://www.fnarena.com/index.php/2021/07/09/esg-focus-its-easy-being-green-for-now/

It's Easy Being Green - For Now (Part 2): https://www.fnarena.com/index.php/2021/07/12/esg-focus-its-easy-being-green-for-now-part-2/

FNArena's dedicated ESG Focus news section zooms in on matters Environmental, Social & Governance (ESG) that are increasingly guiding investors preferences and decisions globally. For more news updates, past and future:
https://www.fnarena.com/index.php/financial-news/daily-financial-news/category/esg-focus/

WEEKLY REPORTS

Weekly Ratings, Targets, Forecast Changes - 09-07-21

Weekly update on stockbroker recommendation, target price, and earnings forecast changes

By Mark Woodruff

Guide:

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

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

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

Summary

Period: Monday July 5 to Friday July 9, 2021
Total Upgrades: 8
Total Downgrades: 11
Net Ratings Breakdown: Buy 53.80%; Hold 39.20%; Sell 6.99%

For the week ending Friday 9 July, there were eight upgrades and eleven downgrades to ASX-listed companies by brokers in the FNArena database.

Woolworths received the largest percentage decrease in forecast target price by brokers to account for the Endeavour demerger. Morgan Stanley lowered its rating to Equal-Weight from Overweight, after shares rallied 7% in the three months leading into the demerger, and a further 4% in the week prior to the broker's rating decision.

Sitting atop the table for the largest percentage increase in forecast target price last week was IGO. As mentioned in last week's article, Credit Suisse lifted near-term lithium pricing forecasts, incorporating exponential lithium demand for EV batteries. An increase by the broker in forecast EPS also reflected the Tropicana divestment, accounting adjustments and changes to the assumed capital structure.

Coming second on the table was Coronado Global Resources, which also featured at the top of the list for percentage increase in forecast earnings by brokers in the FNArena database. Morgans estimates that dilution from a recent capital raise will be offset by leverage to sharply higher coking coal prices.

Next up was Orocobre, which also had a material lift in earnings forecasts by brokers last week. Apart from the new lithium price forecast from Credit Suisse referred to above, the company benefited from the agreed merger with Galaxy Resources, from which the broker sees ample value upside.

Crown Resorts had the largest negative percentage change in forecast earnings by brokers in the FNArena database last week. The broker expects revenue from the company's domestic business in Melbourne and Perth to be trading above pre-covid levels by FY23. However, it's believed there will be a lag in underlying earnings, driven by higher costs and reduced VIP volumes.

While Sydney Airport came second on the table for percentage earnings downgrades, broker commentary centred on an indicative and non-binding $8.25 bid from a consortium of infrastructure investors. Morgans feels a higher bid may emerge, given the significant dry powder sitting in infrastructure funds globally that is looking for investment opportunities. Citi concurs and believes such a unique asset is likely to appeal to a range of infrastructure bidders.

Next was Western Areas, which posted a mixed June quarter production report, with nickel production 7% higher than Macquarie forecast though shipments were -5% lower. Given Flying Fox continues to underperform expectations, the ability to deliver a replacement source is now considered a key catalyst going forward. Based on the trend evident from the June quarter, the broker cuts earnings forecasts, and now expects the miner to report a small loss at its FY21 result release.

As mentioned last week, Morgans lowered FY21 earnings forecasts for Nanosonics to reflect an exchange rate adjustment to consumables. Despite this, the broker feels the investment in R&D is delivering, after the launch of a new digital platform, AuditPro. However, the analyst had already allowed for a second instrument-disinfection product in FY23 forecasts, so makes no adjustments in that period.

Finally, two additional brokers updated forecasts for Lendlease last week, after a trading update on July 1 revealed estimates for FY21 profit will be -13%-20% below consensus estimates. This was largely due to project delays and profit write-backs in London.

Morgan Stanley believes a review of the company’s profit recognition strategy is the first part of the new CEO's reset. While volatility may result from re-prioritising 23 urbanisation projects and announcing plans to divest more non-core businesses, the broker feels a successful cost reduction program could be the remedy. Meanwhile, Macquarie suggests value is emerging though negative earnings momentum needs to be dealt with and visibility needs to improve. The broker suspects there could be more negative news before the market can focus on the medium-term growth outlook.

Total Buy recommendations take up 53.8% of the total, versus 39.2% on Neutral/Hold, while Sell ratings account for the remaining 6.99%.

Upgrade

BLUESCOPE STEEL LIMITED ((BSL)) Upgrade to Overweight from Equal-weight by Morgan Stanley .B/H/S: 4/2/0

Morgan Stanley upgrades the rating for BlueScope Steel to Overweight from Equal-weight, as key steel spreads remain supportive. The spreads are considered likely to drive significant consensus upgrades and facilitate meaningful capital management.

The broker lifts forecasts to reflect the much-improved price and spread environment in the US, an earlier start to the Northstar expansion and to align with revised Morgan Stanley commodity price forecasts.

The analyst lifts EPS estimates for FY22 and FY23 by 11% and 67%, and raises the target price to $27 from $24.50. Industry view: In-line.

CORONADO GLOBAL RESOURCES INC ((CRN)) Upgrade to Add from Hold by Morgans .B/H/S: 3/1/0

After updating views post the company's capital structure re-set, Morgans' valuation rises to $1.06 from $1. Coronado Global Resources' leverage to sharply higher coking coal prices is estimated to offset equity dilution.

The company refinanced debt and raised capital for balance sheet repair. The analyst notes global coking coal prices have move sharply and unexpectedly upward.

The broker upgrades the rating to Add from Hold, noting the company suits sophisticated investors with a high risk tolerance.

CARNARVON PETROLEUM LIMITED ((CVN)) Upgrade to Buy from Hold by Ord Minnett .B/H/S: 1/1/0

Ord Minnett believes M&A could be the catalyst for equity performance and remains positive on most stocks in the Energy and Utilities sector. It's felt compelling valuations could prompt corporate activity across the sector, with a number of assets up for sale.

All energy stocks the broker covers are trading below estimated valuation. The rating for Carnarvon Petroleum is raised to Buy from Hold based on valuation and the target price lifts to $0.35 from $0.33.

INCITEC PIVOT LIMITED ((IPL)) Upgrade to Outperform from Neutral by Credit Suisse .B/H/S: 6/1/0

Fertiliser prices remain strong, supporting the outlook for Incitec Pivot. The steepening cost curve in Europe is also beneficial, the broker suggests, given the company's US gas cost base for ammonia and fixed gas and sulphur cost base for phosphates in Australia.

The broker expects tightness to remain for the remainder of 2021 and makes earnings upgrades that are split evenly between phosphates and ammonia.

There are also increasing signs that fertiliser prices have reached a level where demand is being reduced so there are limited opportunities for further increases even on material volume.

Credit Suisse upgrades to Outperform from Neutral and raises the target to $3.02 from $2.51.

OIL SEARCH LIMITED ((OSH)) Upgrade to Add from Hold by Morgans .B/H/S: 3/3/1

It's surprising to Morgans that Oil and Gas equities have materially underperformed, given the improvement in supply-demand fundamentals, and the steady rise of oil prices. One explanation is considered to be the surge in ESG concerns.

Additionally, the broker notes market pessimism on oil prices holding current levels, and company specific factors as several have looming major capex or recent operational issues.

After upgrading short and medium term oil price forecasts, Morgans upgrades the rating to Add from Hold for Oil Search after recent share price weakness. It's considered the most sensitive of the large-caps to changes in the oil price. Target $4.70.

SEVEN GROUP HOLDINGS LIMITED ((SVW)) Upgrade to Buy from Accumulate by Ord Minnett .B/H/S: 4/0/0

Ord Minnett lifts the rating for Seven Group Holdings to Buy from Accumulate, after identifying significant potential upside to the unchanged $26.50 target price. Applying the average peer multiple for WesTrac and Coates Hire implies a $27.50 share price, estimates the analyst.

The broker also sees significant value creation from Seven Group's listed investments. The Buy rating is maintained.

SYDNEY AIRPORT ((SYD)) Upgrade to Neutral from Underperform by Credit Suisse .B/H/S: 1/5/0

Sydney Airport has received a non-binding indicative cash bid of $8.25 per share from a consortium that comprises IFM Investors, Conyers, QSuper and Global Infrastructure Management.

The offer implies an equity value of $22.3bn and an enterprise value of $30.6bn, and is at a 42% premium to Sydney Airport's closing price on Friday. Credit Suisse notes a 67% probability of a successful deal at the current indicative offer.

Among a number of conditions attached to the offer, the offer is conditional on UniSuper joining the consortium with its current 15% stake. Credit Suisse also notes that given Australian airport cross holding limits, IFM will be unable to hold more than 15% of the equity.

The rating is upgraded to Neutral and the target price increases to $7.70 from $5.30.

See also SYD downgrade.

TABCORP HOLDINGS LIMITED ((TAH)) Upgrade to Add from Hold by Morgans .B/H/S: 3/1/0

The company has announced an intention to demerge its Lotteries & Keno business. The demerger will create two ASX-listed companies in Lotteries & KenoCo and Wagering & GamingCo. The latter will comprise Wagering & Media and Gaming Services business units.

Morgans believes the demerger has the potential to unlock the value inherent in the high quality Lotteries and Keno business and upgrades to an Add rating from Hold. The target price is also lifted to $5.66 from $5.11.

The analyst notes proposals received for Wagering and Media and Gaming Services should continue to provide near-term valuation support for Wagering & GamingCo.

Downgrade

ABACUS PROPERTY GROUP ((ABP)) Downgrade to Hold from Accumulate by Ord Minnett .B/H/S: 1/3/0

Abacus Property has acquired a $160m portfolio of self-storage assets in Sydney's northern suburbs. Ord Minnett assumes the initial yield on the transaction is very tight, at around 3-3.5%, reflecting the premium locations.

The acquisition is included in modelling and has meant Abacus Property has fully utilised its December capital raising.

Ord Minnett downgrades to Hold from Accumulate, given the recent run up in the share price. Target is $3.20.

AMA GROUP LIMITED ((AMA)) Downgrade to Neutral from Buy by UBS .B/H/S: 0/1/0

While the long-term opportunity remains appealing, UBS believes there are a number of near-term uncertainties including the potential impact of current lockdowns and the ability and time required to successfully renegotiate pricing increases.

Additionally, there are labour and parts inflation pressures as well as recent staff turnover within senior management, explains the broker. The rating is downgraded to Neutral from Buy and the target price falls to $0.56 from $0.70.

The analyst considers the risk-return balance has shifted, at least until there's more visibility on the above-mentioned concerns.

ASX LIMITED ((ASX)) Downgrade to Sell from Neutral by Citi .B/H/S: 0/5/2

ASX's volumes for both cash equities and futures fell markedly in second half FY21 by -21% and -14% respectively versus the previous period.

With the stock looking expensive again, Citi moves to Sell and increases the target price to $71.10 from $70.10.

While Citi expects some commentary on medium term growth prospects at ASX's FY21 results, the broker suspects it will be insufficient to materially alter forecasts.

At the upcoming result Citi expects updates on DLT, commodity futures, Sympli and Datasphere.

BORAL LIMITED ((BLD)) Downgrade to Neutral from Outperform by Macquarie .B/H/S: 1/4/0

Seven Group ((SVW)) has increased the bid for Boral to $7.40 a share having taken its stake beyond 34.5%. The offer remains open until July 15 and Macquarie suggests any alteration to the bid now is unlikely.

The broker downgrades to Neutral from Outperform, believing the upside is more limited at the current valuation. The fly ash review is due in coming weeks which presents some risk to a more cautious stance although Macquarie suggests it could go either way. Target remains $7.80.

CENTURIA OFFICE REIT ((COF)) Downgrade to Hold from Add by Morgans .B/H/S: 0/3/1

There were upward revaluations as at June 2021 14 of 22 properties, due to a mix of leasing outcomes and cap rate compression, explains Morgans.The portfolio is now valued at $2bn, with a weighted average cap rate of 5.81%.

The REIT announced $405m in debt refinancing, increasing the weighted average debt expiry to 4.3 years.

Given recent share price strength, the broker moves to a Hold rating from Add, with a revised price target of $2.49 from $2.33. The REIT is considered to offer an attractive distribution yield for income focused investors.

NINE ENTERTAINMENT CO. HOLDINGS LIMITED ((NEC)) Downgrade to Neutral from Outperform by Macquarie .B/H/S: 3/2/0

Macquarie refines its outlook ahead of the FY21 result, noting incremental positive updates have had limited benefit on the share price.

The broker suggests this is a quality cyclical business with a positive trajectory from 9Now, Stan and FTA business but headwinds are likely to loom in the short term from the Olympics.

Valuation support is moderating so Macquarie strategists have shifted to a defensive portfolio position. As a result, the rating is downgraded to Neutral from Outperform. The target is reduced to $3.00 from $3.60.

SENEX ENERGY LIMITED ((SXY)) Downgrade to Neutral from Outperform by Macquarie .B/H/S: 4/2/0

Senex Energy's share price has risen 123% since May 2020. Macquarie continues to see coal seam gas production expansion ahead but delivery will take time, so suggests for now investors may find better returns available elsewhere.

The broker will contiue to monitor valuation upside but on the re-rating has pulled back to Neutral from Outperform. Target unchanged at $3.85.

SYDNEY AIRPORT ((SYD)) Downgrade to Hold from Add by Morgans .B/H/S: 1/5/0

Morgans feels there is a strong likelihood the takeover bid from a consortium of unlisted infrastructure funds will proceed. The rating is lowered to Hold from Add and the target price is raised to the bid price of $8.25 from $7.03.

In predicting whether another bidder could emerge, the broker notes significant dry powder sitting in infrastructure funds globally looking for investment opportunities.

The analyst feels the bid price is sufficiently attractive to entice investors, when compared to an uncertain wait for the distribution to recommence and international traffic to recover.

See also SYD upgrade.

WOOLWORTHS GROUP LIMITED ((WOW)) Downgrade to Equal-weight from Overweight by Morgan Stanley .B/H/S: 0/3/1

Morgan Stanley downgrades the rating for Woolworths Group to Equal-weight from Overweight, after shares rallied 7% in the three months leading into the Endeavour Group ((EDV)) demerger. Since then, the shares have rallied a further 4% in the past week.

With the removal of Endeavour Group from forecasts, the broker's price target declines to $36.50 from $44. Industry view: Attractive. The analyst anticipates an off-market buyback after management has flagged capital management totaling $1.6-2bn.

Given the anticipated balance sheet position, Morgan Stanley expects capital management to come in towards the top end of the range.

WESTERN AREAS LIMITED ((WSA)) Downgrade to Neutral from Outperform by Macquarie .B/H/S: 2/5/0

Western Areas posted a mixed June quarter production report, with nickel production 7% higher than Maquarie forecast but shipments -5% lower. Given Flying Fox continues to underform expactations, the ability to deliver a replacement source is now a key catalyst.

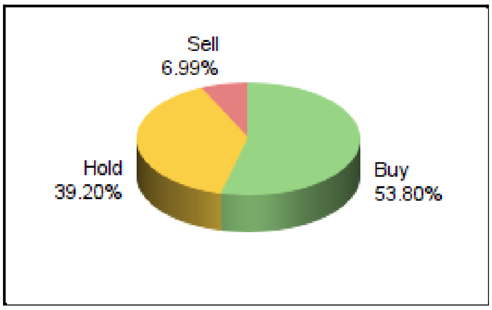
The broker has cut forecasts on the June quarter trend and now expects the miner to report a small loss at its FY21 result release. Target falls to $2.60 from $2.70, downgrade to Neutral from Outperform.

WISETECH GLOBAL LIMITED ((WTC)) Downgrade to Neutral from Outperform by Macquarie .B/H/S: 1/3/0

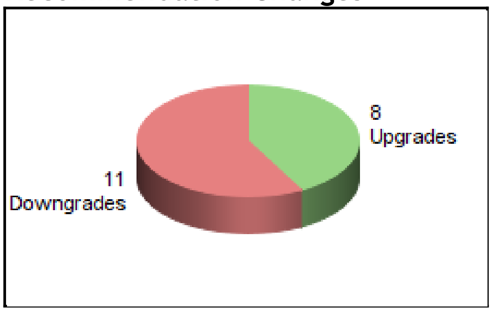
Factoring in the latest container volumes statistics, Macquarie lowers the FY21-23 EPS forecasts by -6%,-1% and -3%, respectively. With limited visibility on catalysts in the coming six months Macquarie downgrades to Neutral from Outperform, ahead of the company’s results.

The broker lowers the target price to $33 from $34, adjusting for the weaker-than-expected container volumes. Longer-term drivers such as a rebound in roll-out global customer growth and Cargowise Neo are considered to remain intact.

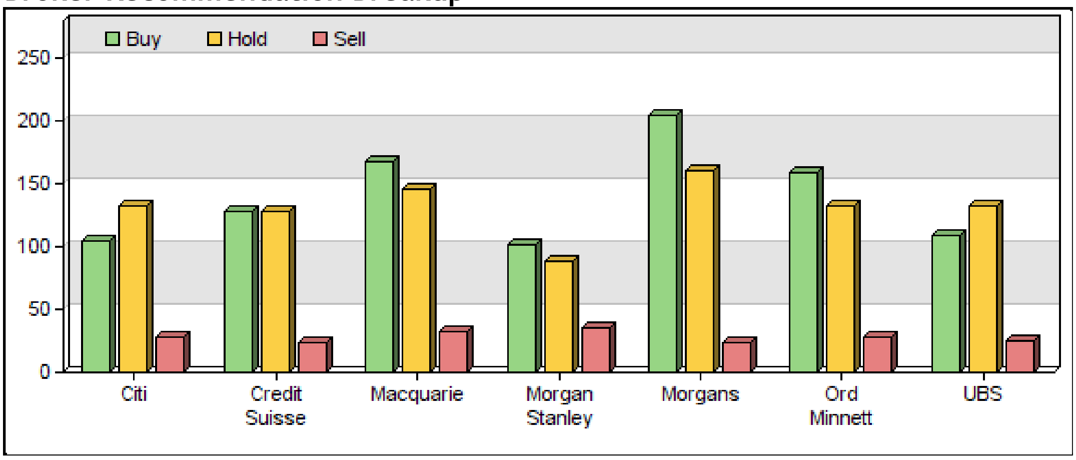
Total Recommendations



Recommendation Changes



Broker Recommendation Breakup



Broker Rating

Order	Company	New Rating	Old Rating	Broker
Upgrade				
1	BLUESCOPE STEEL LIMITED	Buy	Neutral	Morgan Stanley
2	CARNARVON PETROLEUM LIMITED	Buy	Neutral	Ord Minnett
3	CORONADO GLOBAL RESOURCES INC	Buy	Neutral	Morgans
4	INCITEC PIVOT LIMITED	Buy	Neutral	Credit Suisse
5	OIL SEARCH LIMITED	Buy	Neutral	Morgans
6	SEVEN GROUP HOLDINGS LIMITED	Buy	Buy	Ord Minnett
7	SYDNEY AIRPORT	Neutral	Sell	Credit Suisse
8	TABCORP HOLDINGS LIMITED	Buy	Neutral	Morgans
Downgrade				
9	ABACUS PROPERTY GROUP	Neutral	Buy	Ord Minnett
10	AMA GROUP LIMITED	Neutral	Buy	UBS
11	ASX LIMITED	Sell	Neutral	Citi
12	BORAL LIMITED	Neutral	Buy	Macquarie
13	CENTURIA OFFICE REIT	Neutral	Buy	Morgans
14	NINE ENTERTAINMENT CO. HOLDINGS LIMITED	Neutral	Buy	Macquarie
15	SENEX ENERGY LIMITED	Neutral	Buy	Macquarie
16	SYDNEY AIRPORT	Neutral	Buy	Morgans
17	WESTERN AREAS LIMITED	Neutral	Buy	Macquarie
18	WISETECH GLOBAL LIMITED	Neutral	Buy	Macquarie
19	WOOLWORTHS GROUP LIMITED	Neutral	Buy	Morgan Stanley

Recommendation

Positive Change Covered by > 2 Brokers

Order	Symbol	Company	New Rating	Previous Rating	Change	Recs
1	CRN	CORONADO GLOBAL RESOURCES INC	75.0%	50.0%	25.0%	4
2	TAH	TABCORP HOLDINGS LIMITED	75.0%	50.0%	25.0%	4
3	PDL	PENDAL GROUP LIMITED	70.0%	50.0%	20.0%	5
4	COL	COLES GROUP LIMITED	60.0%	43.0%	17.0%	5
5	MTS	METCASH LIMITED	75.0%	58.0%	17.0%	4
6	BSL	BLUESCOPE STEEL LIMITED	67.0%	50.0%	17.0%	6
7	OSH	OIL SEARCH LIMITED	29.0%	14.0%	15.0%	7
8	IPL	INCITEC PIVOT LIMITED	86.0%	71.0%	15.0%	7
9	BOQ	BANK OF QUEENSLAND LIMITED	90.0%	75.0%	15.0%	5
10	AMC	AMCOR PLC	64.0%	50.0%	14.0%	7

Negative Change Covered by > 2 Brokers

Order	Symbol	Company	New Rating	Previous Rating	Change	Recs
1	WOW	WOOLWORTHS GROUP LIMITED	-25.0%	25.0%	-50.0%	4
2	WTC	WISETECH GLOBAL LIMITED	25.0%	50.0%	-25.0%	4
3	NWL	NETWEALTH GROUP LIMITED	20.0%	40.0%	-20.0%	5
4	TLS	TELSTRA CORPORATION LIMITED	80.0%	100.0%	-20.0%	5
5	BLD	BORAL LIMITED	20.0%	40.0%	-20.0%	5
6	NEC	NINE ENTERTAINMENT CO. HOLDINGS LIMITED	60.0%	80.0%	-20.0%	5
7	TNE	TECHNOLOGY ONE LIMITED	33.0%	50.0%	-17.0%	3
8	SXY	SENEX ENERGY LIMITED	67.0%	83.0%	-16.0%	6
9	ASX	ASX LIMITED	-29.0%	-14.0%	-15.0%	7
10	WSA	WESTERN AREAS LIMITED	29.0%	43.0%	-14.0%	7

Target Price

Positive Change Covered by > 2 Brokers

Order	Symbol	Company	New Target	Previous Target	Change	Recs
1	IGO	IGO LIMITED	7.840	7.008	11.87%	5
2	CRN	CORONADO GLOBAL RESOURCES INC	1.215	1.113	9.16%	4
3	NWL	NETWEALTH GROUP LIMITED	16.010	15.140	5.75%	5
4	BOQ	BANK OF QUEENSLAND LIMITED	10.080	9.733	3.57%	5

5	MTS	METCASH LIMITED	4.053	3.927	3.21%	4
6	IPL	INCITEC PIVOT LIMITED	2.976	2.903	2.51%	7
7	PDL	PENDAL GROUP LIMITED	8.548	8.348	2.40%	5
8	TAH	TABCORP HOLDINGS LIMITED	5.190	5.078	2.21%	4
9	SXY	SENEX ENERGY LIMITED	3.845	3.770	1.99%	6
10	OSH	OIL SEARCH LIMITED	4.481	4.403	1.77%	7

Negative Change Covered by > 2 Brokers

Order	Symbol	Company	New Target	Previous Target	Change	Recs
1	WOW	WOOLWORTHS GROUP LIMITED	36.105	40.153	-10.08%	4
2	NEC	NINE ENTERTAINMENT CO. HOLDINGS LIMITED	3.330	3.450	-3.48%	5
3	WTC	WISETECH GLOBAL LIMITED	32.725	32.975	-0.76%	4
4	WSA	WESTERN AREAS LIMITED	2.587	2.601	-0.54%	7

Earning Forecast

Positive Change Covered by > 2 Brokers

Order	Symbol	Company	New EF	Previous EF	Change	Recs
1	CRN	CORONADO GLOBAL RESOURCES INC	2.402	-2.854	184.16%	4
2	ORE	OROCOBRE LIMITED	-4.665	-5.323	12.36%	7
3	PLS	PILBARA MINERALS LIMITED	-0.223	-0.240	7.08%	4
4	WHC	WHITEHAVEN COAL LIMITED	-6.235	-6.600	5.53%	7
5	QUB	QUBE HOLDINGS LIMITED	7.200	6.883	4.61%	6
6	IPL	INCITEC PIVOT LIMITED	14.036	13.536	3.69%	7
7	NHC	NEW HOPE CORPORATION LIMITED	15.655	15.123	3.52%	4
8	FPH	FISHER & PAYKEL HEALTHCARE CORPORATION LIMITED	64.233	62.052	3.51%	4
9	KAR	KAROON ENERGY LIMITED	7.307	7.100	2.92%	3
10	RIO	RIO TINTO LIMITED	1971.467	1918.944	2.74%	7

Negative Change Covered by > 2 Brokers

Order	Symbol	Company	New EF	Previous EF	Change	Recs
1	CWN	CROWN RESORTS LIMITED	-4.914	-3.374	-45.64%	5
2	SYD	SYDNEY AIRPORT	-4.184	-3.231	-29.50%	6
3	WSA	WESTERN AREAS LIMITED	-1.376	-1.090	-26.24%	7
4	NAN	NANOSONICS LIMITED	1.975	2.475	-20.20%	4
5	LLC	LENDLEASE GROUP	58.590	67.437	-13.12%	6
6	IEL	IDP EDUCATION LIMITED	18.860	20.420	-7.64%	5
7	GXY	GALAXY RESOURCES LIMITED	2.634	2.827	-6.83%	6
8	TPG	TPG TELECOM LIMITED	17.973	18.448	-2.57%	6
9	RMS	RAMELIUS RESOURCES LIMITED	16.600	17.033	-2.54%	3
10	ORG	ORIGIN ENERGY LIMITED	19.339	19.727	-1.97%	7

Technical limitations

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

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WEEKLY REPORTS

Uranium Week: Approval For Uranium Investment Fund

As the uranium spot price fell marginally last week, further progress was made to list the first physical uranium fund in both Canada and the US.

-Shareholder approval for creation of uranium investment vehicle
-Bannerman Resources advances project in Namibia
-Uranium spot price falls by less than -1% for the week

By Mark Woodruff

Shareholders of Canadian-listed uranium investor Uranium Participation Corp (UPC) have approved a proposed plan of arrangement to reorganise UPC into the Sprott Asset Management-run investment-fund listed on the Toronto Stock Exchange. UPC is the world's largest publicly-traded investment vehicle offering exposure to uranium, outside of traditional mining company shares.

In explaining last week's lack of activity in the spot uranium market, independent consultant TradeTech observed both buyers and sellers were hesitant to commit to transactions immediately before the July 7 vote by UPC shareholders to approve the creation of the Sprott Physical Uranium Trust.

Since confirmation of the vote in favour of the transaction, sellers have slowly inched up offer prices in expectation of future demand from the fund.

Completion of the transaction is expected in the early third quarter of 2021, and if successful, the new Sprott Trust would be the first physical uranium fund listed in the US. It's thought the listing will enable the raising of new funds for the purchase of physical uranium, placing a strain on existing supply.

The new trust structure will offer lower annual corporate costs and aligns UPC's business with the world's leading physical commodity investment vehicles.

Company News

In a June 30 quarterly report, ASX-listed **Bannerman Resources** ((BMN)) noted advances to its Pre-Feasibility Study (PFS) for the 8Mtpa development of its flagship Etango Uranium Project in Namibia. There is a specialist review underway ahead of PFS finalisation and release, expected in early August 2021.

Commenting on the wider uranium market, CEO Brandon Munro noted secondary demand continues to tighten. "This is in anticipation of market events, not the least of which is the creation of the Sprott Physical Uranium Trust and its anticipated listing in the United States and Canada."

Mr Munro also referenced the impact on the uranium market of a further build in secondary demand from investment funds and other participants. Additionally, the extension by **Kazatomprom** of supply discipline into 2023, removing -13mlbs from forecast global production for the year, is considered significant.

Cameco, GE Hitachi Nuclear Energy (GEH), and Global Nuclear Fuel-Americas (GNF) have signed a memorandum of understanding to explore several areas of cooperation to advance the commercialisation and deployment of BWRX-300 small modular reactors (SMRs) in Canada and globally.

"Cameco intends to be a go-to fuel supplier for these innovative reactors. We're looking forward to working with GEH and GNF to see what opportunities might exist around their novel SMR design," said Cameco President and CEO Tim Gitzel.

In production news, Cameco is planning to restart production at the Cigar Lake uranium mine after it was temporarily suspended and three quarters of the workforce was evacuated on July 1, due to a wildfire in the vicinity.

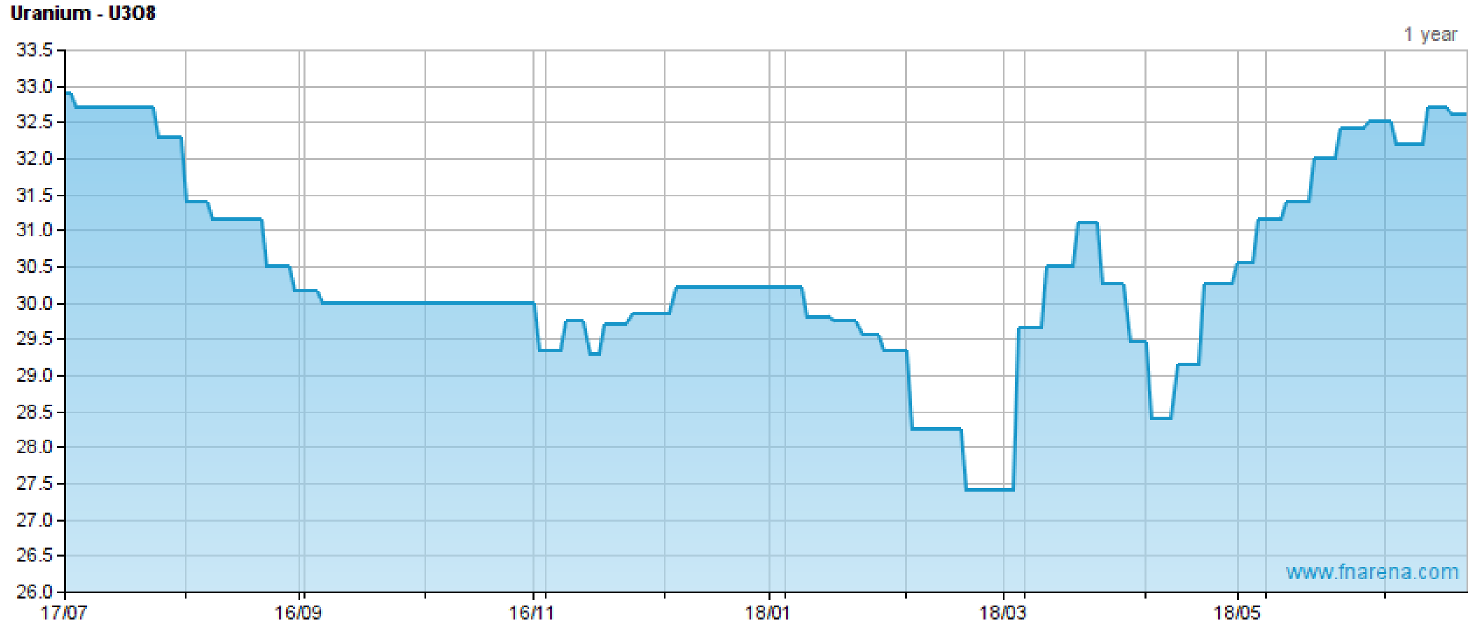
Uranium pricing

TradeTech's Weekly Uranium **Spot Price** Indicator is US$32.60/lb down -US$0.10 from last week. The Indicator has risen steadily since late April, gaining an average of 1.3% per week in that time. It has increased almost 8% overall in 2021, averaging a 0.3% weekly gain.

The average Weekly Spot Price Indicator in 2021 is US$30.23/lb, US$0.52 above the 2020 average.

The spot uranium market was extremely quiet last week, in large part due to the US Independence Day holiday, reports TradeTech.

TradeTech's **term price** indicators are US$32.40/lb (mid) and US$35.00/lb (long).



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

WEEKLY REPORTS

The Short Report - 15 Jul 2021

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

Summary:

By Greg Peel

Week Ending July 8, 2021.

Last week again saw the ASX200 chop around, running fast to get nowhere.

The Incredible Shrinking Short Table continued to shrink last week, with two more stocks dropping out to leave a mere fifteen 5%-plus shorted.

One of those stocks was New Hope Corp ((NHC)), which jumped in from below 5% the week before to 6.8% shorted, and last week dropped out to below 5% again.

I explained last week this was all to do with the arbitrage opportunity created by the company's announced convertible issue – short the stock and buy the note, which contains an implicit stock option at a discount.

There were otherwise no short position changes of one percentage point or more last week.

Resolute Mining ((RSG)), having seemingly overcome its issues with production problems at its Syama gold mine and disputes with the Mali government, has been moving steadily up in share price lately and steadily down in short positions.

Also having had a good run recently is a2 Milk ((A2M)), which has been in the 5%-plus table for a very long time but does tend to jump around. The stock re-rated by 20% in the first week of July, and the shorters may be inspired once more, with shorts moving up 7.3% from 6.3%.

Weekly short positions as a percentage of market cap:

10%+
KGN 10.9
WEB 10.5

No changes

9.0-9.9

FLT

No changes

8.0-8.9%

ING

Out: EOS

7.0-7.9%

Z1P, TPW, TGR, EOS, A2M

In: EOS, A2M Out: RSG

6.0-6.9%

RSG, MTS, MSB

In: RSG Out: A2M, NHC, IVC, BGL

5.0-5.9%

JBH, IVC, BGL

In: IVC, BGL Out: EML

Movers & Shakers

Nothing this week.

ASX20 Short Positions (%)

Code	Last Week	Week Before	Code	Last Week	Week Before
ALL	0.1	0.2	MQG	0.2	0.2
ANZ	0.8	1.0	NAB	0.9	0.9
APT	1.8	1.9	NCM	0.1	0.1
BHP	4.1	4.2	RIO	0.2	0.3
BXB	0.4	0.5	TCL	0.6	0.6
CBA	0.5	0.6	TLS	0.2	0.2
COL	0.6	0.6	WBC	0.8	0.9
CSL	0.2	0.2	WES	0.2	0.3
FMG	0.5	0.6	WOW	0.3	0.3
GMG	0.2	0.2	WPL	1.0	1.0

To see the full Short Report, please go to this link

Guide:

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

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

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

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.

WEEKLY REPORTS

The Wrap: Real Estate, Defence And The Fertiliser Outlook

Weekly Broker Wrap: Fresh real estate perspectives, small-cap defence stock updates and the global fertiliser outlook.

-Positive for residential real estate, office concerns easing and caution on Melbourne malls
-Two top picks in the small-cap defence sector
-Citi's bullish view on the global fertiliser outlook

By Mark Woodruff

Real Estate: Fresh perspectives

In the early stages of a post-covid world, some fresh real estate perspectives from Morgan Stanley alleviate some concerns around suburban offices and highlight that residential intentions remain bullish. There is, however, another reason to be cautious on retail mall landlords, when they have high exposure to Melbourne/Victoria assets.

Of the office workers surveyed by the broker, 28% flagged that their employers have taken up more space since returning to work from covid versus 25% who have taken less, suggesting office pessimists may be too bearish.

As most respondents work in metro (rather than CBD) offices, the broker lifts its rating for **Centuria Office REIT** ((COF)) to Overweight from Underweight and raises its target price to $2.70 from $2.05.

The REIT is a suburban office pure-play, and with occupancy already low at 92.3%, it's thought the trough has passed. It is trading on a circa 7% dividend yield, which is amongst the highest in the broker's coverage universe. This is despite the stock offering less earnings uncertainty than other structurally challenged sectors (eg retail), and the REIT having the potential for consensus upgrades, should management execute on re-leasing vacant office space.

With work-from-home preferences only lifting 0.8 days per week, Morgan Stanley sees limited ability for corporates to give back (rationalise) office space, and therefore sees minimal risk from corporates adopting a 'hub and home' model.

Regarding residential, unless operating/financing conditions change materially, the broker thinks the backdrop is positive for the likes of **Stockland** ((SGP)) and **Mirvac Group** ((MGR)). Both are rated by the broker as Overweight with price targets of $5.00 and $3.30, respectively.

The survey confirms that the strong market momentum in 2020/21 is driven by underlying demand, rather than government stimulus, paving the way for further growth in FY22. Of buyers surveyed, 30% want to purchase within the next 12 months, up from 21% in Morgan Stanley's 2020 survey. Whilst this is not as high as the peak of last cycle (38%, in 2017), it does indicate that the market is back to a 'normalised' level.

In terms of product preferences, there is a strong movement towards land and apartments, and away from established detached dwellings, suggesting affordability is a key consideration. This plays into the strengths of Mirvac and Stockland.

The broker notes the bounce-back is still largely driven by owner-occupiers, rather than investors. Of the respondents who said that they intend to purchase within the next 12 months, 57% were intended owner-occupiers, versus 43% investors. This split is in line with 2020 responses.

Morgan Stanley is cautious on retail REITs in general, but has an Underweight rating on **Vicinity Centres** ((VCX)) and **GPT Group** ((GPT)), due to 40%-50% of their retail portfolio being exposed to malls in the greater Melbourne area. Extended lockdowns may have altered consumers' shopping habits, or at least mean the recovery period will take longer than for other states.

In the survey, a higher proportion of Victorians now intend to shop online 'significantly more', or 'some more', in a post-covid world compared to other states. This was across all categories including homewares, fashion and electronics. The current NSW mobility restrictions, however, pose further downside risks to all retail landlords.

An increase in online shopping will have the potential to impact leasing spreads across the retail REITs upon the expiry of each lease. As such, whilst covid-related relief deals may have only been temporary, it could be some years before rental income reverts to pre-covid levels for the landlords.

Morgan Stanley estimates it could be three years before GPT Group, Vicinity Centres and **Scentre Group's** ((SCG)) retail income gets back to pre-covid (ie FY19) levels. And even then, rental receipts would still be -10%-15% below the pre-covid trajectory, assuming income would have grown at 2.5% per year.

The broker lifts its GPT Group price target to $4.70 from $4.37, largely due to bringing the REIT's office assumptions into line with the other office owners under coverage. The analyst's target prices for Vicinity Centres and the Underweight-rated Scentre Group are both unchanged at $1.59 and $2.98.

Small-cap defence sector: Two top picks

Citi recently reviewed pertinent news items and forecasts leading into the reporting season for its two top picks in the small-cap defence sector. **Austal** ((ASB)) is number one, followed by **Electro Optic Systems** ((EOS)).

The broker forecasts FY21 earnings (EBIT) of $112m (consensus $118m) for Austal, which is at the lower end of the guidance range. Should the Australian government waive penalties related to delays in the Cape Class program, given force majeure circumstances, there could be upside to these forecasts.

It's believed the company could use its strong cash position to either pursue acquisitions, continue investing in existing facilities, pay down debt or pay dividends. A final FY21 dividend of 3.5 cents is expected. The broker has a Buy rating and $3.35 target price for the company.

Recent news articles indicate Australia plans to domestically manufacture guided missiles in collaboration with the US, with the federal government initially investing $1bn on the plan. This could provide Electro Optic Systems with a potential opportunity to leverage its laser technology for guided missiles. Citi notes the company's recent success with high-powered lasers.

The broker forecasts first half earnings (EBIT) of $3m, excluding foreign exchange and interest income, which compares with a -$16m loss a year ago. Over FY21, earnings of $5.5m are forecast, in-line with the mid-point of guidance and broadly consistent with consensus.

The company is expected to have $79m net cash (excluding leases) at the end of the first half. Over FY21, the analyst expects the cash position to improve further driven by conversion of contract assets, and the delivery of remote weapon systems to the Australian Defence Force.

Cit currently has a Buy rating and $5.15 target price for Electro Optic Systems.

Citi's bullish global fertiliser outlook

Citi has maintained its bullish view on the global fertiliser outlook. So far, urea prices are up around 90% year-to-date, diammonium phosphate (DAP) is up circa 50% and potash is up 40%, driving fertiliser and explosive prices. Furthermore, on the fertiliser feedstock side, Citi has raised natural gas price forecasts in all major regions.

Incitec Pivot ((IPL)) remains highly leveraged to fertiliser prices and explosives volumes and Citi lifts its 12-month target price to $3.00 from $2.90. The broker upgrades FY21 and FY22 earnings (EBITDA) by 15% and 4%, primarily driven by sustained elevated ammonia spreads (ammonia – gas price). Citi expects these higher spreads should drive upgrades in FY21/22 consensus earnings.

Compared to the first half, Australian dollar DAP and urea prices are up around 50% and 60% with the Australian dollar-based US ammonia gas spread up around 80%.

A key risk to the broker's Buy call is the operational recovery path at the underperforming US Waggaman ammonia plant.

For **Orica** ((ORI)), the broker believes the impact is mixed and leaves both earnings estimates and its $15.40 target price unchanged, given ammonium nitrate volumes are ticking up, while the price remains subdued.

Both Orica and Incitec Pivot have significantly underperformed North American peers on a six and twelve month basis.

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

RUDI'S VIEWS

Rudi's View: Is Risk-Off The Message?

In this week's Weekly Insights:

-Is Risk-Off The Message?
-Conviction Calls
-Research To Download

By Rudi Filapek-Vandyck, Editor FNArena

Is Risk-Off The Message?

It wasn't that long ago when share markets were dominated by the view that everything old was to become new again, with economic growth and inflation on the rise fueling predictions of much higher bond yields and the swift return of 'value' stocks and cyclicals while Quality and Growth were deemed grossly overvalued, poised for a big punishment to the downside.

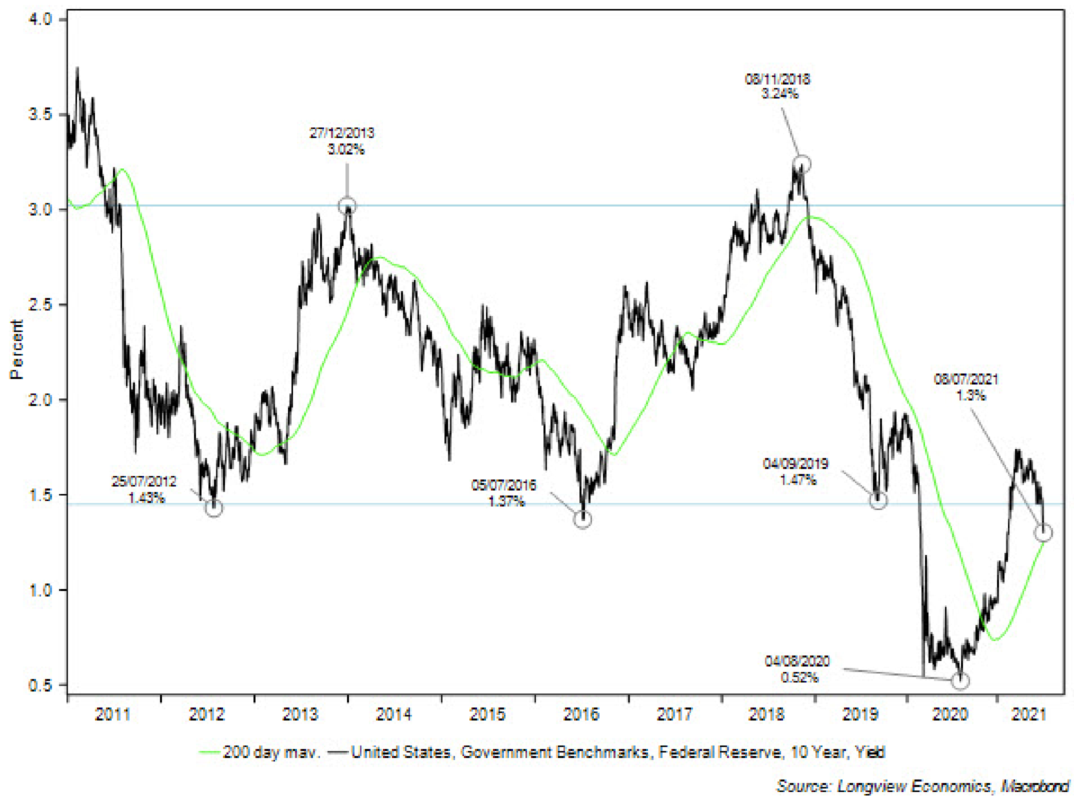
That's not the scenario we have seen unfolding post-March.

Throughout at times excessive volatility, the 2021 whiplash market has directed underlying momentum back towards Quality, Growth and steady defensives, severely testing the conviction and resilience of those who went all-in with the previously so popular reflation trade.

Ten-year government bond yields should have been well on their way to 2% by now but instead they fell to 1.25% in the US last week and remain well below 1.50%. As bond yields remain the primary driver behind the direction of other markets, including FX and equities, it goes without saying the non-compliance of bonds has triggered heavy debates around the world about what exactly is going on.

Below are the views and assessments of some experts who never bought into the majority view that dominated financial markets earlier in the year. Given these alternative views have proved correct to date, investors, at the very least, might want to consider their merits and validity in light of recent market moves.

US 10-year bond yields shown with key support levels



David Rosenberg: Tell'm They're Dreaming!

David Rosenberg, nowadays running his own research and consultancy firm Rosenberg Research, believes today's Grand International Debate merely reflects how economists and market participants get lost in tiny details that will lose all significance in due course. Instead, Rosenberg suggests, investors should focus on the bigger picture: what is the bond market telling us?

Nothing is more liquid than US treasuries, Rosenberg points out, adding: no other security than the long bond contains all the information investors need to know about inflation, growth and fiscal policy. The issue is therefore not whether bonds are "expensive", or in a "bubble", or short term overbought/oversold, et cetera; instead investors should listen to the message the bond market is signalling.

Despite many attacking central bank policies for distorting bonds and other asset markets, Rosenberg points out recent history shows bonds continue to provide important signals for investors. This signalling was as valid early in 2021 as it is today. That should be the focus for investors, not whether bonds should be lower/higher or precisely where they are trading today.

Needless to day, the bond message has changed.

Rosenberg believes the updated message is that inflation expectations have peaked. The new concern should be about economic growth, corporate margins and further growth in profits. If the bond message is correct, the Federal Reserve won't be talking about raising interest rates anytime soon, and neither will the rest of the world.

Rosenberg observes that while everybody is watching the ten-year moves, and debating its drivers and consequences, the 30-year treasury ("long bond") last week broke below its 200-day moving average at around 1.96%. While the 30-year yield has slightly recovered since, he reminds everyone the last time the US long bond made a similar move was back in 2018, prior to the -20% correction in US equities that followed. In mid-March, the long bond yield rose to near 2.50%.

But what about the double-digit GDP growth number many are predicting for the fourth quarter?

Rosenberg's analysis suggests economic growth and data have been propped up by government stimulus and support programs. Keep your focus on recent surveys and data and it should be obvious economic momentum the world around is decelerating, and that was already happening even before further setbacks in the fight against the virus announced themselves (like the lockdown in NSW).

Growth in core retail sales has been negative in the US in April and May, while sales of cars are deflating too, and so are mortgage loan applications.

Rosenberg: "*Housing and autos typically lead economies in the early parts of recovery as pent-up demand gets filled. But because of the bizarre nature to this pandemic-related disturbance, these areas have already peaked out and rolled over. Now we have a restaurant/theme park/entertainment/hotel/casino/air travel led economy - good luck with this because it is only 4% of GDP. The stuff that has peaked out already is four times bigger*."

If Rosenberg's assessment proves correct, equity markets could be facing a nasty correction with current overvaluation estimated at 25%, or more. The current market consensus is too sanguine on further margin increases, he believes.

Hoisington: We're Trapped!

Hoisington Investment Management Company is a US specialist on US treasuries. Its quarterly reviews are read by many in the industry. Hoisington's core assessment remains that excessive debt is changing economies and the impact from central bank and fiscal policies.

Recent Quarterly Letters: https://hoisington.com/economic_overview.html

Hoisington's assessment is probably best summarised as: too much debt cannot be resolved by adding more debt. The short-term positive impact of ever more debt reduces noticeably, creating a debt trap that forces over-indebted countries into a low growth environment. Hence, while growth, inflation and bond yields can certainly rise for brief periods, the bigger trend will eventually exert itself.

The only way to resolve the debt trap is through austerity, believes Hoisington, but modern day society won't allow it, so there is effectively no way out.

"*Thus, while long Treasury yields can increase over the short run, the fundamentals are too weak for yields to stay elevated. More debt does not cure a subpar economy mired in a debt trap. [...] our view is that the trend in long-term Treasury yields remains downward.*"

Longview Economics: Risk-Off Period Ahead

While not necessarily in agreement with the above mentioned topics, economists at **Longview Economics** equally believe global bond markets are likely signalling a period of risk-off is approaching for global equities. Their immediate framework for an historical reference is also the second half of 2018.

On Longview's assessment, the current reversal in government bond yields can be explained via:

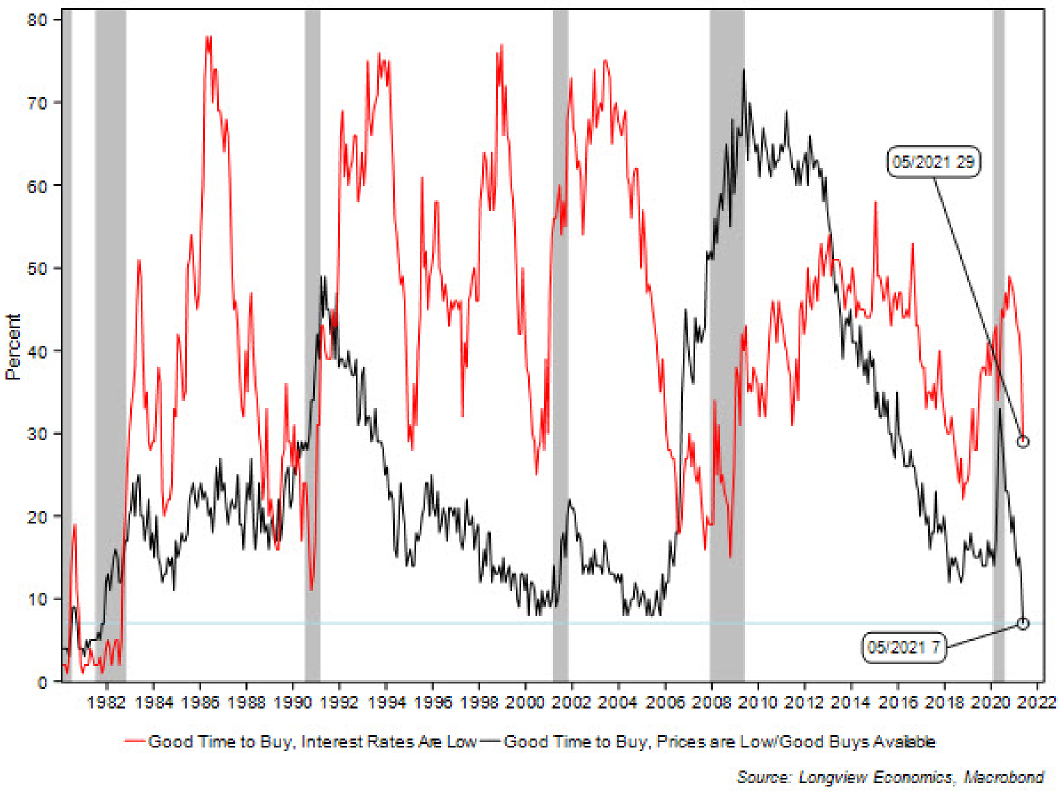
1. technical factors (such as large portfolios rebalancing)
2. economic factors (momentum is slowing)
3. liquidity factors (banks are buying bonds with excess cash, including from overseas)
4. imminent start of Fed tapering (history shows tapering or ending QE leads to lower ten-year bond yields and a flattening yield curve)
5. China representing rising risks (yields have risen on China's high yielding corporate bonds)

Among the technical factors identified by Longview Economics is the observation that bonds became deeply oversold in February/March with investor sentiment having turned excessively bearish. History suggests it can take between 9 and 12 months for markets to unwind and before yields can start rising again, reports Longview.

This implies lower yields might stay with us for at least another quarter, and potentially for the remainder of the year.

Longview also notes housing is "pausing" in the US, seen as a primary reason why bond yields need to soften in order to re-stimulate the US housing market later on.

US Michigan homebuying conditions (index) – reasons good/bad time to buy



Longview believes the long term trend in bond yields is now 'up' and the current moves are simply part of the inevitable counter-trend; nothing goes up in a straight line.

When it comes to US and global equities, Longview has recently adopted a more cautious stance (though not yet negative). The forecaster believes general complacency is dominating the investor community, also reflected in the observation that nobody seems to be genuinely bearish equities these days.

Longview's proprietary global volatility indicator is at its lowest since February 2020 while a number of market indicators might be suggesting a pullback is forthcoming. The recent rally's lack of breadth is seen as yet another possible omen.

Conviction Calls

Morgan Stanley's research into **Global Best Business Models** could be described as an alternative version of my personal research into All-Weather Stocks (*) but then there are sufficient differences in both approaches to declare such direct comparison a little bit of a stretch.

Morgan Stanley tries to identify those companies that represent the highest quality in a given sector, including an assessment of whether the share price is somewhat attractively priced as well. Selection involves a plethora of fundamental filters, including ESG. It is the analysts' view that owning such companies should always be done with a two-year horizon in mind, at a minimum.

The difference in basic approach shows itself via the three ASX-listed entities that made it to the global selection in early January this year: Macquarie Group ((MQG)), BHP Group ((BHP)), and Sonic Healthcare ((SHL)). They are accompanied by the likes of Adobe, Apple, Amazon, Ball Corp and Crown Castle in the US; Akzo Nobel, ASML Holding, Evolution AB, Ferrari and Nestle in Europe; as well as Chugai Pharmaceutical, Fast Retailing and Samsung Electronics in Asia.

The average performance of "Global Quality" has failed to keep pace with general indices over the first six months of 2021 but then this should hardly come as a surprise. The calendar year started off with an unrelenting focus on cyclicals and share market laggards, even though this group of stocks has found the going a lot tougher during the second quarter.

In the long run, the team at Morgan Stanley reports, a basket of Global Quality stocks outperforms the broader market by some 2.2% annually, but thus far in 2021 the comparison with the MSCI ACWI shows a -2.8% relative underperformance. Of the 41 selected stocks, 22 outperformed while 27 generated a positive return over the period.

This still leaves 14 stocks with a negative return to date and 19 stocks underperforming.

Morgan Stanley remains optimistic noting, on an equally weighted basis, there should be 13% upside for the selection, which is trading on an average forward looking Price-Earnings (PE) ratio of 26x, with average return on equity (RoE) of 31.3% and a dividend yield of 1.8%.

(*) Paying subscribers have access to my research into All-Weather Stocks via a dedicated section on the website

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Share market experts at **Morningstar** remain of the view Australian shares are, broadly taken, some 15% overvalued, even with an economic recovery that is occurring more quickly and with more gusto than previously anticipated. The sole exception is the local energy sector which Morningstar finds is some -20% undervalued.

Morningstar does believe there remain pockets outside energy in the domestic market that are still good value. Morningstar analysts have identified 30 stocks -**Top Picks**- for the year ahead:

-In Basic Materials: Orica ((ORI)), Nufarm ((NUF)), and Newcrest Mining ((NCM));
-Communication Services: Southern Cross Media ((SXL)), TPG Telecom ((TPG)), and Sky Network Television ((SKT));
-Consumer Discretionary: Myer ((MYR)), G8 Education ((GEM)), and InvoCare ((IVC));
-Consumer Staples: Endeavour Group ((EDV)), Blackmores ((BKL)), and a2 Milk ((A2M))
-Energy: Woodside Petroleum ((WPL)), Beach Energy ((BPT)), and Whitehaven Coal ((WHC));
-Financial Services: Westpac ((WBC)), Challenger Financial ((CGF)), and Magellan Financial ((MFG));
-Healthcare: Australian Pharmaceutical Industries ((API)), Avita Medical ((AVH)), and CSL ((CSL));
-Industrials: Brambles ((BXB)), Cimic Group ((CIM)), and Aurizon Holdings ((AZJ));
-Real Estate: GPT Group ((GPT)), Ryman Healthcare (RYM on NZX), and Lendlease ((LLC));
-Technology: TechnologyOne ((TNE)), Computershare ((CPU)), and Link Administration ((LNK));
-Utilities: Spark Infrastructure ((SKI)), APA Group ((APA)), and AGL Energy ((AGL))

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Analysts at **Bell Potter** also released their **stock picks for FY22**:

-Among LICs: WAM Alternative Assets ((WAM)), MFF Capital Investments ((MFF)), and Ellerston Asian Investments ((EAI));
-Agricultural & FMCG: Elders ((ELD)), Bega Cheese ((BGA)), and a2 Milk;
-Technology: Nitro Software ((NTO)), Life360 ((360)), and Adacel Technologies ((ADA));
-Discretionary Retail & Professional Services: City Chic Collective ((CCX)), InvoCare, and Propel Funeral Partners ((PFP));
-Industrials: Imdex ((IMD)), Mader Group ((MAD)), Emeco Holdings ((EHL)), Money3 ((MNY)), ikeGPS ((IKE)), Flight Centre ((FLT)), and Rhipe ((RHP));
-Engineering & Construction: Monadelphous ((MND)), Lycopodium ((LYL)), and GR Engineering Services ((GNG));
-Healthcare: Avita Medical, Kazia Therapeutics ((KZA)), Mayne Pharma ((MYX)), Immutep ((IMM)), Genetic Signatures ((GSS)), Mesoblast ((MSB)), Aroa Biosurgery ((ARX)), Imricor ((IMR)), and Alcidion ((ALC));
-Resources & Precious Metals: Nickel Mines ((NIC)), Aeris Resources ((AIS)), and Regis Resources ((RRL));
-Energy: Cooper Energy ((COE)), Central Petroleum ((CTP)), and Beach Energy;
-Strategic Minerals: Alpha HPA ((A4N)) and Agrimin ((AMN));

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The research team at **Canaccord Genuity** published its selection of **Top Australian Stock Picks for the September quarter**. Canaccord specialises on small and micro cap stocks in the Australian share market, hence investors should not be surprised to spot a few names they might not have heard about before today:

Canaccord's selection consists of 23 ASX-listed stocks:

-DDH ((DDH))
-MacMahon Holdings ((MAH))
-Ardent Leisure ((ALG))
-Ricegrowers ((SGLLV))
-DGL Group ((DGL))
-Electro Optic Systems ((EOS))
-Fleetwood ((FWD))
-Trajan Group Holdings ((TRJ))
-Calix ((CXL))
-Secos Group ((SES))
-Adriatic Metals ((ADT))
-Bellevue Gold ((BGL))
-Boss Energy ((BOE))
-Orocobre ((ORE))
-OZ Minerals ((OZL))
-Perseus Mining ((PRU))
-Betmakers Technology Group ((BET))
-Elmo Software ((ELO))
-GTN ((GTN))
-MNF Group ((MNF))
-Praemium ((PPS))
-Uniti Group ((UWL))
-OFX Group ((OFX))

Research To Download

Independent Investment Research (IIR) on MA Secured Real Estate Income Fund:

https://www.fnarena.com/downloadfile.php?p=w&n=F367B30B-C960-846E-FB960C29FDFFCA4B

Independent Investment Research (IIR) on KKR Credit Income Fund ((KKC)):

https://www.fnarena.com/downloadfile.php?p=w&n=F35DFB68-94F5-2E7C-8E2F96679F49628B

(This story was written on Monday 12th July, 2021. It was published on the day in the form of an email to paying subscribers, and again on Thursday as a story 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. 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).

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- 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

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