Week

25

Stories To Read From FNArena

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Momentum Accelerates For A2 Milk

A2 Milk is becoming a global nutritional dairy provider and increased production, still barely keeping up with orders, is considered a sign of unrelenting demand.

-Strong trading leads to increased FY17 revenue guidance -Risks of competition moving in heightened with shortage of stock -Expansion in the US fresh milk market a catalyst in the next 12 months

By Eva Brocklehurst

A2 Milk ((A2M)) is placed in the enviable position where product is moving out of the company's store room as fast as it is being produced. Demand for the a2 Platinum brand continues to exceed supply and the company is upgrading revenue guidance to NZ$545m for FY17, which suggests around 55% growth on the prior year.

UBS recently downgraded the stock to Neutral and retains this rating based on the strong share price performance and risks regarding the Chinese Food & Drug Administration's infant formula registration process. The broker believes there is increasing risk that the a2 Platinum brand may not be registered in time for the new regulations.

The company previously stated it expected Synlait Milk ((SM1)), a supplier of raw milk, to lodge its application with the CFDA by the end of May but this appears to have been delayed. UBS expects a small delay beyond January 1, 2018, when new regulations are due to be implemented, would not have material impact on a2 Milk, as other channels would likely take up the slack, but an extended delay may damage the brand's standing with Chinese consumers.

Citi estimates the revenue upgrade will equate to an upgrade to earnings per share of around 10% after taking into account that infant formula gross margins are higher than the company average and there is a reduction in marketing costs.

The broker believes the reduction in marketing expenditure, which has been flagged at around NZ$5m, is sensible in the short term because the company is short on stock, but would like marketing to increase to ensure the company builds a long-term sustainable business in China. Citi believes the the best time to be ramping up marketing in China is ahead of the CFDA-led brand rationalisation that commences in January.

The broker envisages risks to the sustainability of growth rates for monthly sales, which are up 18% in the June quarter versus the prior quarter, given prolonged periods when shortage of stock may lead to existing consumers switching to competitors and new consumers commencing with competitor brands.

In order for the broker to become more positive on the stock comfort is required regarding the margin outlook, as the company moves to a direct and sustainable model. The broker also envisages downside risks to a2 Milk for the Lion court case, regardless of the outcome, given the potential for negative press coverage. There is also the potential for competitor Bellamy's Australia ((BAL)) to get back on track later this year.

Catalysts

UBS forecasts cumulative investment in the US to be US$56m over 2015-19 and does not expect new "a1-free" competition to materially affect growth over the medium term. Nevertheless, this needs to be monitored as the company expands on the US east coast and patent protection rolls off.

Bell Potter envisages scope for further value creation from any sign the company's products are gaining traction in the US and UK fresh dairy markets, noting the stock is trading at around a -5% discount to its peer group, based on FY18 operating earnings forecasts.

The broker, not one of the eight monitored daily on the FNArena database, upgrades to Buy from Hold and raises the target to $4.22. Bell Potter upgrades profit forecasts by 11% for FY17, 21% for FY18 and 16% for FY19. These upgrades to FY18-19 reflect increased optimism the company can sustain around a 30% market share in a domestic infant formula category with re-worked supply agreements with Synlait Milk.

Increased production and delivery of infant formula to distributors is a sign of ongoing strong demand and an indication that the economic incentives remain attractive to channel partners, Credit Suisse believes. The broker notes a2 Milk has successfully capitalised on the emergence of the daigou in China and cross-border e-commerce. as well as some of the mistakes made by competitors in the marketplace.

Despite the product shortage, and a risk that end-customers may permanently abandon the company's product, there are no signs from sales momentum this is the case. In contrast, Credit Suisse notes a2 Milk appears to be gaining rather than losing momentum.

In evidence, the broker cites overall volume for all infant formula brands sold by retail channels in Australia appears to be down around -5% over the past year while, on its forecasts, a2 Milk sales volumes across all channels are projected to rise by 80% in FY17. By default, the company seems to be gaining share at the expense of other brands in Australia.

Credit Suisse believes the risk to the company's gross margin in FY18 is to the upside, as costs for one of the primary inputs for infant formula appear to have receded from the high levels witnessed at the beginning of this year. While not a base case, should the company continue to take share in a Chinese market that is projected to grow at 5-10% per annum, and lift overall sales to 45,000 tonnes of infant formula by FY2025, this would imply a lift in the broker's spot valuation to NZ$5.10 from NZ$4.09.

Key Products

The company sells branded dairy and infant formula product in Australasia, China, the US and UK. The milk contains only a2 protein rather than both the a1 and a2 proteins which are found in regular cow's milk and the company targets food markets where a premium can be generated.

A2 Milk's hypothesis rests on the single a2 protein and the benefits claimed for digestion, coupled with a suite of patents and trademarks, which have provided a marketing platform for premium-priced differentiated products. Credit Suisse retains a positive view on the stock based on the successful rolling out of these dairy products globally. The key is a successful management of channels to market and regulatory changes, and risks that come with exposure to the agricultural supply chain.

Moreover, the company and its strategic suppliers require certain licenses, approvals and consents in order to conduct business. At this stage no material changes in China's laws are expected but there remains the risk these could have a detrimental impact on the level of sales of Australian infant formula. UBS also believes the key near-term risk is a potential for de-stocking of infant formula in China in the lead up to CFDA registration.

There are three Hold ratings on FNArena's database and one Buy (Credit Suisse).

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InvoCare's Attractive Fundamentals Prevail

Funeral services provider InvoCare offers attractive operating metrics. Bell Potter initiates coverage on the stock.

-Investing capital to protect network and market share -Attractive fundamentals support organic revenue growth

By Eva Brocklehurst

Funeral services provider InvoCare ((IVC)) is continuing with its strategy to invest capital to protect its network and stem market share losses going forward. The company's plans for growth are important as it cannot rely on acquisitions, given likely competition restrictions, as it has done in the past.

While market fundamentals remain the primary driver for growth, the extent of the stock's performance is likely to rely on the success of its "Protect & Grow-2020" plan, Bell Potter suggests. This plan is a $200m investment, announced at the beginning of the year, which includes a refreshing of both old sites and expenditure on new sites. The expenditure is planned over four years.

While most brokers expect this plan will limit short-term earnings growth it should be supportive of longer-term revenue. Morgan Stanley has flagged the additional capital expenditure is expected to return the business to sustainable double-digit growth in earnings.

The main positive aspect of the stock, for brokers, is the attractive fundamentals of the industry, which has helped the company achieve consistent organic revenue growth since it listed. Revenue is supported by providing funeral and related services, which are less affected by economic cycles.

The company also stands to benefit from a positive long-term trend in the number of deaths resulting from an increasing and ageing population. InvoCare operates in Australasia and Singapore and provides a complete offering, including funeral directing, crematorium, cemetery operation and related services.

Bell Potter observes the operating metrics are attractive, as returns-on-equity and returns-on-invested-capital are around 25% and 14% respectively, along with 100% gross cash conversion. These features support a high dividend pay-out ratio.

The broker, not one of the eight monitored daily on the FNArena database, initiates coverage on the stock with a Hold rating and $14.30 target. While Bell Potter has a positive view on the business it believes the stock is trading at fair value currently. Moreover, InvoCare also recently lost 90 basis points in market share which the broker would like to see stabilise.

Most brokers on the database suggest the stock may be defensive but its current valuation limits the upside, in the absence of earnings surprises. There are two Buy ratings on the database, two Hold and three Sell. The consensus target is $13.39, suggesting -9.0% downside to the last share price. Targets range from $11.50 (Citi) to $15.50 (Morgan Stanley). The dividend yield on FY17 and FY18 in forecasts is 3.0% and 3.2% respectively.

Brokers Divided On QBE's Outlook

QBE has downgraded its expected returns from emerging markets in 2017 and brokers are divided about the outlook.

-Larger-than-expected claims and lower premium rates beset the company in Asia -Should the company shed more business? -Has the sell-off provided a buying opportunity?

By Eva Brocklehurst

QBE Insurance ((QBE)) has endured larger-than-expected claims in emerging markets, particularly in Asia, while crop insurance issues in Ecuador and the Chile business in the four months prior to sale have damaged 2017 forecasts. Lower premium rates have also beset the company in Asia. Meanwhile, the Australasian business is performing to expectations.

The company provided few indications about the business outside of the downgrades in the update, and beyond the fact that original guidance has been maintained when excluding emerging markets. QBE has signalled a 100 basis points drag on insurance profit because of poor claims experiences in emerging markets. There is a lack of offsetting gains elsewhere, which highlights ongoing earnings pressure, in Credit Suisse's view.

The broker suggests that, when premium rates are going down, it is very likely that underwriting profit margins are also declining. Hence, while risk claims and increased frequency in other issues arise that justify the downgrades, the fact that premium rates have declined -5-10% in recent years suggests the margin was bound to fall anyway.

As a result, the broker contends the drag on margins is an underlying issue, and not one-off in nature as has been suggested by some investors. Credit Suisse is also disappointed that improvements elsewhere in the business could not offset the pressure on margins and believes that obtaining improved returns will be difficult in a falling premium rate environment.

The company is targeting a combined operating ratio of 93% in 2018 and above a 10% return on equity. As Morgan Stanley calculates, with around 10% of the book underperforming by around -10% and driving a -1% hit to the combined operating ratio, the margin for error in guidance is disappointing.

In a complex global business the broker would have hoped for some countering factor and outperformance elsewhere in the portfolio, or self-help options, to soften the downgrade. Singapore and Hong Kong hubs are competitive markets where the company has been targeting growth, yet the company is seeking remediation of the issues in this region and Morgan Stanley also takes heart in the fact that the Latin American losses are non-recurring.

The Australasian backdrop is improving, a trough seems to be forming in the US and the broker finds Europe has a better outlook following Lloyds withdrawing 10% of capital. Hence, the outlook for QBE is more encouraging and Morgan Stanley retains a Overweight rating.

Divestments?

The company's probable option, in Credit Suisse's opinion, is to shed more business and take pain in the expense ratio. While the stock may be closing in on fair value, with earnings risk to the downside, the broker retains an Underperform rating.

UBS also expects the obvious questions around the quality of the portfolio will be posed after this downgrade, amid speculation as to whether further divestments are required. The broker suggests the market will be nervous about the company's ability to cover all its bases across a complex group and deliver on profit guidance.

Regardless, with improving market conditions across Australasia and greater stability in other major jurisdictions, the broker is not changing its overweight view on either the company or the sector. Deutsche Bank is not overly concerned by the impact of the downgrade and believes earnings volatility can be managed through active risk limits and risk diversification, processes which the company is currently undertaking.

The broker believes the fall in the share price goes well beyond the temporary nature of the downgrade and the market's reaction reflects a loss of confidence in management being able to manage a very complex business. Deutsche Bank notes the company is yet to start its buying back of shares and would expect the program to provide some support to the stock in the short term.

Value?

QBE has flagged that, excluding the downgraded items, interim insurance margins are expected to be 8.5-9.5%. Ord Minnett has an insurance margin forecast of around 8% for 2017 and retains its previous concerns about optimistic guidance on underlying margins but also, now, has concerns over emerging markets.

Shaw and Partners, not one of the eight stockbrokers monitored daily on the FNArena database, believes, while the downgrade is disappointing, the problems should be fixed in the medium term. While acknowledging the update is likely to raise questions of execution risk and the company's track record, the broker maintains a Buy rating and $14.17 target.

Another downgrade has delivered a blow to sentiment that has undermined whatever credibility management has re-built, Citi asserts. Consequently, although the stock appears to still offer value, it remains hard for investors to buy with conviction in the near term. The broker downgrades to Neutral from Buy.

Morgans goes the other way, upgrading to Add from Hold. While acknowledging the bumps on the road to recovery are annoying, the broker believes the drivers of the downgrade are largely one-off in nature and the sell-off in the share price overdone. Underlying business trends are expected to improve following the remediation work that the company has done recently. The broker accepts the stock is not a clean story but believes it offers relative value.

Macquarie considers the downgrade largely abnormal in nature, yet concedes underlying guidance appears softer relative to bullish consensus expectations, and the market will likely use the update as an opportunity to revise forecasts.

The broker believes the medium-sized risk claims in Asia are the core of the problem and concurs that the pricing environment in Singapore and Hong Kong remains competitive. Macquarie believes a discount valuation to peers is justified, given ongoing earnings certainty, but suggests the stock now presents an attractive longer-term value opportunity.

The database has four Buy ratings, three Hold and two Sell. The consensus target is $12.86, signalling 9.1% in upside to the last share price. Targets range from $11.32 (Ord Minnett) to $13.80 (Macquarie). The dividend yield in present FX values on FY17 and FY18 forecasts is 4.9% and 6.0% respectively.

Debate Grows Over Caltex Premium Fuel

An emerging debate among brokers regarding Caltex explores the trends in premium fuel consumption.

-Premium petrol volumes are softer in first half but is this a sign of a continuing trend? -Brokers await further details on strategy to offset loss of Woolworths contract -What if regular unleaded is banned in Australia?

By Eva Brocklehurst

For the first time Caltex ((CTX)) has reported declines in premium petrol consumption in the first half, while transport fuel margins have continued to expand despite subdued volumes. The company has guided to net profit for the half of $290-310m and marketing & supply operating earnings (EBIT) of $360-375m.

Morgan Stanley's suspicions on premium petrol consumption are confirmed with this first time ever decline in premium volumes and suspects higher prices and a slowing consumer sector are having an impact. Admittedly, this is offset by growth in premium diesel.

The broker's base case assumption is that premium petrol will gradually decline while premium diesel grows, although this could reverse over time as car manufacturing trends in Europe suggest diesel car demand peaked in 2012. The broker expects lower volumes will lead to modest and gradual pressure on prices over time for premium fuels.

Credit Suisse notes the concerns regarding premium volumes in the market but believes that while volumes maybe softening slightly, margins are compensating, bearing in mind that Coles ((WES)) has stepped away from discounting as well. Both Credit Suisse and Citi point to the continued rise in the proportion of premium fuels in the company's sales mix, irrespective of one fuel type experiencing a modest decline.

Yet, Morgan Stanley argues that over the past few years the company has done well selling premium petrol, and the volumes were always going to make it easier for retailers to pass on the premium margins. With early signs the price differential is starting to have an impact on consumption this should lead to greater price pressure over time, further aggravated by the risk from changes to fuel standards.

Citi brushes aside the negative assumptions finding no evidence as yet that the decline in premium petrol volumes, in isolation, is having an adverse impact on margins and believes it is premature to sound a warning on premium fuels.

The broker retains a Buy rating, which is not reliant on further premium fuels penetration, and suggests flat premium fuel volumes will continue, despite diesel surprising on the upside. Citi also believes the market is yet to give the company the benefit of the doubt about replacing lost Woolworths ((WOW)) earnings and the offsets should come from recent acquisitions and cost reductions, ultimately delivering earnings growth.

Woolworths Contract

The company has indicated it is working on a strategy to offset the loss of the Woolworths fuel supply contract by the end of the year. UBS notes recent acquisitions add $50m in operating earnings versus the $100-140m loss from the Woolworths contract.

This implies $50-90m of efficiency measures are required to fully offset the Woolworths contract. UBS incorporates cost reduction measures in its forecasts which are envisaged more than offsetting more modest fuel sales and retains a Buy rating on a positive outlook.

Ord Minnett maintains a Lighten rating because of a lack of valuation support, particularly given the capital intensity of the business and net debt, as well as the impact of the loss of Woolworths petrol volumes. The broker expects the loss of volumes will deliver a significant decline and reduced scale in Ampol Singapore for Caltex, estimating a reduction in operating earnings of $132.9m.

The broker supports the decision by Caltex to pursue a medium-term growth avenue in convenience and notes early signs at Foodary are positive, although execution risk remains elevated. The broker would be more constructive on the stock at a lower price, which provides valuation upside to the existing business and incorporates more of the downside risk from loss of Woolworths petrol volumes, or when greater confidence can be obtained on the convenience business.

Credit Suisse will welcome the update in August for an opportunity to obtain details of further cost reduction, growth opportunities and associated capital requirements. The broker continues to believe that transactions on almost all of the company's value chain support a break-up value estimate of around $50 a share.

Fuel Standards

Morgan Stanley flags two implications for Caltex from potential changes to fuel standards. Firstly, it will need to spend money to keep its Lytton refinery open, or spend more to convert it to an import facility. Secondly, Caltex has been making premium margins on premium fuels. If regular unleaded is banned in Australia it will become more difficult to maintain this margin over time.

There are five Buy ratings on FNArena's database and two Sell. The consensus target is $33.12, suggesting 5.1% upside to the last share price. Targets range from $27.00 (Morgan Stanley) to $39.70 (Credit Suisse).

Bright Outlook For Gold

Several analysts point out that the outlook for gold and, by association, gold stocks, is bright despite rising US interest rates.

-Demand in India and China rebounds sharply in recent months -Trend towards increased use of scrap gold reverses over past five years -Divergence in cash costs between USD and non-USD denominated companies

By Eva Brocklehurst

Gold retains a role as both an investment and defensive asset and analysts believe it will remain an important part of portfolios for both the private sector and central banks. Gold is a store of wealth in unstable times and such times prevail.

ANZ analysts expect increased political uncertainty in the US will support gold in the short term despite higher interest rates. Gold prices are forecast to push past US$1300/oz over the next 12 months and there are positive long-term prospects as well.

In the wake of the US Federal Reserve's recent increase to its Fed Funds rate, and if the three rate rises in the current cycle are anything to go by, Bell Potter also considers the outlook positive for gold. Typically, rising interest rates are considered negative for gold because of the increased opportunity cost of holding an asset with no yield. As the gold price is appreciating amid rising interest rates in the US this signals to the broker that both inflation and safe-haven trade are key themes in the gold market.

The ANZ analysts do not envisage rising US interest rates as a negative. Gold has rallied in all but one of the past seven rate-hike cycles since the 1970s. Gold has also outperformed when interest rates were increasing relatively slowly. Furthermore, the analysts believe, if the US political situation worsens this year, there is a possibility gold prices will breakthrough US$1300/oz. Safe-haven buying is a strong driver of investor demand and is usually sparked by macro shocks or political instability.

Emerging markets should drive demand for physical gold for some time and China and India are already the world's largest gold consumers. Demand in India and China has rebounded sharply in recent months and the analysts observe the issues around de-monetisation in India are abating, while there has been a sharp pick up in China's gold imports, which suggests previous constraints have eased.

Growth in salaries, automobile sales and passenger air travel in India is expected to support the country's gold market over the next year as India's gold demands tend to correlate with income growth. Gold holdings are also likely to increase at central banks and most of the future buying is expected from central banks in emerging markets as they move closer to developed world levels.

China is likely to dominate the recovery in the gold price as Asian financial centres open up and the ANZ analysts find no reason why Shanghai should not become a major centre for gold trading, provided the appropriate institution and legal reforms take place. Asia is expected to account for over half of the global economy by 2050.

Supply

On the supply side prices are supported by the fact that gold mines cannot expand rapidly. Gold production has risen by an average of just 0.9% since 1995, year-on-year. Mine supply remains the primary source of gold and the trend towards increasing use of scrap has reversed over the past five years. New gold in total supply rose to over 70% in 2016.

Those countries driving the growth in the primary source of gold are ones best place to do so in the future, the analysts assert. Gold reserves are concentrated, at around 70%, in just 10 countries and Australia and South Africa have the largest unmined reserves. Meanwhile, scrap supply is volatile and the extraction from recycled electronics costly, so scrap gold is heavily influenced by both the price of gold and economic cycles.

As the ASX gold index is now down -3% year-to-date, Bell Potter believes the best performances are being driven by company-specific catalysts among the single-mine producers and successful explorers. The broker observes, while the gold price has not cracked US$1300/oz yet, it has established a pattern of higher lows and higher highs.

With a relatively steady exchange rate the Australian-dollar gold price has followed a similar track. The broker also believes relative outperformance of equities versus gold bullion is an indicator of positive sentiment.

Meanwhile, the costs associated with gold mining have fallen globally by around 15% over the past three years. Most of the reductions have been made in operating or production costs. The biggest cost reductions have been experienced in Australia, the ANZ analysts observe, where total cash costs have declined an average -30% since 2012.

Two factors, exchange rates and oil prices, have helped drive costs down and the analysts estimate around 60% of gold mining costs are based in local currency terms and around 10-12% related to oil prices. Indonesia, South Africa, Australia and Canada appear to have been the biggest beneficiaries in this regard.

Divergence In Cash Costs

Citi has highlighted a divergence between the cash costs of US dollar-denominated and non-US dollar-denominated companies. South African gold producers, in particular, have sustained all-in cash cost hikes of 16% while those of US dollar-denominated companies declined by -2.7%. Citi expects that a strengthening South African rand will continue to put pressure on South African gold stocks as will rising capital and exploration expenditure.

The broker expects costs in the industry to rise this year as years of under-investment unwind, especially if a stable, or higher, gold price prevails. Citi believes consensus expectations do not appropriately reflect the rising costs and maintains a bearish view on the sector, particularly South African gold stocks.

Based on recent changes to the underlying MVIS Junior Gold Miners index and significant changes to the GDXJ methodology in the US, Macquarie expects the main impact will be on North America markets. Yet, key beneficiaries in the Australian context are Newcrest Mining ((NCM)), Evolution Mining ((EVN)), Northern Star ((NST)) and OceanaGold ((OCG)).

These stocks have been are seen returning to the index as the eligibility band is widened. Smaller stocks are expected to suffer as a result of the re-balance. Macquarie believes investors should keep buying quality in good jurisdictions where there are cornerstone assets.

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.

Lithium Coverage Broadens, Outlook Mixed

Brokers have recently broadened coverage of the lithium sector and modified price assumptions as demand for the material continues unabated. Yet the road from production to end-use is not straightforward.

-Australia's spodumene suppliers likely to fill near-term deficit in the market -Pressure on lithium pricing suspected later in 2017 -Production problems and technical issues mean supply may not be consistent

By Eva Brocklehurst

Lithium is mineral on everyone's lips these days, along with graphite and cobalt. Brokers have recently pushed through modified price assumptions and industry outlooks, as demand for the materials, which are critical to the revolution in electric vehicles and big storage batteries, continues unchecked. However, producing the material and converting it to a form suitable for end use is not straightforward.

Macquarie upgrades its expectations for lithium and cobalt prices in the longer term and delves into the implications for several Australian stocks. While maintaining its estimates and Neutral rating for key lithium producer, Orocobre ((ORE)), Macquarie upgrades Pilbara Minerals ((PLS)) and Galaxy Resources ((GXY)) to Outperform and Altura Mining ((AJM)) to Neutral.

The broker does not expect Pilbara's Pilgangoora concentrate project to be in full production until FY19, although earnings are expected to start flowing in FY18. Earnings estimates for Galaxy are unchanged because of the contract nature of its sales. Galaxy recently recommissioned its Mt Cattlin mine in Western Australia, which is expected to produce around 160,000t of spodumene (hard rock) in 2017/18.

Citi assumes coverage of Pilbara Minerals with a Buy/High Risk recommendation and Galaxy Resources with Neutral/High Risk. By 2023, the broker estimates each will contribute around 11% of global supply of lithium. Macquarie prefers hard rock projects over brine developments and in this analysis increases the discount applied to Galaxy's Sal De Vida project, which results in a -8% reduction to the target price.

The broker also reverts to an equity share valuation for Neometals ((NMT)), given the failed sale of its 13.8% stake in the Mt Marion lithium project, 43.1% owned by Mineral Resources ((MIN)). The broker maintains its Outperform recommendations for graphite producers Syrah Resources ((SYR)) and Magnis Resources ((MNS)).

UBS also recently initiated coverage on Galaxy, Orocobre and Syrah Resources and believes Syrah offers a unique proposition in being both the largest and most advanced new entrant to the flake graphite market. The broker notes Orocobre's execution at Olaroz has not been without incident and future expansions are unlikely to be without delays.

Despite the operating risks in Orocobre's lithium brine processing, UBS highlights the stock is one of the few new entrants with a producing asset, which could mean it benefits from an interim shortfall in supply more readily than earlier-stage peers.

In the meantime, with a shortfall of hard rock supply, Galaxy should also benefit from spodumene concentrate prices. Nevertheless, with a number of new competitor projects under construction the broker envisages the heightened lithium concentrate price is likely to be short lived.

Price Outlook

The basis for Macquarie's upgrade to lithium and cobalt price forecasts is a belief that increased electric vehicle production in China, based on the recently-announced credit system, will continue to drive demand in the medium term. The broker is more cautious about policy translating immediately to Chinese consumer uptake but, in conjunction with a slower ramping up of new projects, envisages a supply deficit extending into the early 2020s.

Australia's spodumene sector is the most likely source to fill the deficit, in the broker's opinion. Chilean brine production is trending sideways and there is little in the way of expansion in the near term.

Meanwhile, ramping up of new supply at Australia's Mt Marion and Mt Cattlin have been slower than anticipated, as technical difficulties at the mines and the issues surrounding integrating new concentrate feed into existing conversion capacity continue. These are expected to be overcome in time.

Macquarie believes lithium pricing has the potential, when fed through Chinese conversion facilities, to push the top end of the cost curve higher. As Australian lithium output is almost doubling this year the broker expects pressure on pricing into the second half and estimates December quarter prices at around US$8000/t versus the US$10,900/t witnessed in the current quarter.

Cobalt continues to surprise to the upside in terms of pricing and the broker raises its forecasts for this year by 20% to US$25/lb and 2018 forecasts by 11% to US$20/lb. The broker also raises its long-term price by 32% to reflect the lack of high-quality projects that are needed to balance the market.

Citi describes the lithium market as a wrestle between strong demand growth and a building wave of supply from existing and new producers. Spodumene projects have lower capital expenditure and shorter lead time to production and are expected to capture an increasing share of the market in the near term. But longer term these projects are at risk from the lower-cost brine projects.

The broker expects increased supply to cool lithium prices towards a long-term rate of US$7500/t for lithium carbonate and US$550/t for spodumene. The emergence of DSO (direct shipping ore), the broker suspects, is opportunistic, as at current prices it is economically viable to ship unprocessed ore to China from Australia. The broker believes this is not a structural market threat, as the economics do not work at its long-term price forecasts over a five-year period.

Citi is cautious and suspects the wave of supply that the spike in lithium prices encouraged has the potential to overwhelm demand growth, even if it continues to surprise to the upside. While delivery on projects may disappoint relative to expectations, the performance of Galaxy and Pilbara will be critical for absolute and relative performance.

Deutsche Bank believes it will take time for the DSO product to work its way through the Chinese supply chain and may not affect pricing until the December quarter. The broker currently forecasts Chinese battery grade prices of US$17,000/t for lithium hydroxide and US$15,000/t for lithium carbonate by the year, around -25% below spot pricing.

Canaccord Genuity has noticed a recent sell-off among several ASX-listed lithium companies amid fears of an oversupply from DSO. The broker believes these fears are significantly overstated. There are significant economic and technical reasons as to why the material is unlikely to present a meaningful, or sustainable, supply.

The broker, not one of the eight monitored daily on the FNArena database, reiterates its Buy calls for both Galaxy and Orocobre, maintaining a Speculative Buy rating for Altura.

What is DSO?

The concept of lithium DSO is based on the mining and crushing of lithium-bearing pegmatite ore before transporting it to China. The material is then concentrated before being delivered to mineral converter plants and made into either lithium carbonate or lithium hydroxide.

Canaccord Genuity estimates the production cost for lithium carbonate from DSO sources is around US$14,300/t, affording less attractive margins for converter plants based on current pricing. Hence, the broker envisages little incentive for converters to resort to DSO-sourced concentrate as an alternative feedstock despite its apparent availability.

Moreover, the broker suspects a considerable bottleneck will occur, given a lack of adequate converter capacity to handle large volumes of concentrate produced from DSO. Other key considerations include the disposal and storage of large volumes of waste material produced from the concentration process.

See also, Wodgina Boosts Mineral Resources' Lithium Stakes on June 13, 2017.

Material Matters: Gold, Oil, Coal & Iron Ore

A glance through the latest expert views and predictions about commodities. Gold stocks; oil; coal; and iron ore.

-UBS forecasts company-specific catalysts to drive gold stocks -Oil inventories may not reach five-year average -Coal supply to lift in 2018 and demand expected to shrink -Bearish outlook for iron ore prices

By Eva Brocklehurst

Gold Stocks

UBS observes the three main ways to gain exposure to gold on the ASX100 are via Newcrest Mining ((NCM)), Evolution Mining ((EVN)) and Northern Star Resources ((NST)). In balancing the risk/reward outlook, the broker's preference is for Evolution Mining, giving it a Buy rating. The broker remains neutral on the outlook for gold and believes catalysts that are stock-specific will drive performances over the next 12 months.

The stock has recently outperformed heavyweight Newcrest but this is mostly a reflection of Newcrest weakness following the specific seismic event at Cadia. The broker nevertheless believes Evolution can re-rate towards Newcrest's valuation, all things being equal. It will take time, nonetheless, for foreign investors to familiarise themselves with the stock and for local fund managers to overcome their Newcrest fixation, the broker suggests. UBS has lifted its target to $2.70 from $2.59.

While there are a few catalysts for Evolution Mining on the horizon, the broker suspects this is a good aspect, as the company's diversified portfolio reduces the impact from any potential upset to operations.

For Newcrest, UBS suspects the use of stockpiles masks the pace of the return to full production at Cadia, after an earthquake crimped production. The broker expects nameplate production by late this year. The stock remains a best proxy in the ASX100 for gold, in the broker's opinion. However the market historically values Newcrest with a -5% discount (mining risk) but the broker believes -10% is more appropriate given longer term concerns at Lihir. The broker suggests -10% is conservative, but -5% is too generous. If the broker assumed -5%, its valuation would rise to meet the current share price.

UBS thus retains Sell, despite Newcrest being Australia's "go-to" gold name. Aside from Lihir issues, Cadia is still out. The broker nevertheless lifts its target to $12.98 from $12.68.

UBS recently initiated on Northern Star with a Sell rating and is convinced the shares are fully priced. With a growing proportion of the company's output coming from lower grade surface material and most of its resources attributable to underground, the broker wonders if the latter ounces will be commercialised sooner rather than later.

Oil

Morgan Stanley suspects oil inventories will not reach their five-year average. Saudi Arabia has suggested bringing stock levels back to the five-year average as an objective for OPEC. The broker agrees that bloated inventories are maintaining pressure on oil prices but does not believe a return to normal levels is likely.

Nevertheless, the seasonal upswing in demand suggests inventories will decline throughout the rest of the year before a reversal in 2018, as strong growth from US shale should coincide with rising production from OPEC and Russia after the expiry of the current output agreement in the March quarter.

The broker does not expect OPEC to flood the market but, on current trends, even a partial unwinding of production cuts should mean the market is oversupplied again next year. Morgan Stanley estimates OPEC would need to continue with its current quota for the whole of 2018 to prevent an increase in inventories, or would need to cut much deeper to get inventories back to five-year averages.

Coal

Morgan Stanley observes the spot price for thermal coal's top grade product, Newcastle, at US$85.50/t has converged on the FY17 contract price that was settled last month. The broker suspects re-stocking in China has kicked spot prices along, helped by the fact that China is still stabilising its local output after previous reforms.

The broker expects these trading conditions to reverse in 2018, as supply lifts on higher prices and demand shrinks on a withdrawal of China/India from global trade, subsequently undermining prices.

Morgan Stanley flags the fact that seaborne thermal coal trade is heavily dependent on the import demands of China and India. Together these two countries account for almost 40% of globally traded thermal coal. Yet both are, in fact, largely self-sufficient in coal. Furthermore, the broker suspects China's reform of its industry and India's expansion of its resources may prompt a sustained withdraw from the global trade.

Macquarie raises its medium-term price forecasts for thermal coal by 4-9%. This reflects a view that a US$65/t spot price will now be sufficient to displace marginal Indonesian production. The broker reduces second half 2017 coking (metallurgical) coal forecast by -7-11% on the back of a faster-than-expected supply response but raises long-term forecast by 9% to US$125/t to reflect changes to modelling.

Iron Ore

Higher shipping rates and widening product discounts affect Macquarie's estimates for iron ore stocks and material downgrades are made to earnings estimates for Fortescue Metals ((FMG)) and Mount Gibson ((MGX)). The broker now expects Fortescue to report a realised price below 70% of benchmark for the June quarter.

Citi downgrades average estimates for 2017 iron ore prices to US$61/t from US$70/t, which reflects a reduction in the second half price forecast to US$49.50/t from US$62/t. The broker notes prices have slumped despite steel prices/margins remaining healthy.

After a surplus in 2016, port inventories have built to over 440mt and, with further low-cost supply coming on board, the broker is bearish on the outlook for iron ore, as prices need to go below US$50/t to shut down high-cost domestic Chinese and other supply which has re-started. The broker also notes discounts for lower grade ore have also widened as mills prefer higher grades in order to maximise production and take advantage of rebar margins.

Ongoing environmental pressures favour higher grade ore. The broker does not expect the larger discounts to be structural but suspects the cyclical component may hang around until port inventory is reduced, high-grade supply increases and margins are normalised.

Citi downgrades Fortescue to Sell and reduces the target to $3.90 from $5.80. The broker forecasts a realisation of 65% of benchmark in the June quarter with an FY17 average of 79%.

With the exception of cobalt, manganese and zinc Macquarie's 2018 forecasts are largely unchanged. Marking-to-market prices across base metals reduces the broker's June quarter forecasts for copper, zinc and lead by -8%, -11% and -10% respectively. Small upgrades are made to alumina, aluminium and gold.

Cobalt continues to surprise on the upside and the broker raises 2017-18 forecasts by 11-20%, and long-term prices by 32% to US$16.50/lb. The broker upgrades its estimates for lithium in the longer term, with a 19% increase to 2021 forecasts.

Material Matters: Oil, Gold, Silver, Zinc, Lead

A glance through the latest expert views and predictions about commodities. Oil; gold and silver; zinc and lead.

-Has the oil market become too bearish? -US Fed the main risk for the gold outlook, Macquarie suggests -Ongoing weakness in silver market expected -Downside risks to zinc supply suggest deficit to continue -Lead prices likely to drift around current levels

By Eva Brocklehurst

Oil

Bearish sentiment has pervaded the oil market, Citi observes, and this has triggered an unwinding of investor long positions on financial crude futures. Yet the broker believes the change in sentiment has not matched the fundamental backdrop, and several misconceptions about the current market are keeping oil prices depressed.

Citi points out that a combination of the drawing down of physical oil inventories from record highs, given a financial crude futures curve in which investors are increasingly active, is always going to be a bumpy process. The broker points out money market short positioning is prone to sharp reversals and upward momentum can quickly be generated as, and when, sentiment improves.

On the other hand, outright investor long flows tend to be slower to move and probably need oil prices to move sustainability higher in the second half.

The main misconception is the state of storage and market balances for the next 18 months, in the broker's opinion. Optics suggest that OECD inventories have increased in the year to date whilst non-OECD inventories and floating storage have both fallen.

Citi believes this latter observation is misconstrued, in that deferred crude futures are not an accurate predictor of where oil prices will go. The broker believes this is, instead, indicative of lopsided corporate investor flows and a bad predictor of future oil prices. On base case US shale production estimates, the broker suggests markets are unlikely to be in surplus until mid 2018 at the earliest.

Gold And Silver

Macquarie believes the US Federal Reserve is the main risk, and opportunity, around gold. The broker contemplates two likely scenarios, both of which mean higher gold prices. Raising rates despite low inflation while promising more appears bearish for gold in the short term but, ultimately, the broker believes the Fed will realise it cannot deliver the said rate hikes, or it makes an error, hikes and risks recession.

The US Fed Funds rate is now 1-1.25%, a percentage point higher than its low. Rising rates are generally envisaged to be bad for the gold price and gold has descended to below US$1250/oz. Yet the broker warns correlation is not causation and such analysis risks being simplistic. Historically, gold has done quite well during cycles when the US Fed is hiking rates. At this point, the broker suggests fading US political risks are the factor behind the recent sell-off.

Macquarie's US economists calculate, based on worsening demographics in the US and falling long-term growth potential, that Fed's "neutral" rate is just 1.75%. Therefore, if the Fed insists on tightening rates as current projections suggest, it risks a policy error and recession. This would, in turn, be supportive of gold. Macquarie expects gold to average US$1250/oz and US$1325/oz in the September and December quarters respectively.

Since 2008 the annual supply of new gold has grown by around 800t/annum, an increase of around 30%. This growth has been driven by the rise of China, Russia and Mexico as major gold producers as well as new mines starting up across Africa, outside of South Africa, and a recovery in mature jurisdictions such as Canada and Australia. With this background, Metals Focus expects production growth to grind to a halt this year.

The March quarter signalled a marginal contraction, as supply declined by -0.4% year-on-year. Chinese output fell around -10% in the quarter largely from stricter environmental regulations targeting the discharge of cyanide in tailings, which meant a number of marginal operations were forced to close. The Metals Focus analysis shows over 90% of mines were profitable in the March quarter and supply will hold up in the near term.

Meanwhile, ongoing market weakness in silver is expected. Research has confirmed the extent of the drop in US silver coin and bar demand last year, estimated at -18%. This is been supported by several factors, as silver prices have been largely tied to a range.

The analysis suggests the price needs to break out significantly, perhaps falling to a low of around US$14-15/oz to help attract retail investors. Another reason for the ongoing weakness is the prospect that the market has become saturated.

Finally, there has been a jump in the selling back of coins and bars into the secondary market which has reduced the need for dealers to buy newly fabricated product. Metal Focus forecasts a -20% decline in 2017 in silver demand, to around 78m ozs and the lowest level this decade.

Zinc And Lead

Tightening supply has caused both zinc and lead prices to rally in 2016 and markets have cautiously embraced this story so far this year. Citi expects zinc supply to grow by 2.0% this year and lead 1.8%. Nevertheless, the broker notes increasing downside risks to zinc supply forecasts.

Citi suspects investors may be slow to adopt a favourable outlook on zinc into the September quarter, although the emergence of several constructive themes defies an outright bearish view. Based on historical mine strikes in Peru, and noting the call for a general strike on June 19, the broker suspects the disruption could hold back around 10,000t of zinc in concentrate from Antamina, the country's largest mine.

On the demand side, the closure of several Chinese smelters has prompted a pick-up in refined zinc imports in April. There is also surprising resilience in property commencements in China, despite government controls. Taking these factors into account Citi expects a zinc market to remain in deficit this year and into 2018.

Lead, meanwhile, has derived price improvements from a spike in refined imports to China but Citi suspects this situation is unlikely to persist for the rest of the year. Citi does not expect London Metal Exchange lead prices will surpass zinc over the medium term, particularly as scrap supply is catering for more than half of global lead consumption.

Rather, modest expectations of a deficit are a function of poor mine output. Citi expects a modest deficit in 2017 with global mine supply roughly in line with expectations, despite a ramp up in Chinese production. Absent an outsized boost to mine output the broker suspects lead prices will continue to drift around current levels for the rest of the year.

Weekly Ratings, Targets, Forecast Changes

By Rudi Filapek-Vandyck, Editor FNArena

Guide:

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

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

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

Summary

Period: Monday June 12 to Friday June 16, 2017 Total Upgrades: 3 Total Downgrades: 8 Net Ratings Breakdown: Buy 41.81%; Hold 42.35%; Sell 15.84%

The Australian share market is not receiving any support from local stockbroking analysts. For the week ending Friday, 16th June 2017, FNArena registered three rating upgrades versus eight downgrades. Two out of three upgrades are linked to brokers responding to extreme weakness in lithium-related share prices.

The only other stock to receive an upgrade is Ansell. The good news is all upgrades went to Buy.

High flyer CSL, perennial disappointer Gateway and retailer Nick Scali were among those receiving downgrades.

Lithium producers also command pole position for positive revisions to target prices, followed by CSL and Ansell. The flipside only contains two names: Syrah Resources and Medibank Private.

Resources stocks also dominate the table for positive revisions to earnings estimates with Western Areas and Syrah Resources leading the pack, ahead of Bellamy's and Northern Star. Virgin Australia suffered the largest decrease in earnings estimates, followed by Independence Group, Santos, Oil Search and Orocobre.

For the week, positive changes to target prices/valuations and earnings forecasts are larger than negative adjustments. This is a notable break from the underlying trend since May. Investors will be hoping this positive trend can be maintained in the six weeks or so leading into the August reporting season.

Upgrade

ANSELL LIMITED ((ANN)) Upgrade to Overweight from Equal-weight by Morgan Stanley .B/H/S: 1/3/2

Morgan Stanley expects the company to be a strong performer in the next 12 months, although raw materials remain the swing factor.

Positive manufacturing data from the US and inflection points in emerging markets make the broker confident that the company can maintain organic growth at the upper end of guidance.

The broker also suspects the influence of foreign exchange will be largely neutral in FY17. This could also continue into the next year and offset the influence of raw material price inflation.

Rating is upgraded to Overweight from Equal-weight and the target is raised to $25.35 from $23.59. Sector view is In-Line.

GALAXY RESOURCES LIMITED ((GXY)) Upgrade to Buy from Neutral by Citi .B/H/S: 1/2/0

A previously cautious Citi has upgraded to Buy/High Risk from Neutral/High Risk. The analysts believe the -30% decline in the share price doesn't seem justified, despite market concerns about lithium over-supply next year.

It is Citi's view that the current build up in direct shipping ore (DSO, unprocessed product) will prove unsustainable, hence so too will be current market concerns. In addition, Galaxy is going to miss its own production guidance for the year, on the analysts' calculations.

Price target has been reduced by 5c to $2.70. Given Galaxy's current cash flow profile and solid project pipeline, namely James Bay/Sal de Vida, Citi analysts see an attractive entry point post share market sell-off.

MINERAL RESOURCES LIMITED ((MIN)) Upgrade to Buy from Hold by Deutsche Bank .B/H/S: 3/0/0

Deutsche Bank recently visited the company's Wodgina lithium mine in Western Australia. The company is set to become a 100,000 tonne per annum producer in FY18. The inclusion of direct shipping ore has increased the broker's valuation for Wodgina.

The scale suggests to Deutsche Bank that the company will soon be the world's largest lithium producer once Mt Marion and Wodgina are ramped up.

FY18 and FY19 estimates for earnings per share have increased by 85% and 32% respectively. The broker upgrades to Buy from Hold and raises the target to $12.00 from $10.80.

Downgrade

CSL LIMITED ((CSL)) Downgrade to Hold from Add by Morgans .B/H/S: 4/2/0

The company has acquired an 80% equity stake in a Chinese plasma fractionator for US$352m. The market is significant, Morgans observes, with demand for immunoglobulin estimated to outstrip supply over the next 10 years.

Expanding its market-leading footprint in China should allow CSL to better exploit the projected growth in demand, the broker adds. While confident in the future growth trajectory the broker believes consensus expectations are high for FY18 and valuation is stretched.

The broker downgrades to Hold from Add. Target is raised to $140.20 from $133.30.

GATEWAY LIFESTYLE GROUP ((GTY)) Downgrade to Neutral from Outperform by Macquarie .B/H/S: 1/1/0

The company has provided an update on FY17 guidance, which implies better pricing but delays with higher margin sales. Macquarie reduces FY17 forecasts for earnings per share by -10.4% and FY18 by -0.4%.

Macquarie envisages long-term growth in the sector on the back of positive trends such as an ageing population, financial pressure on retirees and housing affordability.

Nevertheless, the broker does not believe the share price will outperform until the market is confident that earnings have found a bottom. Rating is downgraded to Neutral from Outperform. Target is $2.19.

ILUKA RESOURCES LIMITED ((ILU)) Downgrade to Underperform from Neutral by Macquarie .B/H/S: 3/2/2

Macquarie observes sentiment is improving and the company has been able to push through a 13% rise in zircon reference prices. Nevertheless, despite strong demand for titanium dioxide, the increase in rutile pricing has been more subdued at just 4%.

The broker suspects the company is likely to focus capital on the Sierra Rutile assets over the next few years in preference to Balranald, and develop Cataby in tandem. The development of Cataby is critical in Macquarie's opinion as the company needs it to sustain output of synthetic rutile.

Macquarie transfers coverage to a new analyst and downgrades to Underperform from Neutral. The broker makes a number of material changes to production assumptions with a net earnings impact of a -24% reduction to 2017 estimates offset by a 77% increase to 2018 and 2019 estimates. Target is raised to $6.70.

MIRVAC GROUP ((MGR)) Downgrade to Hold from Buy by Deutsche Bank .B/H/S: 4/2/1

Deutsche Bank has adopted a more grim outlook for housing starts in Australia in the coming years, now forecasting a drop in the order of -20% by 2019. The analysts point out, multi-family housing starts represent circa 50% of Mirvac's Residential portfolio.

In addition, the share price is close to the broker's price target. Price target drops to $2.32 from $2.39.

MEDIBANK PRIVATE LIMITED ((MPL)) Downgrade to Sell from Neutral by UBS .B/H/S: 0/3/4

The erosion of margins is not a new theme yet UBS is becoming more bearish following analysis of the escalating underlying inflationary pressures in private health insurance.

The broker concedes, off a low base, the brand data points could improve in coming months and regulatory reform for claims inflation may help. Both will take time to meaningfully affect earnings per share.

While appreciating the defensiveness of the stock, the broker believes the margin outlook is a core driver of both sentiment and earnings momentum and finds it increasingly difficult to be optimistic. Downgrade to Sell from Neutral. Target drops to $2.50 from $2.75.

NICK SCALI LIMITED ((NCK)) Downgrade to Neutral from Buy by Citi .B/H/S: 1/1/0

Downside risks arising from a slowing domestic housing cycle combined with weak consumer environment have made Citi analysts uncomfortable with their Buy rating and elevated price target for Nick Scali.

Hence the decision was made to downgrade to Neutral from Buy. Earnings per share estimates for FY18 and FY19 have been reduced by -7% and -17% respectively. Target price falls by -23% to $6.45.

RELIANCE WORLDWIDE CORPORATION LIMITED ((RWC)) Downgrade to Sell from Hold by Deutsche Bank .B/H/S: 2/1/1

Deutsche Bank has adopted a more grim outlook for housing starts in Australia in the coming years, now forecasting a drop in the order of -20% by 2019. Reliance Worldwide has been downgraded to Sell from Hold, but the move is inspired by what looks like a lofty valuation supported by elevated market expectations.

Target price has increased to $3.06 from $3.00.

STEADFAST GROUP LIMITED ((SDF)) Downgrade to Accumulate from Buy by Ord Minnett .B/H/S: 3/0/0

Ord Minnett has reviewed the company's investor presentation. The broker notes additional focus on international expansion opportunities in the briefing.

The stock has risen strongly in recent months which leads Ord Minnett to reduce its recommendation to Accumulate from Buy on valuation grounds. Target is $2.70.

Total Recommendations Recommendation Changes

Broker Recommendation Breakup

Broker Rating Order Company New Rating Old Rating Broker Upgrade 1 ANSELL LIMITED Buy Neutral Morgan Stanley 2 GALAXY RESOURCES LIMITED Buy Neutral Citi 3 MINERAL RESOURCES LIMITED Buy Neutral Deutsche Bank Downgrade 4 CSL LIMITED Neutral Buy Morgans 5 GATEWAY LIFESTYLE GROUP Neutral Buy Macquarie 6 ILUKA RESOURCES LIMITED Sell Neutral Macquarie 7 MEDIBANK PRIVATE LIMITED Sell Neutral UBS 8 MIRVAC GROUP Neutral Neutral Deutsche Bank 9 NICK SCALI LIMITED Neutral Buy Citi 10 RELIANCE WORLDWIDE CORPORATION LIMITED Sell Neutral Deutsche Bank 11 STEADFAST GROUP LIMITED Buy Buy Ord Minnett Recommendation Positive Change Covered by > 2 Brokers Order Symbol Company New Rating Previous Rating Change Recs 1 MIN MINERAL RESOURCES LIMITED 100.0% 67.0% 33.0% 3 2 ANN ANSELL LIMITED -17.0% -33.0% 16.0% 6 3 BHP BHP BILLITON LIMITED 63.0% 50.0% 13.0% 8 4 NWS NEWS CORPORATION 50.0% 40.0% 10.0% 4 5 DLX DULUX GROUP LIMITED -50.0% -56.0% 6.0% 7 6 ORE OROCOBRE LIMITED 80.0% 75.0% 5.0% 5 7 SYR SYRAH RESOURCES LIMITED 80.0% 75.0% 5.0% 5 8 TAH TABCORP HOLDINGS LIMITED 13.0% 10.0% 3.0% 4 Negative Change Covered by > 2 Brokers Order Symbol Company New Rating Previous Rating Change Recs 1 RWC RELIANCE WORLDWIDE CORPORATION LIMITED 13.0% 38.0% -25.0% 4 2 NST NORTHERN STAR RESOURCES LTD 17.0% 40.0% -23.0% 6 3 SDF STEADFAST GROUP LIMITED 83.0% 100.0% -17.0% 3 4 CSL CSL LIMITED 58.0% 75.0% -17.0% 6 5 ILU ILUKA RESOURCES LIMITED 7.0% 21.0% -14.0% 7 6 MPL MEDIBANK PRIVATE LIMITED -57.0% -43.0% -14.0% 7 Target Price Positive Change Covered by > 2 Brokers Order Symbol Company New Target Previous Target Change Recs 1 ORE OROCOBRE LIMITED 4.346 4.183 3.90% 5 2 MIN MINERAL RESOURCES LIMITED 13.220 12.820 3.12% 3 3 CSL CSL LIMITED 138.700 135.050 2.70% 6 4 ANN ANSELL LIMITED 24.093 23.800 1.23% 6 5 NST NORTHERN STAR RESOURCES LTD 4.432 4.390 0.96% 6 6 DLX DULUX GROUP LIMITED 6.290 6.234 0.90% 7 7 RWC RELIANCE WORLDWIDE CORPORATION LIMITED 3.460 3.445 0.44% 4 8 ILU ILUKA RESOURCES LIMITED 8.431 8.403 0.33% 7 Negative Change Covered by > 2 Brokers Order Symbol Company New Target Previous Target Change Recs 1 SYR SYRAH RESOURCES LIMITED 4.700 4.925 -4.57% 5 2 MPL MEDIBANK PRIVATE LIMITED 2.671 2.707 -1.33% 7 Earning Forecast Positive Change Covered by > 2 Brokers Order Symbol Company New EF Previous EF Change Recs 1 WSA WESTERN AREAS NL 0.867 0.567 52.91% 7 2 SYR SYRAH RESOURCES LIMITED -5.330 -6.413 16.89% 5 3 BAL BELLAMY'S AUSTRALIA LIMITED 22.167 19.433 14.07% 3 4 NST NORTHERN STAR RESOURCES LTD 32.386 30.983 4.53% 6 5 PTM PLATINUM ASSET MANAGEMENT LIMITED 30.900 30.375 1.73% 4 6 ORG ORIGIN ENERGY LIMITED 15.926 15.783 0.91% 7 7 ALQ ALS LIMITED 28.070 27.884 0.67% 7 8 ANN ANSELL LIMITED 138.079 137.811 0.19% 6 9 MIN MINERAL RESOURCES LIMITED 103.260 103.060 0.19% 3 10 NAB NATIONAL AUSTRALIA BANK LIMITED 242.963 242.600 0.15% 8 Negative Change Covered by > 2 Brokers Order Symbol Company New EF Previous EF Change Recs 1 VAH VIRGIN AUSTRALIA HOLDINGS LIMITED 0.495 0.570 -13.16% 6 2 IGO INDEPENDENCE GROUP NL 8.198 8.490 -3.44% 6 3 STO SANTOS LIMITED 18.025 18.529 -2.72% 8 4 OSH OIL SEARCH LIMITED 26.879 27.552 -2.44% 8 5 ORE OROCOBRE LIMITED 8.729 8.911 -2.04% 5 6 ILU ILUKA RESOURCES LIMITED 15.447 15.676 -1.46% 7 7 WPL WOODSIDE PETROLEUM LIMITED 165.749 167.989 -1.33% 8 8 AZJ AURIZON HOLDINGS LIMITED 21.940 22.131 -0.86% 8 9 QAN QANTAS AIRWAYS LIMITED 55.073 55.535 -0.83% 7 10 IPL INCITEC PIVOT LIMITED 19.585 19.735 -0.76% 8 Technical limitations

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

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Uranium Week: Close But No Cigar

The spot uranium market last week grafted closer to the US$20/lb mark, by US5c.

By Greg Peel

It remains a glacial process, but the number of Japanese nuclear reactors satisfying regulations and overcoming legal challenges to restart electricity generation is quietly growing. Last week a Japanese local court dismissed a request from local residents for an injunction to halt the restart of Kyushu Electric's Genkai units 3 and 4.

The lawsuit was filed in 2011, four months after the Fukushima disaster. Kyushu Electric hopes to restart the reactors within the next few months, pending final safety inspections.

Only five Japanese reactors have to date passed those safety inspections, with the last two preparing for restart this month and next. There are a further 19 reactors waiting permission for restart. There are 42 operable reactors in the country.

Meanwhile the story is an opposite one in the US, where the most recent reactor threatening to shut down is the infamous Three Mile Island. If relevant states do not agree to provide subsidies for zero-emission energy as is the case for renewables, more will shut down due to a lack of economic viability in the face of cheap gas-fired energy.

The US nuclear industry did receive a boost last week, with the US Department of Energy announcing US$67m in grants to fund nuclear energy research, facility access and cross-cutting technology development long with infrastructure in 28 states. A total of 85 projects were selected for funding.

The news did little to inspire the uranium sport market, which for the third week running found plenty of buying interest below US$20/lb but none above. While many sellers held their offers steadfastly above US$20/lb in the hope of luring up buyers, enough broke ranks to ensure six transactions were concluded for a total of 800,000lbs U3O8 equivalent, industry consultant TradeTech reports.

Utilities were among the buyers, but it appears utilities are only really interested in picking up material opportunistically below the US20/lb mark. The past three weeks have seen TradeTech's weekly spot price indicator graft its way up US25c to US$19.75/lb, then another US15c to US$19.90/lb, and last week a further US5c to US$19.95/lb.

There was one transaction concluded in uranium term markets last week, for delivery of 2mlbs over four years. Several other utilities are contemplating entry into the term markets during the September quarter, TradeTech reports.

Producers have been growing old waiting for the much vaunted rekindling of term market buying interest, having held high hopes for a couple of years now. In the meantime, TradeTech's term market indicators have been quietly slipping lower.

They remain unchanged last week at US$24.25/lb (mid) and US$34.00/lb (long).

The Short Report

Guide:

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

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

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

Summary:

Week ending June 15, 2017

Last week saw the ASX200 perplex all and sundry by shooting straight up from 5680 support back to 5800 resistance in a couple of sessions, before tanking again on derivatives expiry day. This week sees us back at 5680.

Despite the volatility, last week saw far fewer notable movements in short positions than the prior two weeks. And nothing overly spectacular.

Unless we count Myer ((MYR)), which I highlighted in last week's Report as having jumped to 18.2% shorted from 15.2%. I blamed Amazon. Last week did see Myer's share price recover somewhat (until this week) but given shorts have now fallen back down to 14.6%, it's hard to know if this is real or just an ASIC data blip.

Vocus Communications ((VOC)) has dropped again, to 8.7% from 12.9%, but that is easily explained by a takeover bid from private equity prompting a short-covering scramble.

On the subject of Amazon, Harvey Norman ((HVN)) enjoyed some bargain hunting last week (but not this week) which likely explains a drop in shorts to 9.2% from 10.5%. However peer JB Hi-Fi ((JBH)) had the same experience but its shorts have crept up to 11.2% from 10.5%.

Qube Holdings ((QUB)) has dropped to 5.2% shorted from 6.2% but this was a play against the company's rights issue, and Qube will probably drop out of the 5% plus table by next week's Report.

Speaking of capital raisings, the stock to watch in next week's report will be Bellamy's Australia ((BAL)). Announced capital raisings will often result in a share price fall but not if the market believes the purpose of the additional funding is worthwhile, as is the case with Bellamy's canning factory acquisition on a path to securing Chinese registration of its infant formula.

Bellamy's remained 10.4% shorted last week but its share price has since taken off. Peer a2 Milk's ((A2M)) share price has also taken off, this time following a profit upgrade due to unrelenting Chinese demand for a2 Platinum formula. a2's short position was also little changed last week at 7.7%.

Which about sums up the week. Hence no Movers & Shakers this week.

Weekly short positions as a percentage of market cap:

10%+

ORE 20.1 SYR 18.9 WSA 15.9 IGO 15.3 MYR 14.6 MYX 13.2 MTS 12.7 ACX 12.4 DMP 11.9 FLT 11.8 ISD 11.6 JBH 11.2 RFG 11.2 AAD 11.1 SHV 10.4 BAL 10.4

In: SHV Out: VOC, HVN

9.0-9.9%

SAR, NEC, HVN In: HVN Out: SHV

8.0-8.9%

VOC, PRU, EHE, JHC, QIN

In: VOC Out: MND

7.0-7.9%

NWS, MND, GTY, A2M, BKL, OFX, GXY, HSO, CTD, BEN, IPD, TPM, AHG

In: MND, GXY, AHG

6.0-6.9%

BAP, MYO, RWC, BGA, IFL, CSV, RIO

Out: GXY, AHG, QUB, SGH, BDR

5.0-5.9%

WGX, SEK, GXL, BDR, KAR, NXT, OSH, PLS, MTR, AWC, QUB, AAC, SRX, VRT, CCP, MSB

In: BDR, QUB Out: BAP, CSV, AHG

Movers and Shakers

See above.

ASX20 Short Positions (%)

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

IMPORTANT INFORMATION ABOUT THIS REPORT

The above information is sourced from daily reports published by the Australian Investment & Securities Commission (ASIC) and is provided by FNArena unqualified as a service to subscribers. FNArena would like to make it very clear that immediate assumptions cannot be drawn from the numbers alone.

It is wrong to assume that short percentages published by ASIC simply imply negative market positions held by fund managers or others looking to profit from a fall in respective share prices. While all or part of certain short percentages may indeed imply such, there are also a myriad of other reasons why a short position might be held which does not render that position "naked" given offsetting positions held elsewhere. Whatever balance of percentages truly is a "short" position would suggest there are negative views on a stock held by some in the market and also would suggest that were the news flow on that stock to turn suddenly positive, "short covering" may spark a short, sharp rally in that share price. However short positions held as an offset against another position may prove merely benign.

Often large short positions can be attributable to a listed hybrid security on the same stock where traders look to "strip out" the option value of the hybrid with offsetting listed option and stock positions. Short positions may form part of a short stock portfolio offsetting a long share price index (SPI) futures portfolio – a popular trade which seeks to exploit windows of opportunity when the SPI price trades at an overextended discount to fair value. Short positions may be held as a hedge by a broking house providing dividend reinvestment plan (DRP) underwriting services or other similar services. Short positions will occasionally need to be adopted by market makers in listed equity exchange traded fund products (EFT). All of the above are just some of the reasons why a short position may be held in a stock but can be considered benign in share price direction terms due to offsets.

Market makers in stock and stock index options will also hedge their portfolios using short positions where necessary. These delta hedges often form the other side of a client's long stock-long put option protection trade, or perhaps long stock-short call option ("buy-write") position. In a clear example of how published short percentages can be misleading, an options market maker may hold a short position below the implied delta hedge level and that actually implies a "long" position in that stock.

Another popular trading strategy is that of "pairs trading" in which one stock is held short against a long position in another stock. Such positions look to exploit perceived imbalances in the valuations of two stocks and imply a "net neutral" market position.

Aside from all the above reasons as to why it would be a potential misconception to draw simply conclusions on short percentages, there are even wider issues to consider. ASIC itself will admit that short position data is not an exact science given the onus on market participants to declare to their broker when positions truly are "short". Without any suggestion of deceit, there are always participants who are ignorant of the regulations. Discrepancies can also arise when short positions are held by a large investment banking operation offering multiple stock market services as well as proprietary trading activities. Such activity can introduce the possibility of either non-counting or double-counting when custodians are involved and beneficial ownership issues become unclear.

Finally, a simple fact is that the Australian Securities Exchange also keeps its own register of short positions. The figures provided by ASIC and by the ASX at any point do not necessarily correlate.

FNArena has offered this qualified explanation of the vagaries of short stock positions as a warning to subscribers not to jump to any conclusions or to make investment decisions based solely on these unqualified numbers. FNArena strongly suggests investors seek advice from their stock broker or financial adviser before acting upon any of the information provided herein.

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The Wrap: Millennials, Mobile & A-REITs

Weekly Broker Wrap: Millennials; health insurance; housing; supermarkets; mobile; A-REITs; equity strategy.

-Composition of expenditure will change as buying power of Millennials rises -Morgan Stanley flags rising structural pressure on health insurers -UBS suggests price war in supermarkets unlikely -Price competition in mobiles heats up -Retail landlords facing cyclical consumer -China taking a greater part of regional equity weighting to reduce Oz weighting

Millennials

Millennials, as those born either side of the turn of the century are described, will earn two out of every three dollars of income generated in Australia by 2030, Macquarie estimates, thus their spending power is set to rise. The broker believes this will accompany a large shift in the composition of expenditure.

Millennials stand in stores and compare prices and review products on their smart phones, while friends influence their decisions via social media and, when they are ready to buy, they expect direct delivery.

The broker believes logistics providers of last-mile express business-to-consumer services will be the major winners in an online world. Meanwhile, home ownership is less significant and, with this, the desire for furniture and house-related products.

There is a rising preference for products that are healthier and associated with health and wellness, based on convenience or spending associated with experience. Companies which stand to benefit from these priorities, Macquarie observes, include a2 Milk ((A2M)), Blackmores ((BKL)) and Bingo Industries ((BIN)).

Health insurance is expected to become more discretionary, while the sharing economy and affordability opens up downside risk in personal insurance. Insurance Australia Group ((IAG)) and Suncorp ((SUN)) are likely to be most disrupted given their high exposure to personal insurance.

Oz Health Insurance

While defensive growth underpins the price/earnings premium in Australian health care and insurance stocks, Morgan Stanley observes structural shifts in participation, household budgets and the competitive landscape means they are actually more cyclical than at first glance.

The main drivers of declining participation in hospital insurance include deteriorating affordability and a squeeze on household cash flows, as well as a falling value proposition. The broker suspects the status quo will likely prevail as current trends continue over the medium term.

Morgan Stanley downgrades top-line forecasts and flags rising structural pressures on claims inflation for health insurers. The broker suspects that restoring the Medibank Private ((MPL)) franchise and sustaining nib Holding's ((NHF)) 4% per annum growth is becoming tougher and retains an Underweight rating on the former and Equal-weight rating on the latter.

In terms of hospitals, the broker downgrades Healthscope ((HSO)) to Underweight from Equal-weight and retains an Equal-weight rating for Ramsay Health Care ((RHC)). Morgan Stanley observes Healthscope is more exposed to Australian volume pressures and sub-capacity utilisation versus Ramsay and little FY18 earnings growth is anticipated.

Oz Housing

Deutsche Bank reduces year-on-year growth forecasts for Australian housing starts in FY18 and FY19. The reduced forecasts are a result of weaker multi-family sector expectations because of increased interest costs and increased stamp duty for foreign investors. Affordability remains an issue in NSW particularly. The broker now factors in around a -20% decline to FY19 multi-family housing starts.

Given recent outperformance in the share price, the broker downgrades Reliance Worldwide ((RWC)) to Sell from Hold. The broker likes the exposure to a growing US market but notes the risks from the Lowe's distribution ramping up and the Home Depot ramping down.

Deutsche Bank downgrades Mirvac ((MGR)) to Hold as it is now trading in line with the broker's target. The broker continues to like the company's exposure to office and its high-quality retail assets but reduced expectations for multi-family housing starts have an impact as these represent around 50% of the residential portfolio.

Supermarkets

UBS observes discussion has increased regarding the potential for a price war in supermarkets, after comments by Wesfarmers ((WES)) that its investment in Coles will likely triple in the September and December quarters. UBS believes a price war is unlikely, and believes much of the increased investment is a result of negative operating leverage, labour investment and, to a lesser extent, price.

The broker considers the market is rational and industry margins will bottom in FY17. The broker believes the market is under-appreciating the medium-term margin margin opportunity for Woolworths ((WOW)). UBS forecasts a 5.5% EBIT margin in FY20, which it believes is 50-60 basis points ahead of consensus. The main risk is a resurgent Aldi, outside of an unlikely price war, as Amazon's entry to Australasian fresh food is some way off.

Mobile

Following a period of relative stability, Credit Suisse observes mobile price competition has recently heightened. Vodafone is now offering a SIM-only plan with 18GB of data for $45 a month. Meanwhile Optus has cut its iPhone7 and Samsung Galaxy S8 handset prices on key post-paid plans and is offering a 10% discount on SIM-only plans. Telstra ((TLS)) has not made any major pricing changes at this stage. However, its price premium has blown out and the broker expects it will react.

The broker believes the increase in mobile price competition, in the wake of TPG Telecom's ((TPM)) acquisition of mobile spectrum, may be a sign that carriers are starting to prepare for its entry. The broker expects operators to lock in customers to new plans in order to make life harder bull for TPG.

Credit Suisse also suggests the recent increase in data allowances may be the first stage of a broader shift to unlimited mobile data allowances. The US has already moved to unlimited data and unlimited data plans are becoming more commonplace in Europe.

Macquarie also observes competition is heating up and has pared back growth assumptions for the market for FY18 to 1% from 3%. The broker notes, following a period of investment in network coverage in capacity, Optus is looking to improve share and the difference in the network to Telstra has narrowed.

The broker suspects amaysim ((AYS)) has more leverage to any pressure on revenue per unit given its business model. The broker expects it to introduce more aggressively-priced plans shortly.

A-REITs

Morgan Stanley observes, after a 20-year period of strong growth, retail landlords are now facing a severe cyclical consumer slowdown amidst structural pressure from e-commerce. The broker expects this to accelerate pressure on retailer margins and reduce the demand for physical space.

As store rationalisation intensifies and the pricing power of landlords diminishes, shopping mall operators will be forced to spend more on keeping their centres competitive along with tenant incentives. The broker believes maintenance and incentive capital expenditure is closer to 80 basis points of gross asset value, which is not reflected in cash flow forecasts or asset valuations and envisages risks to asset values on the downside.

Morgan Stanley downgrades Scentre Group ((SCG)) and GPT Group ((GPT)) to Underweight. GPT is mainly downgraded on valuation after outperforming retail peers by 10% in the year to date. The broker generally prefers to combine any retail exposure with office, industrial and, even residential. Hence, Mirvac is its preferred stock in the sector.

Strategy

Credit Suisse believes Computershare ((CPU)) and Macquarie Group ((MQG)) will benefit from the opening up of China's capital markets. However, large stocks listed in Australia are likely to be relative losers, as they have a greater proportion of passive investors on their registers that are set to follow the changes in regional benchmark weighting. MSCI has announced it will now include a tiny portion of the US$7.7tn China's A-share market in its indices.

Initial effects in Australia will be minimal but as China's equity weighting in the region grows Australia's is set to fall. By 2030, the broker forecasts the Chinese and Hong Kong equities will make up almost 50% of the regional benchmark as opposed to 30% now. The weight of Australian equities are set to fall to 6% from 12%.

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Low Risk Entry Into Caltex

By Michael Gable

Last week we had a surprisingly strong couple of days on the market but then it fizzled out. We still think that the banks will see further upside here in the short term, so offsetting that against the weak materials sector, you get a market that isn't going anywhere in a hurry. The Aussie dollar also got its head above US$0.76 but then met some selling overnight so a currency that is trending down will also weigh on the market. In today's report, we run the ruler over Caltex Australia ((CTX)).

We looked at the CTX chart 4 weeks ago and commented that if it pushes through $32, then it should run up to the high $30's. We can see that it broke above that resistance level and is now retesting the breakout. From a charting point of view, this level in CTX now seems to be a low risk entry point and stops can be placed just under the breakout line.

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