Week
28

Stories To Read From FNArena
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FNArena
Financial News, Data & Analysis

GPO Box 3145
Sydney NSW 2001

info@fnarena.com

Your editor
Rudi Filapek-Vandyck

Your dedicated team of journo's
Greg Peel
Eva Brocklehurst

Contents

Appin To Drag On South32

While an extended shutdown at Appin has led to forecast downgrades, broker valuations are little changed and Buy ratings have been maintained.

- Outage timing unknown - Earnings forecasts downgraded - Valuations little changed

By Greg Peel

On June 28, diversified miner South32 ((S32)) advised it had withdrawn the workforce at its Appin underground coal mines in the Illawarra as a precautionary measure following a tripping of the circuit during work on the gas extraction plant. In layman's terms, the canary snuffed it.

While it was subsequently confirmed there had been no breach of gas limits, a recent run of such gas issues at the company's Illawarra operations prompted the NSW Department of Planning & Environment to issue a prohibition notice and express its concern regarding the number of such events and operating practices at Illawarra over the last nine months.

In the past, such mine outages have lasted for a couple of weeks to a month. Brokers initially adjusted their forecasts accordingly. But yesterday South32 announced the Appin 7 and 9 mines will remain suspended while a full review of operations is conducted. Management did not provide guidance on estimated timing, as it has in the past. Brokers therefore are unsure just how long it will take. As Macquarie puts it, the outage "could be for months rather than weeks".

Appin makes up around 60% of South32's Illawarra coal production, with Dendrobium producing the other 40%. Dendrobium will continue to operate while Appin is suspended. UBS calculates every month Appin is off line represents some 450-500kt of production and a -2% hit to earnings per share.

For brokers to adjust their earnings forecasts this time around they have to have a guess at length of downtime, which "is hard to quantify to be honest," by Credit Suisse's admission.

Credit Suisse is assuming at least a month followed by a cautious resumption of production. UBS is assuming two months in "an attempt to be conservative" yet Macquarie has gone for a full three months, given the number of operational issues at Appin over the past year. Unsurprisingly, Macquarie's -16% cut to FY18 forecast earnings is the greatest of the three.

All of the eight major brokers in the FNArena database cover South32 but only three have updated their numbers to date with regard yesterday's announcement. One thing that the three updaters do agree on, however, is that despite the earnings downgrades the impact on share price valuation is minimal. This is because Appin has such a long mine life, two or three months of outage is not material in the wider scheme of things.

Macquarie has cut its target price to $3.30 from $3.50. Credit Suisse's valuation drops to $2.69 from $2.77 but the broker's target is unchanged at $2.95. UBS's valuation drops one cent, hence an unchanged $3.00 target.

All three brokers retain their Buy or equivalent ratings, ensuring a stable six Buy and two Hold ratings on the database at this stage for a consensus target of $3.20.

Underscoring Buy ratings is South32's significant free cash flow, irrespective of the loss of Appin production. On brokers' own commodity price forecasts, all agree the stock continues to offer value. Plug in current spot prices and it becomes a steal. That cash flow provides the opportunity for the company to extend its capital management initiatives, by boosting its share buyback and/or increasing its dividend.

Brokers nevertheless agree the market will now be more wary of management's operational performance and until it is clear just when Appin might restart, and how much any problem-fixers might cost, investors may well stay on the sidelines.

Gas Powering Electricity Prices Higher

Electricity prices are expected to remain elevated with gas prices having a more important role in influencing east coast electricity prices.

- Elevated gas prices are pushing up electricity prices - Higher gas prices are expected to remain - Australian gas prices linked to oil prices

By Nicki Bourlioufas

Electricity prices are expected to remain elevated for the next two to three years, with a higher gas price pushing up energy costs.

A July research note from the Commonwealth Bank's Global Markets Research team said gas has become a vital part of electricity generation in the National Electricity Market (NEM).

Australian gas prices have lifted with supply limited by restrictions on unconventional gas exploration and development in several states. Unregulated pipelines have also added meaningfully to costs. That means that high gas prices may be the norm even if liquefied natural gas (LNG) exporters are compelled to fulfill Australia's gas shortfall in the short term.

"With the withdrawal of coal power and the consequent reliance on gas power to meeting domestic power needs, electricity prices are being set by the gas price," the note said.

In particular, the cost of gas power generation (GPG) has surged on the back of higher domestic gas prices. With GPG now a vital part of the NEM, it is increasingly setting the price of electricity.

"Most market participants that we spoke to believe that GPG will set the marginal cost of electricity for another two to three years. While we see high electricity prices edge lower, we don't envisage electricity prices falling back to around AU$60/MWh.

"An industrial price around AU$100/MWh could be a sustainable long-term level," CBA suggests.

Higher domestic gas prices to remain

The LNG market has ballooned in a relatively short period of time, with LNG now accounting for around 70 per cent of gas consumption in the eastern gas market.

While increased demand is leading to higher gas prices, conventional gas production is on the decline - due largely to falling output in offshore Victoria – and future projects require gas prices closer to AU$11/mmbtu to come online.

"Another factor holding back more supply in Australia is that some state governments have restrictive regulations and moratoria on the exploration and development of gas reserves," CBA said.

"Pipeline tariffs are also adding as much as around AU$2.7/mmbtu to deliver gas from Queensland to the southern states. These charges are well above marginal costs and have led to calls for more pipeline regulation.

"These supply-side factors will need to be addressed if Australia's eastern gas market is to re-balance via a supply response. The evidence points to higher gas prices remaining for longer as Australian gas supply needs those prices for further investment."

Domestic gas price linked to international LNG

Higher costs have forced Queensland LNG producers to tighten their budgets and slash capital expenditure. Some operators are now buying gas from third parties rather than investing in new fields.

"The end-result is a greater association between domestic Australian gas prices and international prices," CBA notes.

With Australia's eastern market gas prices now closely associated with international LNG prices, gas producers and wholesalers are taking advantage of newfound market power by supplying the highest bidder between LNG producers and domestic gas users.

“In some cases, that market power has resulted in prices tracking higher than international prices. LNG exporters like Gladstone LNG (GLNG) have exacerbated this linkage by purchasing domestic gas to fill their LNG contracts.”

Given Queensland’s three LNG projects can choose to supply domestic or international energy markets, it is unlikely domestic gas and international LNG prices will de-link in the foreseeable future.

Australia’s production of LNG will continue to grow over the next year before plateauing in late 2018. It’s around then Australia is expected to take the mantle as the world’s largest LNG exporter, before being overtaken by the United States by the middle of next decade.

Decoupling gas from electricity

Gas power generation provides a level of flexibility and fast frequency response that cannot currently be replicated by renewables, making the decoupling of gas from electricity difficult.

Without taking appropriate steps, however, risks such as shortfalls in gas supply, coal supply contracts, and delayed renewable generation mean exposing the market to higher electricity prices linked to GPG for longer than two to three years.

“With all the shortfall risks facing the domestic gas market, it would sound counter intuitive to add incremental gas power. However, that is exactly what is happening now,” the analysts note.

“The remaining black coal-fired generation fleet in the NEM are broadly expected to increase output from historical levels. That will help minimise the role of GPG in setting the marginal price of electricity in the next couple of years.

“If black-coal fired generation fails to lift above historical levels, AEMO sees a GPG shortfall of 55-65PJ (26 per cent of GPG demand) and electricity supply shortfalls of 5.6-6.8TWh (3 per cent of NEM demand).”

Oil prices a key factor

The link between electricity and oil prices works through Australian LNG exports, which are priced via oil-indexed contracts. LNG contracts are being used to set the price of Australian gas.

Despite oil prices hovering near nine-month lows on mounting oversupply concerns, oil prices are expected to trend higher in coming months as OPEC cuts back supply, which will flow-on to the price of electricity.

“We believe that oil prices have room to move higher if OPEC-led production cuts are successful in bringing down global oil stockpiles,” the note said.

But the links are not instant. With fixed-price contracts common, the link with oil prices will become more obvious as contracts are renegotiated.

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AP Eagers' Road Not So Smooth

Car dealership conglomerate AP Eagers has enjoyed a welcome bounce back in sales but brokers are not that positive on the outlook ahead.

-Swift turnaround sector dynamics reverses May profit warning -Brokers question a possible one-off impact from SME tax incentive -Maybe rising mortgage rates are the biggest risk?

By Greg Peel

Australia's car dealerships began 2017 with a rosy outlook but the mood soured when sales started falling away in March and April. This prompted AP Eagers ((APE)) to issue a profit warning in May, downgrading first half 2017 profit guidance to an expected -7-9% drop on the same period last year. The share price suffered as a result.

Automotive Holdings ((AHG)) has been another company suffering the same malaise, and the same share price trajectory, having been hot property not so long ago.

The good news is that car sales unexpectedly rebounded in May and June. As you were, said AP Eager's yesterday, we now expect first half profit to be flat on the previous first half.

Four FNArena database brokers cover AP Eagers and the three that have updated on the announcement so far are pleased with the rebound in sales. Earnings forecast upgrades have followed and the consensus target price on the database has risen to $8.04 from $7.84. But as to the outlook for sales from here, the story is not so inspiring.

One-Off Tax Impact?

Morgans remains the most upbeat. The broker suggests increased sales towards the end of the financial year likely reflect another year of the government's small business tax incentive but this was the case last year too and hence AP Eagers is cycling already solid comparables. It is also likely the rebound in profit expectations reflects lower bonus hurdles for dealerships given weaker prior sales, Morgans believes, increasing margins.

If June sales are tax related then one might expect a lull in July as everyone who intended to buy did so ahead of end of financial year, but history shows a solid June usually implies a solid July as well, Morgans notes. The other point to note is the company is working operational improvements that should reduce costs and the broker believes further material cost productivity improvement can be extracted from here.

The only issue is the stock has now rebounded 20% from its May low to what Morgans sees as around fair value, hence a Hold rating retained.

Most broker notes include as standard a list of risks to forecasts. Morgans' note cites risks as including possible regulatory changes, slowing vehicle sales and higher interest rates.

To wit, Ord Minnett is pleased with improved sales but patchiness and consumer headwinds imply uncertainty in the sales outlook ahead, the broker believes. The other main issue for the broker is both AP Eagers and Auto Holdings have driven growth through acquisitions, to the point new acquisition opportunities are becoming thinner on the ground and competition will push up required purchase prices.

Ord Minnett also retains Hold.

Risk From Rising Mortgage Rates

Morgan Stanley agrees it will be tough for both companies to execute on substantial acquisitions in the near term which have been a key driver of growth. The broker also queries the implications of AP Eagers' rebound in profit expectation given that by the broker's calculation, sales are actually down -8% on new guidance when one adds in the contributions from new acquisitions over the period.

Most clouding the outlook however, as far as Morgan Stanley is concerned, are rising mortgage rates. While it makes sense that rising household debt costs would make a consumer think twice about buying a new car, the broker's research has indeed found a very strong inverse correlation between new car sales and mortgage rates.

Then there is the attention ASIC is now paying to the industry, focusing on responsible lending and subsequently risking lower volumes and commissions if regulatory changes are made.

Put this together and of the three brokers, Morgan Stanley is the least optimistic, as reflected in the broker's unchanged Underweight rating.

The fourth broker, Credit Suisse, has a Neutral rating.

While all of the issues cited above also apply to Automotive Holdings, Ord Minnett sums up broker perceptions in suggesting the company has more “self-help” opportunities to exploit, particularly in the struggling logistics business which is separate to the car business.

To that end, by comparison Auto Holdings boasts four Buy (or equivalent) ratings from seven covering brokers with two Holds and one Sell, to AP Eagers' three Holds and one Sell.

Material Matters: China, Miners, Coal & Oil

A glance through the latest expert views and predictions about commodities. China and the miners; gold miners; coal; and oil.

-China's material needs remain skewed to bulks -Resource stocks with healthy cash flows preferred by brokers -UBS singles out company-specific catalysts for gold miners -China clamping down on low-quality thermal coal imports -US rig count seen key to a more balanced oil market

By Eva Brocklehurst

China & Miners

Morgan Stanley is constructive on China, although acknowledges the outlook depends on the government's infrastructure promise delivering as other parts of the economy moderate. In steel, capacity will probably move to long products from flat and close the margin gap. Demand for iron ore appears stable, while below-average coal inventories at port and seasonal demand should support seaborne prices.

Copper imports were up in May but are down -20% year-on-year. Meanwhile, supply rationalisation is occurring in aluminium and the broker is waiting to see if relative Chinese beneficiaries affect regional trade. China's material needs remain skewed to the bulks and prices are down -17-34% in the year-to-date and the broker observes this has been priced in by most bulk miners.

Morgan Stanley likes stocks that have healthy cash flow margins, financially robust enough to weather weakness. The list is topped by South32 ((S32)), as it has strong free cash flow and cash to re-invest or return. BHP Billiton ((BHP)) and Rio Tinto ((RIO)) are also at the top of the list because of their strong margins.

Lithium leverage underpins Mineral Resources ((MIN)), while the broker likes Iluka Resources ((ILU)), Evolution Mining ((EVN)) and Independence Group ((IGO)) as they have strong exposure in mineral sands, gold and base metals respectively.

UBS observes the underperformance of the mining sector has been driven by pulling back of commodity prices, off somewhat elevated and unsustainable levels in the case of bulk miners, along with a macro environment that is more challenging. The broker maintains an overweight position towards the mining sector but believes the 12-month view is somewhat less favourable as Chinese property is expected to slow and offset steady/robust infrastructure expenditure.

The broker believes recently constrained steel production and robust demand have led to low inventories and this supports iron ore prices. While UBS does not expect a meaningful change in China's policy after the change of leadership in October, visibility is notably limited and thus equities with strong balance sheets and the propensity for increased cash returns are preferred.

The broker is slightly less bullish on copper and has marked down iron ore, metallurgical (coking) coal and zinc forecasts for 2017 because of a slightly weaker than expected June quarter. The broker favours those miners with improving fundamentals, such as mineral sands, copper, zinc and bulks, through the September quarter.

Rio Tinto and South32 are preferred stocks among the Australian large miners, as they have already stepped up returns to shareholders and have strong balance sheets. The broker recently upgraded BHP to Buy, believing it to be unloved and its high-quality assets and improving balance sheet should mean return step-up.

UBS is cautious on Fortescue Metals ((FMG)) and Mount Gibson Iron ((MGX)), given the large discounts in the market for low quality iron ore. Alumina Ltd ((AWC)) is considered fully valued, while Whitehaven Coal ((WHC)) needs some reassurance from China's policies.

Gold Miners

UBS observes sentiment towards gold has lifted slightly. The market is currently pricing in falling gold prices, reflected in the lift in short interest in Evolution Mining and Northern Star Resources ((NST)). Nevertheless, inflation is not rising as expected and this could eventually curb forecasts for higher interest rates, which in turn would be supportive for gold equities. As the outlook is mixed UBS focuses on company-specific catalysts.

Evolution Mining is preferred, because of its rapid de-gearing. UBS still believes risks are skewed to the downside for Newcrest Mining ((NCM)). At the smaller end, UBS upgrades Beadell Resources ((BDR)) and Silver Lake Resources ((SLR)) to Neutral, noting these stocks have underperformed in the year-to-date, and if gold rallies those that are leveraged will benefit.

Coal

Macquarie's suspicions that China would clamp down on coal imports at some stage this year are being confirmed, with news that the government has banned smaller provincial approved ports from accepting coal imports from July 1. The implementation details remain unclear but the main goal is believed to be restricting low-quality coal imports. Most of the ports likely to be affected are power plant-captive ports and this shows the target of restrictions is clearly thermal rather than coking coal.

As Chinese thermal coal prices were in a down trend in the June quarter, the government asked major power plans to reduced imports in order to stabilise the domestic market. Media reports also suggest that the government was planning to lift quality requirements for imported coal.

Macquarie notes the government has been intent on making life harder for coal importers for a number years, after initially introducing and raising coal import taxes in 2013 and 2014 when domestic coal prices kept falling. However, as ASEAN countries and Australia have free trade agreements with China the import tax had no impact on two thirds of China's coal imports.

China's coal imports last year came mainly from Indonesia, Australia, Inner Mongolia, North Korea and Russia, and imports from North Korea have already stopped because of sanctions. The target of restrictions is low-thermal coal, which means Indonesia may be the main country to suffer from the tightening measures. The restrictions supports the broker's structural expectation that seaborne coal prices will experience widening quality discounts going forward.

Oil

Oil prices have bounced from their lows of the year, Citi observes, noting the market was aggressively shorted and this has been the platform for a reversal in the oil price. Is this a dead cat bounce or a more sustainable rally? The broker tends towards the latter and expects that stock draw down in the order of around -1m b/d over the rest of 2017 is likely, although Libyan output sustained at around this level would counter this.

The issue is whether this will be reversed in 2018 because of rampant US growth. Citi expects US shale production could grow by around 1m b/d this year, assuming West Texas Intermediate prices are realised in the range of US$50-60/bbl over the rest of 2017. The main factor driving higher forecasts for US production this year is stronger-than-expected Permian production on the back of soaring rig counts.

The broker notes this year either lower or higher prices appear to have had a minimal impact on growth. This is because of several factors, including hedges covering production and the lagged impact of prices on drilling activity. In 2018, nonetheless, Citi suspects the impact of lower prices may be meaningful. The broker expects a decline of around -170,000 b/d in 2018 if prices were to fall to US$40/bbl.

Morgan Stanley believes, if OPEC does not balance the market, stabilisation will have to come from somewhere and most likely this will be US shale. For a chance of a balanced market in 2018, the broker suggests the US rig count can no longer grow and may need to contract by around 150 rigs.

Given current levels of breaking even, this requires WTI to be between US$46-50/bbl. The broker notes OPEC's production cuts to date have not made a dent in inventory levels. Morgan Stanley estimates at least 600,000 b/d of OPEC growth next year, which means US shale growth is constrained to 900,000 b/d at best.

While it may be tempting to interpret a recent decline in US oil-directed rig count as a sign of a falling back of investment, Deutsche Bank suspects further growth in oil-directed rigs is likely over the next six months. The broker takes note of the rolling four weeks average for evidence of a sustained slowing in growth and, on this measure, observes rigs are still running at 5.75 in terms of growth per week.

This may be down from the 13-plus per week rate in March and April but remains faster than what was assumed for the balance of the year. Meanwhile, upside from exempt OPEC countries has now just reached the level of Deutsche Bank's production assumptions, meaning that the assessment of a modest global deficit in the oil market in the second half the year remains intact.

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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 July 3 to Friday July 7, 2017 Total Upgrades: 8 Total Downgrades: 8 Net Ratings Breakdown: Buy 42.33%; Hold 41.25%; Sell 16.42%

For the week ending Friday, 7th July 2017, FNArena registered eight downgrades and eight upgrades in broker ratings for individual ASX-listed stocks, with the added observation that both Flight Centre (2x) and Magellan Financial (3x) account for more than half of all downgrades.

A stark difference between the two is Flight Centre reaped two extra Sell ratings following its short covering inspired rally, while downgrades for Magellan stopped at Neutral.

Two banks and BHP Billiton were among the stocks receiving recommendation upgrades during the week.

Upward revisions to valuation/price targets remained rather benign, which can also be seen in a context of a quiet corporate calendar, even though this is confession season ahead of the August reporting time. oOh!Media and Origin Energy top the tables with increases of 1.9% and 1.7% respectively.

The downside offers higher numbers as Myer took another -3.78% hit, followed by APN Outdoor (-2.87%) and Link Administration (-2.42%). The latter raised fresh capital to pay for a potentially transformational UK acquisition.

Changes to earnings forecasts were more brisk, with Xero enjoying a solid boost, followed by Brickworks, oOh!Media and St Barbara. Again, negative adjustments tended to be larger with Mt Gibson Mining receiving the biggest blow, followed by Janus Henderson Group, Mineral Resources, Resolute Mining and Oz Minerals.

Special note: analysts are shifting their forecasts into USD for Janus Henderson as the merged entity is not only listed on NYSE, its prime reporting currency will now be the greenback.

Upgrade

AUSTRALIA & NEW ZEALAND BANKING GROUP ((ANZ)) Upgrade to Outperform from Neutral by Macquarie .B/H/S: 3/5/0

The ability and willingness of the banks to reprice their mortgage books has surprised Macquarie, and led the broker to believe near term earnings trends should remain supportive. There is scope, the broker suggests, for the majors to beat FY17 consensus forecasts.

ANZ leads the big four in capital position, therefore it is well placed to meet APRA's new capital requirements, the announcement of which is pending. Macquarie upgrades to Outperform. Target rises to $30.50 from $30.00.

BEADELL RESOURCES LIMITED ((BDR)) Upgrade to Neutral from Sell by UBS .B/H/S: 1/2/0

UBS upgrades to Neutral from Sell, suspecting the de-rating in the share price is complete. As the stock now factors in a stronger Brazilian real the risks appear balanced to the broker.

Nevertheless, as Australian investors have considerable choice locally, the broker believes the company's single asset exposure and currency risks are likely to keep some on the sidelines until the exposure to the real is reduced. Target is reduced to $0.23 from $0.24.

BHP BILLITON LIMITED ((BHP)) Upgrade to Buy from Hold by Deutsche Bank .B/H/S: 6/2/0

BHP has underperformed global mining peers over the past three years and Deutsche Bank finds automation, productivity and high returning growth are the most compelling features of the company's opportunities.

The broker believes a sharper focus on returns could create significant value for shareholders. Rating is upgraded to Buy from Hold and the target to $27.50 from $24.40.

DEXUS PROPERTY GROUP ((DXS)) Upgrade to Hold from Lighten by Ord Minnett .B/H/S: 1/2/3

Ord Minnett reviews estimates, focusing on the Sydney CBD exposure and incorporating the acquisition of the MLC and Pyrmont buildings. The broker also notes the share prices declined by around -11% in the last two weeks, with the securities underperforming the sector.

Continued strength in Sydney is priced in, the broker believes. Hence, rating is upgraded to Hold from Lighten and the target is increased to $9.50 from $9.00.

INVESTA OFFICE FUND ((IOF)) Upgrade to Accumulate from Hold by Ord Minnett .B/H/S: 1/1/2

Ord Minnett believes the outlook for the fund's Sydney portfolio has improved because of the pace at which market rents continue to rise in recent sales, which suggest asset values have increased a further 15% in the past three months.

Earnings forecasts are increased by 10%. The broker upgrades to Accumulate from Hold. Target is $5.00.

NATIONAL AUSTRALIA BANK LIMITED ((NAB)) Upgrade to Neutral from Underperform by Macquarie .B/H/S: 3/2/3

The ability and willingness of the banks to reprice their mortgage books has surprised Macquarie, and led the broker to believe near term earnings trends should remain supportive. There is scope, the broker suggests, for the majors to beat FY17 consensus forecasts.

Given recent share price underperformance against peers, Macquarie upgrades NAB to neutral. Target rises to $32.00 from $31.50.

ORIGIN ENERGY LIMITED ((ORG)) Upgrade to Buy from Neutral by Citi .B/H/S: 4/3/0

Citi has upgraded to Buy from Neutral while lifting the target price by 14% to $8.59 as increased cash flows should assist with rebuilding the balance sheet.

The analysts explain their modeling now includes the increased asset divestments announced May 19th, plus a mark to mark on electricity/gas prices and tariffs.

Both have been partially offset by higher costs. The risk, suggest the analysts, is that without an oil price recovery, any share price recovery may be longer dated.

SILVER LAKE RESOURCES LIMITED ((SLR)) Upgrade to Neutral from Sell by UBS .B/H/S: 0/1/0

UBS upgrades to Neutral from Sell, following a sharp pull-back in the share price. The broker suspects, with an increasing gold price outlook, that the stock's leverage may see it outperform peers.

Target is reduced to $0.48 from $0.53.

Downgrade

DORAY MINERALS LIMITED ((DRM)) Downgrade to Underperform from Neutral by Macquarie .B/H/S: 0/0/1

Mining is to be suspended at Andy Well as mining of the Wilbur and Judy lodes have demonstrated less extensive gold mineralisation than previously expected.

The company has been considering supplementing underground ore from Andy Well with open pit ore from the nearby Gnaweeda project but this is not a possibility until late FY18. The Deflector mine will now become the company's sole operation.

The suspension of operations at Andy Well comes as a surprise to Macquarie. Rating is downgraded to Underperform from Neutral. Target is reduced to $0.19 from $0.28.

FLIGHT CENTRE LIMITED ((FLT)) Downgrade to Underperform from Outperform by Credit Suisse and Downgrade to Sell from Neutral by Citi .B/H/S: 0/4/4

The recent gains in the share price have overshot valuation, Credit Suisse believes. The broker downgrades to Underperform from Outperform.

The broker increases FY17 earnings estimates in line with recent guidance and, despite the rating change, notes several avenues for improvements to valuation are emerging. Target is raised to $37.41 from $34.90.

Ultimately, it took five downgrades in three years, note the analysts at Citi, but Flight Centre has -finally!- managed to publish an upwardly revised guidance for FY17; towards the top end of the previous range.

In addition, management has announced an efficiency program which should drive the PBT / TTV ratio from 1.6% to 1.9% over five years. Citi analysts note the supply-demand outlook for airfare pricing has clearly improved.

Citi has implemented double-digit earnings upgrades in FY18 and FY19, Target price moves to $40.00 from $30.90 as a result. Alas, following yesterday's jump in the share price, the analysts are also of the view the share price has factored in a rather optimistic organic growth profile and/or major cost out program. Downgrade to Sell from Neutral.

HANSEN TECHNOLOGIES LIMITED ((HSN)) Downgrade to Accumulate from Buy by Ord Minnett .B/H/S: 1/1/0

The company has made a sizeable acquisition with Enoro but Ord Minnett notes, unfortunately, it was combined with a downgrade to second half underlying earnings. Hence, the broker finds FY18 estimates end up relatively flat overall, post the capital dilution.

The broker has no problem with the Enoro business, or the price paid, but the magnitude of the earnings downgrade creates a reason to be cautious.

Ord Minnett no longer envisages sufficient upside to retain a Buy rating and downgrades to Accumulate. Target is reduced to $4.59 from $4.73.

MAGELLAN FINANCIAL GROUP LIMITED ((MFG)) Downgrade to Neutral from Buy by UBS and Downgrade to Neutral from Outperform by Credit Suisse and Downgrade to Hold from Add by Morgans .B/H/S: 1/5/0

The stock has been the top performer in Australia diversified financials in the year-to-date, UBS observes.

The company has delivered a 24% total return and investment outperformance has also been a factor, with key global equity funds 1.4% ahead of benchmark.

UBS now believes the stock is fairly valued and downgrades to Neutral from Buy. Target is raised to $28.40 from $26.40.

Weaker Australian equity markets have negatively affected earnings in June. Following around 20% outperformance in 2017 Credit Suisse is downgrading to Neutral from Outperform.

The broker envisages the current trading multiples are justified, considering the double-digit earnings growth outlook, but there is limited upside from this point. Target is reduced to $27.00 from $27.50.

Morgans suspects that a negative performance in June, lower-than-expected FY17 performance fees and further market volatility may mean the share price weakens in the short term.

The broker estimates that outperformance versus benchmark has been eroded in the primary funds in June and lowers its expectations for performance fees in FY17.

Rating is downgraded to Hold from Add. The broker believes any broader market volatility could provide a better entry point for longer-term investors. Target is raised to $27.95 from $27.80.

VILLAGE ROADSHOW LIMITED ((VRL)) Downgrade to Sell from Neutral by Citi .B/H/S: 0/3/1

Box office numbers are weak, according to the latest industry data. Not just in Australia, but also in New Zealand and in Germany. In addition, price discounting seems to be forcing the whole industry into lower priced tickets in Australia.

Citi analysts are clearly worried, also because a revamped Hoyts seems to be grabbing more market share. It is Citi's long standing view that Hoyts now can offer a superior product at a comparable price to both Village Roadshow and Event Hospitality and Entertainment.

As risks are building for disappointment, Citi analysts have decided to downgrade Village Roadshow to Sell, and retain the Sell rating for Event. Target for Village Roadshow falls to $3.85. Earnings estimates have been cut.

Total Recommendations Recommendation Changes

Broker Recommendation Breakup

Broker Rating Order Company New Rating Old Rating Broker Upgrade 1 AUSTRALIA & NEW ZEALAND BANKING GROUP Buy Neutral Macquarie 2 BEADELL RESOURCES LIMITED Neutral Sell UBS 3 BHP BILLITON LIMITED Buy Neutral Deutsche Bank 4 DEXUS PROPERTY GROUP Neutral Sell Ord Minnett 5 INVESTA OFFICE FUND Buy Neutral Ord Minnett 6 NATIONAL AUSTRALIA BANK LIMITED Neutral Sell Macquarie 7 ORIGIN ENERGY LIMITED Buy Neutral Citi 8 SILVER LAKE RESOURCES LIMITED Neutral Sell UBS Downgrade 9 DORAY MINERALS LIMITED Sell Neutral Macquarie 10 FLIGHT CENTRE LIMITED Sell Neutral Citi 11 FLIGHT CENTRE LIMITED Sell Buy Credit Suisse 12 HANSEN TECHNOLOGIES LIMITED Buy Buy Ord Minnett 13 MAGELLAN FINANCIAL GROUP LIMITED Neutral Buy Morgans 14 MAGELLAN FINANCIAL GROUP LIMITED Neutral Buy UBS 15 MAGELLAN FINANCIAL GROUP LIMITED Neutral Buy Credit Suisse 16 VILLAGE ROADSHOW LIMITED Sell Neutral Citi Recommendation Positive Change Covered by > 2 Brokers Order Symbol Company New Rating Previous Rating Change Recs 1 ORG ORIGIN ENERGY LIMITED 50.0% 36.0% 14.0% 7 2 BHP BHP BILLITON LIMITED 75.0% 63.0% 12.0% 8 3 ANZ AUSTRALIA & NEW ZEALAND BANKING GROUP 31.0% 19.0% 12.0% 8 4 IOF INVESTA OFFICE FUND -38.0% -50.0% 12.0% 4 5 JHG JANUS HENDERSON GROUP PLC. 60.0% 50.0% 10.0% 5 6 DXS DEXUS PROPERTY GROUP -33.0% -42.0% 9.0% 6 7 VRT VIRTUS HEALTH LIMITED 33.0% 25.0% 8.0% 3 8 APO APN OUTDOOR GROUP LIMITED 80.0% 75.0% 5.0% 5 9 OML OOH!MEDIA LIMITED 88.0% 83.0% 5.0% 4 Negative Change Covered by > 2 Brokers Order Symbol Company New Rating Previous Rating Change Recs 1 MFG MAGELLAN FINANCIAL GROUP LIMITED 17.0% 67.0% -50.0% 6 2 LNK LINK ADMINISTRATION HOLDINGS LIMITED 33.0% 60.0% -27.0% 6 3 MYR MYER HOLDINGS LIMITED -7.0% 7.0% -14.0% 7 4 TPM TPG TELECOM LIMITED -6.0% 6.0% -12.0% 8 Target Price Positive Change Covered by > 2 Brokers Order Symbol Company New Target Previous Target Change Recs 1 OML OOH!MEDIA LIMITED 5.013 4.917 1.95% 4 2 ORG ORIGIN ENERGY LIMITED 7.799 7.667 1.72% 7 3 BHP BHP BILLITON LIMITED 27.523 27.135 1.43% 8 4 DXS DEXUS PROPERTY GROUP 9.468 9.385 0.88% 6 5 MFG MAGELLAN FINANCIAL GROUP LIMITED 27.127 26.910 0.81% 6 6 ANZ AUSTRALIA & NEW ZEALAND BANKING GROUP 30.625 30.563 0.20% 8 Negative Change Covered by > 2 Brokers Order Symbol Company New Target Previous Target Change Recs 1 MYR MYER HOLDINGS LIMITED 0.917 0.953 -3.78% 7 2 APO APN OUTDOOR GROUP LIMITED 6.124 6.305 -2.87% 5 3 LNK LINK ADMINISTRATION HOLDINGS LIMITED 8.790 9.008 -2.42% 6 4 TPM TPG TELECOM LIMITED 7.025 7.113 -1.24% 8 5 VRT VIRTUS HEALTH LIMITED 6.427 6.495 -1.05% 3 Earning Forecast Positive Change Covered by > 2 Brokers Order Symbol Company New EF Previous EF Change Recs 1 XRO XERO LIMITED -15.978 -52.290 69.44% 4 2 BKW BRICKWORKS LIMITED 128.775 123.750 4.06% 4 3 OML OOH!MEDIA LIMITED 25.460 24.613 3.44% 4 4 SBM ST BARBARA LIMITED 33.313 32.270 3.23% 4 5 SWM SEVEN WEST MEDIA LIMITED 11.069 10.811 2.39% 4 6 IGO INDEPENDENCE GROUP NL 7.868 7.785 1.07% 6 7 QBE QBE INSURANCE GROUP LIMITED 81.301 80.484 1.02% 8 8 ILU ILUKA RESOURCES LIMITED 15.440 15.297 0.93% 7 9 CTX CALTEX AUSTRALIA LIMITED 227.014 225.486 0.68% 7 10 HVN HARVEY NORMAN HOLDINGS LIMITED 35.252 35.035 0.62% 7 Negative Change Covered by > 2 Brokers Order Symbol Company New EF Previous EF Change Recs 1 MGX MOUNT GIBSON IRON LIMITED 1.750 4.100 -57.32% 3 2 JHG JANUS HENDERSON GROUP PLC. 259.636 317.408 -18.20% 5 3 MIN MINERAL RESOURCES LIMITED 95.060 103.260 -7.94% 3 4 RSG RESOLUTE MINING LIMITED 22.733 24.650 -7.78% 3 5 OZL OZ MINERALS LIMITED 50.496 53.246 -5.16% 8 6 BHP BHP BILLITON LIMITED 191.776 196.495 -2.40% 8 7 RIO RIO TINTO LIMITED 643.747 659.163 -2.34% 8 8 SFR SANDFIRE RESOURCES NL 54.224 55.349 -2.03% 8 9 BAP BAPCOR LIMITED 23.825 24.250 -1.75% 4 10 APO APN OUTDOOR GROUP LIMITED 35.552 36.062 -1.41% 5 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: Taking Its Toll

Persistently low spot uranium prices have all but claimed another victim, as Australia’s Paladin Energy enters administration.

By Greg Peel

Australian uranium miner Paladin Energy ((PDN)) was forced into administration last week and trading in the company’s shares were halted. The move comes as a result of China’s CNNC seeking to exercise an option to acquire the 75% of Paladin’s flagship Langer Heinrich mine in Namibia it doesn’t own – an option triggered by debt default.

Paladin initially wanted to fight CNNC in court, claiming it was not in default, but after consulting with debt holders agreed not to do so due to prohibitive cost. Paladin conceded to losing Langer Heinrich and wanted to proceed with restructuring the remaining business and debt obligations, until Electricite de France introduced a new problem.

Paladin was due to pay EdF $277m this week under a long term supply agreement signed in 2012, in which EdF provided the miner with prepayment. Paladin requested a standstill on the repayment until a restructure can be achieved, and EdF said no. Prior to this refusal, Paladin had secured sufficient support from bond holders for its restructuring plans that would see equity holders highly diluted. As CNNC awaits an independent valuation of Langer Heinrich, the administrators will undertake assessment of the remaining debt position and the company’s assets, which include an 85% share in the Kayelekera mine in Malawi, under care & maintenance since 2014.

It’s a far cry from the glory days of early 2007 when Paladin shares traded at over A$10 and the uranium spot price neared US$140/lb. That year saw a peak for both, and a sharp retracement. Then along came the Japanese tsunami in 2011 and the rest is history. Saddled with excessive debt and electing not to lock in long term contract pricing at higher levels ahead of the Fukushima disaster, Paladin has been fighting against a falling spot uranium price ever since. Prior to the trading halt, Paladin shares were trading at A4.7c.

Back in May, UBS valued Paladin at A28c on the assumption the Kayelekera mine would restart in 2020 as planned, but applied a -50% discount due to restructure risk to arrive at a A12c price target for the stock. UBS retained its target and Neutral rating last week but warned Paladin was a high risk investment.

July is typically a quiet month in the uranium market and the first week has brought no surprises, with the US Independence Day holiday a contributing factor. Industry consultant TradeTech’s weekly spot price indicator did manage to rise for the sixth consecutive week, but only by another US5c to US$20.25/lb.

That glory run of six weeks has only managed to produce a US75c net gain.

Two transactions were reported in term markets last week totalling 6mlbs U_3O_8 equivalent. TradeTech’s term price indicators remain at US$24.45/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 July 6, 2017

There is only one “theme” in the Australian market at present – bouncing hard back and forth between 5680 and 5800 without going anywhere, yet still giving everyone apoplexy. Yesterday we were down -50 and today we’re up 50 so far. Mindless stuff that makes one wonder just what role HFT and EFTs are playing in this charade.

Suffice to say there is no market trend to suggest short-covering, either profit or loss, or short position building. As usual there’s a fair amount of red and green below representing only small changes, and again there are only a couple of exceptions amongst individual stocks.

Yet realistically there’s nothing new to report.

Lithium miner Orecobre ((ORE)) cut production guidance last week due to bad weather and saw short profit-taking, falling to 17.7% shorted from 20.0%. Orecobre has ceded most shorted position to graphite miner Syrah Resources ((SYR)) but these battery-related stocks fly up and down in share price every other day for no apparent reason.

The nickel price has been up and down and short positions in Western Areas ((WSA)) and Independence Group ((IGO)) tend to follow, although both remain incumbent towards the top of the table.

As does Myer ((MYR)) which has crept up further.

Just when shorts in Ardent Leisure ((AAD)) had quietly started to reduce, the company issued yet another profit warning and the shorters have jumped back in, taking positions back up to 11.4% from 8.5%.

While such movements would normally classify as Movers & Shakers the stories above are so well worn they are not worth expanding on any further.

I will note, for sake of anything interesting, that Automotive Holdings Group ((AHG)) persistent march up the brackets continued last week, to 8.1% from 7.6%, and also that APN Outdoor ((APO)) – a player in the currently hot-to-trot outdoor advertising game – popped into last week’s table in the 5% bracket and this week has moved up into the 6%.

Weekly short positions as a percentage of market cap:

10%+

SYR 17.8 ORE 17.7 MYR 16.0 IGO 14.9 WSA 14.6 ISD 13.0 JBH 12.8 MTS 12.5 RFG 12.2 MYX 12.0 AAD 11.4 ACX 11.3 FLT 11.0 DMP 10.7 SHV 10.0

In: AAD

9.0-9.9%

GXY, NEC Out: HVN, JHC

8.0-8.9%

HVN, JHC, GTY, QIN, HSO, BKL, AHG, A2M, CTD

In: HVN, JHC , AHG, A2M Out: AAD

7.0-7.9%

TPM, NWS, GXL, BAP, EHE

In: GXL Out: AHG, A2M, OFX, BGA, MND, VOC

6.0-6.9%

BEN, VOC, IPD, RIO, MND, OFX, PRU, APO, SAR, SEK, RWC, BAL, BGA SRX, CSV, NXT, IFL

In: VOC, MND, OFX, BGA, APO, BAL Out: GXL, SRX, CSV, NXT, IFL

5.0-5.9%

OSH, MYO, NXT, SRX, IFL, CSV, AWE, RCG, AWC, DCN, AAC, KAR, AYS, PPT, VRT, CCP

In: NXT, SRX, IFL, CSV, AYS, PPT Out: APO, BAL, PLS, MSB

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: Rates, Bonds, AREITs, Power Price Misery

Weekly Broker Wrap: markets not reading central bankers well; global growth is flattening; AREITs and rising interest rates; the effect of high power prices on supermarkets and miners; merged AfterPay Touch in focus.

-Normalising is not tightening -Global Growth - Flattening -Back To Normal, And AREITs -High Electricity Prices: From Supermarkets To Miners -AfterPay Touch: In Focus

By Rudi Filapek-Vandyck

Normalising is not tightening

Central bankers are moving away from emergency settings, but investors are not understanding the message correctly, argue economists at Standard Life. The end of emergency does not equal the start of tightening and neither does it signal the end of the cycle is near.

Having said so, the post GFC-crisis has been more complex than the era before it and Standard Life admits even central bankers themselves are still trying to grapple with what exactly is happening under the bonnet of their economies and why, and what the impact is on interest rates and policy measures.

The underlying message remains the same, however, and that is that things are improving around the world, which is a positive. Meanwhile, markets and the Federal Reserve continue to see things a little differently when looking ahead and that, explains Standard Life, is due to the gap between "hope" and "experience".

"For much of the post-crisis period, expectations about policy normalisation have been confounded by events that have forced delays and even policy reversals. Once bitten twice shy, many market participants remain wary of the Fed's ability to deliver on its current guidance despite the three rate hikes since December and effective pre-announcement of balance sheet run-off, neither of which were anticipated this time last year."

Standard Life's prognostication remains for the Fed to start shrinking the balance sheet, most likely in September, and then maybe with a follow-up rate hike in December. For the whole of 2018 only two more hikes are anticipated, below the infamous dot plots communicated by the Fed and certainly below predictions of four hikes as put forward by more hawkish forecasters elsewhere.

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Over in the UK, Standard Life's forecasts remain more cautious than those communicated by the Bank of England and the economists agree it appears the BoE may well be prepared to tighten policy before the UK exits the single market, even if its forecasts have not been met.

But Draghi's speech at the ECB forum on Central Banking in Sintra, Portugal, should not be interpreted as a more hawkish stance by the central bank that warrants significant market repricing. Standard Life observes financial markets are missing the point in that here is an evolving policy stance towards normalisation on display, not the advent of a new tightening phase.

Standard Life's view remains that the ECB asset purchase program will be wound down in stages from the beginning of 2018 with purchases ending by the end of the year. Extension is possible if conditions deteriorate significantly, say the economists.

Meanwhile in Japan, the Bank of Japan is expected to stick to its ultra-accommodative yield curve control (YCC) with Standard Life anticipating no change, probably for as far as the eye can see, but definitely throughout the remainder of calendar 2017. The only major market circuit breakes, speculate the economists, would be a significant rise in the US dollar-yen rate in the event of a gapping of real yield differentials.

All around Emerging Economies, Standard Life sees the same dynamic now in play. Policy rates, in real terms (adjusted for inflation), are still negative and given the recovery in economies, and tightness in labour markets, such extreme policy settings no longer seem appropriate. Here too a "normalisation process" is taking shape.

Standard Life's view was backed up by economists at National Australia Bank who concluded that, while advanced economy central bankers are looking to remove the proverbial 'punch bowl', "For the moment, near term rate hikes by these central bank are not in prospect, and in the case of the ECB and Riksbank QE programs are continuing for now, but the change in direction has had an effect on markets, reflected in a marked rise in 10 year government bond yields – across many countries – starting around late June."

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There were no specific forecasts for the RBA cash rate in Australia in Standard Life's market update, but Pimco Managing Director Portfolio Manager, Robert Mead offered to fill the void during the week. Pimco's base case is for GDP growth to keep shugging along between 2-3% for the next 3-5 years, with inflation well contained in the 1.5%-2.5% range.

But complacency is not appropriate with Australian households' debt surging to well over 100% of GDP. This means, offers Mead, any changes to the supportive environment (read: China) could have major ramifications for the Australian economy. Pimco suggests any rate hike aspirations by the RBA will have to wait at least until "well into 2018".

Since the Federal Reserve is expected to continue hiking rates in the meantime, it is likely next year the RBA cash rate will end up below the US Fed funds rate, points out Mead.

Global Growth - Flattening

Economists at both National Australia Bank and ANZ Bank report that on forward looking indicators it appears the global economic upturn that started in 2016 and hit a bit of a speed bump in the past six months, is likely to decelerate in the second half of the year.

Says National Australia Bank: "Our leading indicator of global economic activity shows growth trending down rather than up through the latter half of the year, driven by two especially volatile components of the measure – the drop in industrial metals prices and a subsiding in air freight volume growth to more normal levels. Their volatility means it is too early to move away from our forecast that the global economic upturn continues, with growth lifting from 2016’s 3.1% to a predicted 3.3% this year and another rise to a trend-pace of 3.5% in 2018."

Says ANZ Bank: "The ANZ Global Economic Advance Reading (GEAR) Index, which is a composite index of financial conditions and liquidity, is foreshadowing an easing in our [Global Lead Index] GLI over 2H 2017. The GEAR is becoming less positive for global growth as the Fed is about to embark on balance sheet normalisation alongside further rate normalisation. In addition, other major central banks, with the exception of the BoJ, appear to be shifting away from explicit easing biases. In some cases the shift in policy bias is towards tightening."

Back To Normal, And A-REITs

What if? The question has been asked a few times by A-REIT sector specialists at Citi. What if everything were to revert back to normal? Meaning interest rates would have a lot higher to climb.

The impact on share prices for the REIT sector on the ASX would be quite devastating, on the analysts' calculations. In late May, Citi's analysis suggested potential share price downside of -25% on average. Since then, note the analysts, share prices have fallen by circa -9%.

The latter signals a whole lot more adjustment would need to happen in case of full normalisation to pre-GFC settings (which Citi is not forecasting).

Of more importance, however, is that Citi's research runs contrary to popular perception that under a scenario of interest rates normalisation, actively managed REITs should perform better than their passive peers. As the prior period of exceptionally low global interest rates and bond yields has primarily led to a bull market in asset values, it is Citi analysts' conclusion that this time the wheels will turn into the opposite directon, with passive funds to outperform the active ones.

As such, for investors who require exposure to the sector, and under the assumption the global normalisation has further to go, Citi's sector preferences are Vicinity Centres ((VCX)), Stockland ((SGP)) and Scentre Group ((SCG)); all are currently trading below normalised multiples, note the analysts, while the sector overall continues to trade at a premium.

Least liked are Mirvac ((MGR)) and Goodman Group (GMG)) and Dexus Property ((DXS)) respectively on perceived earnings downside risk and cyclically elevated multiples.

High Electricity Prices: From Supermarkets To Miners

A recent study by analysts at Morgan Stanley suggests Australia's experience with persistent food deflation might be coming to an end, despite both Coles ((WES)) and Woolworths ((WOW)), as well as key competitors Aldi and IGA ((MTS)), continuing to reduce prices.

The reason, states the report, is "significant cost inflation driven by electricity". Morgan Stanley reports electricity costs are expected to rise by some 40% in FY18 for one unnamed retailer. Suppliers to supermarkets have already begun lifting prices since July 1st for that same reason, states the report.

A different angle on the theme was provided by mining analysts at Goldman Sachs who believe power bills for the mining sector are set to increase significantly in coming years. While electricity remains a small component of costs - Goldman Sachs estimates it represent no more than.6.3% for the industry on average- rising power cost will nevertheless have an impact on profitability, predict the analysts.

Most at risk will be grid fed operations in Queensland and NSW, while self-generation companies, such as the WA iron ore miners, will have a bigger buffer, according to the report. The analysis indicates circa US$500m of annual power contracts are up for renegotiation between now and 2020 with futures markets pointing towards the potential of a 20-40% lift in contract rates.

Amongst the operations that are due for a power shock are gold mines such as Cowal ((EVN)) and Cadia ((NCM)) and coal assets such as Illawarra Coal ((S32)) & Narrabri ((WHC)). Companies that might have to temper earnings expectations for FY18 include Newcrest Mining, Evolution Mining, South32 and Whitehaven Coal.

AfterPay Touch: In Focus

Recently merged AfterPay Touch ((APT)) is attracting quite the bullish broker updates. Last week The Wrap included Bell Potter's positive assessment post merger (July 7). This week we picked up an update by Wilsons, with the report stating: "APT is not an easy business to value given the growth profile."

A quick look at the revised numbers instantly reveals the problem Wilsons had to struggle with: projected growth in earnings per share this year (FY17): 184.9%. For FY18: 455.1%. For FY19: 36.5%.

For those as yet unfamiliar with this company, Afterpay provides consumers with a short-term, deferred payments option, allowing them to 'buy now and pay later', usually in four increments. No interest is being charged. The Touch System Platform is cloud-based and enables the secure electronic delivery of non-physical products, services and entitlements, including vouchers, tickets and other tokens.

Wilsons has slapped a $3.95 price target on top of its Buy rating. The shares are trading near $3.

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Tomorrow's Looking Bright for EML Payments

Canaccord Genuity has initiated coverage with a Buy recommendation on EML Payments suggesting the company offers investors good exposure to the growing prepaid financial products industry.

-Canaccord Genuity initiates coverage with Buy recommendation for EML Payments -EML Payments seen offering above-average revenue growth -Prepaid financial products industry shows signs for growth

By Nicki Bourlioufas

Small cap specialist Canaccord Genuity has given ASX fintech EML Payments ((EML)) a Buy recommendation on its first commentary on the stock, with a price target of $2.05 per-share. The stock currently trades around $1.53.

EML –formally eMerchants– provides prepaid cards and has undergone strong growth in recent years, expanding its footprint with acquisitions in key markets such as the United States and Europe.

The company offers payment solutions for gift cards, incentives and rewards programs and supplier payments. After its expansion, EML now manages more than 850 prepaid programs across 13 countries in five currencies.

Key customer segments include gaming and wagering services, consumer lending, shopping malls and salary packing firms. Contracts are typically signed on exclusive five-year terms providing predictability to EML's revenue and gross profit with negligible customer churn.

Canaccord Genuity analyst Owen Humphries said in a note to clients that EML had experienced healthy growth, enjoyed gross profit margins of around 80% and had an attractive earnings profile.

"We believe EML offers investors exposure to the emerging and fast growing [general purpose reloadable] payments industry," Humphries said.

"The company's above-average organic revenue growth – fuelled by share gains, market growth and increased card usage – coupled with strong operating leverage, should support a meaningful sustainable valuation premium in our view.

"We are encouraged by EML's medium-term growth prospects and valuation metrics (higher growth, market multiple)."

EML had earnings before interest, tax, depreciated and amortisation (EBITDA) of $5m in FY16. This is expected to rise to $13.9m in FY17. The company's outlook has earnings continuing to rise to $25.5m and $28.3m in FY18 and FY19 respectively.

EML also reported several large potential opportunities in its pipeline which could see more than 15% upside to Canaccord Genuity's FY18/FY19 EBITDA forecast, primarily in UK shopping malls, casinos and European online gaming.

Company and product background

EML is an issuer and processor of prepaid debit cards, ranging from reloadable cards such as gaming cards, fuel cards and corporate cards to traditional non-reloadable cards such as gift cards.

Prepaid cards allow the consumer to use a conventional plastic card linked to a unique account that is held at a financial institution, and similar to a debit card, the payments that are made deduct funds directly from the account. The cardholder has the ability to access these funds at an ATM, a point of sale location, or both.

Prepaid represents one of the fastest growing segments in the electronic payment space, says Humphries. The pre-paid card market is broken into four quadrants: closed or open loop, and reloadable or non-reloadable.

Open-loop cards connect to one of the major payment networks to complete transactions (e.g Visa or MasterCard). Closed loop networks largely rely on the retailer's private network and can sometimes require separate payment systems.

EML generates revenue through the various stages of a card's lifecycle. This comprises set-up fees (10% of gross profit), transaction fees (16%), interchange and breakage fees (59%), and interest earned on funds (15%).

Revenue is segmented into three product lines: Non-reloadable or single use cards cards (FY17 revenue $45m, gross profit $35.8m); Reloadable (FY17 revenue $12.4m, gross profit $9.1m); and Virtual B2B (FY17 revenue $1.4m, gross profit $1.3m).

Non-reloadable cards are branded for EML's clients. They can be used anywhere Visa or MasterCard are accepted and come pre-loaded with cash. Their primary use has been for welfare payments and as gift cards. In its first-half results for FY17, EML was generating interest revenue on around $383m in non-reloadable card funds.

But it's in breakage fees where EML's revenue model really shines. For every $100 loaded onto a non-reloadable card, approximately 5% remains on the card at the time of expiry with EML sharing this fee with the client. In the first half of FY17, breakage fees accounted for 72% of the gross profit generated from non-reloadable cards.

Reloadable cards have a smaller revenue profile than their single-use siblings, but represent a major driver of EML's growth profile. As the name suggests, reloadable cards can be regularly topped up.

The company has experienced success in the Australia domestic online gaming industry, issuing reloadable prepaid cards to Ladbrokes, Bet365, WilliamHill, CrownBet and Sportsbet, which allows cardholders to receive winnings instantaneously from payment terminals.

EML is attempting to export the success demonstrated in Australia to the North American and European markets. It's had some early successes, signing up Bet365 in the UK and Caesars Entertainment and LuLaRoe in the US.

"This is the major driver of EML's growth profile and in our view deserves a premium valuation given the predictable nature of its revenue streams," Canaccord Genuity's Owen Humphries said.

"The innovative approach to specific industry verticals is a key competitive advantage versus the incumbent banks, with EML working collaboratively with the corporate in designing/implementing a payment solution and acting as full service program manager."

Virtual B2B is EML's smallest product segment and remains in the start-up phase. It involves the automation and facilitation of payments from companies to their suppliers, and focuses on converting cheque payments to electronic payments over a virtual prepaid card.

Scottish Pacific: Niche Financier With Upside Potential

Canaccord Genuity has initiated a Buy recommendation on ASX-listed Scottish Pacific Group, saying the debtor finance company could grow steadily once it beds down recent acquisitions.

-Scottish Pacific has potential to grow faster than competitors -Scottish Pacific needs to satisfactorily integrate recent acquisitions -Peer-to-peer lending not seen as a genuine threat

By Nicki Bourlioufas

Small caps specialist Canaccord Genuity has initiated coverage of Scottish Pacific Group ((SCO)) with a Buy recommendation, accompanied by a price target of $2.94. The stock currently trades around $2.77.

Valuation and outlook

Scottish Pacific listed in July 2016 at $3.20 per share, but missed its prospectus earnings forecast and has drifted to $2.77 after a guidance downgrade in November.

Canaccord Genuity values Scottish Pacific at $3.13 a share using a discounted cash flow methodology but it notes any future re-rating by the market will depend on the company's ability to increase revenue and to satisfactorily integrate recent acquisitions. With these factors in mind, the maiden price target was set at $2.94.

The one broker in the FNArena universe that also covers the stock is Citi, which is currently rating the shares Buy with a price target of $3.50.

Debtor finance Industry

Scottish Pacific is the leading independent debtor finance company in Australia, holding about 20% of the market. The Debtor and Invoice Finance Association says the market has total turnover of about $65m a year.

Debtor finance is attractive to SMEs, companies with short trading histories, and those experiencing rapid growth or needing working capital. Companies pledge their receivables as collateral, so property is not required as security. A facility acts like revolving line of credit, automatically adjusting to the value of the client's invoices on issue. The major business risk Scottish Pacific faces is fraud by clients and their debtors.

Scottish Pacific background

Scottish Pacific has about 1,750 clients, with about 60% of its leads coming from its broker network and accountant contacts. It turns over 20% of its client base every year, so constant business development is imperative.

The business has operated for about 30 years and broking analysts highlight its executive ranks have a considerable depth of management experience in the industry.

Scottish Pacific securitises its clients' receivables by selling them into special purpose funding vehicles. Each of its three facilities has a senior lender that contributes 85% to 90% of the funding, plus a group of mezzanine lenders. Two of the senior lenders have provided funds for more than a decade.

Scottish Pacific also offers trade finance, which helps importers manage their long working capital cycle, based on its purchases of Tradeline in 2012 and Sterling Trade Finance in 2017.

During the eight months before it listed, Scottish Pacific bought competitor Bibby Financial Services and the debtor finance businesses of GE Capital Finance and Suncorp.

"Integrating Bibby proved problematic: Scottish Pacific tweaked some of Bibby's unique products to match its credit policies, prompting higher than usual levels of client attrition. The market is watching to see whether Scottish Pacific can complete the integration process smoothly and increase revenue to offset the costs of adjustment," said Canaccord Genuity in its first report on the company.

Some of the larger clients from the GE and Suncorp books also reduced borrowing, prompting the company to issue a guidance reducing its forecast of Earnings Before Interest and Tax (EBIT) by - 9% below the prospectus forecast.

In the wake of the acquisitions, and cuts to employee incentives after it missed the prospectus forecasts, Scottish Pacific is facing an employee cost of about $3m.

However, Canaccord Genuity maintains Scottish Pacific enjoys strong growth potential. “The recent onboarding of clients from the GE and Suncorp portfolios should improve its ability to pitch for larger accounts, and wider marketing of new products inherited from Bibby offers the potential of better margins and new client wins. Earnings translate strongly into operating cash flow, facilitating a high dividend payout ratio which should provide share price support.”

New products to expand opportunities

Scottish Pacific is developing a range of niche products that could appeal to a broader range of clients. One example is selective invoice financing, which provides loan funds against specific debtors rather than a client’s entire portfolio of receivables.

Another is bad debt protected facilities, under which the company takes out insurance against the risk of debtor default and agrees not to recoup most of the cost of any bad debts from the client.

Progress claim finance makes debtor finance available to companies in the construction and contracting sector.

Scottish Pacific inherited several such products from its Bibby acquisition, and it expected to increase marketing once it has structured them in a manner consistent with its existing credit policies.

Downside risks

Like all debtor finance providers, Scottish Pacific is exposed to fraud events. As protection, the company relies on its underwriting experience to identify risks, implement proper credit process and diversify its exposures.

The company’s acquisitions from GE Capital Finance and Suncorp have given rise to some client concentration, with its largest client having a facility of $80m. However, this concentration risk is lessened slightly by the 12-month contracts and three-month notice periods for terminating debtor finance facilities.

Canaccord Genuity says Scottish Pacific is highly dependent on its senior lenders, which provide up to 90% of the capital it advances to clients.

To preserve these relationships, as well as its reputation, the company must guard against any deterioration in the credit quality of the receivables portfolios it sells into the special purpose vehicles.

As the provider of first loss capital, Scottish Pacific is also in the front line – along with other mezzanine lenders – in the event of any defaults.

At least half a dozen fintech entrants are active in the Australian debtor finance market, using peer-to-peer platforms to link borrowers with sophisticated investors.

Several players require clients to link their accounting data via accounting software providers such as MYOB ((MYO)) and QuickBooks.

“While we believe these businesses are small at present, the ability to provide businesses with a fast and flexible form of financing is likely to be an attractive proposition to SMEs.

“The establishment of sustainable market share is dependent on increased liquidity on their respective platforms, which will require maintenance of strict credit processes to minimise investor losses. Should any of the online models experience high levels of losses, this may sour broader support for P2P debtor financing as an investment class.”

As a result, true disruption to Scottish Pacific’s business remains unlikely, Canaccord Genuity concludes.

Adairs Spring Cleaning Pays Off

Homemaker retailer Adairs recovers from bed linen buyer mistakes and aims to steadily expand and improve retail execution

By Nicki Bourlioufas

-Adairs shares spike after positive earnings guidance; more gains seen -Potential for growth in store expansion and better retail execution -Risks lurk in intensifying competition and cooling housing market

Analysts say share price rise justified

Adairs ((ADH)) share price shot up 30% on Wednesday after the manchester and fashion homewares retailer said its 2016-17 result would be at the top end of its profit guidance. The improved outlook is based on a significant recovery in fourth-quarter sales.

The improvement partially offset Adairs' downward trajectory since it listed in June 2015.

The stock fell by -40% in November 2016 after the company warned full-year performance would be affected by its failure to respond to a shift in bed linen fashions. The share price fell further in February after the company reported a -35% slump in half-year profit.

Adairs closed at $1.275 on Wednesday, well above its June 2017 low of $0.56, after the trading update by chief executive Mark Ronan.

Analysts at Goldman Sachs, UBS and Morgan responded positively to Ronan's statement, indicating they see potential for the stock to rise even further.

Goldman Sachs was most optimistic, reiterating its Buy recommendation and raising its target price to $1.48. It sees Adairs' vertically integrated model, in which private label products account for 90% of sales, as remaining relevant and defensive in a challenging retail environment.

UBS also maintained its Buy rating with a target price of $1.45, up from $1.16, saying Adairs is a vertically integrated retailer with a best-in-class supply chain operating in a fragmented industry.

Morgans, however, pulled back its rating from Add to Hold, while lifting its target price to $1.35 from $1.20. It said Adairs' new product hitting shelves is clearly resonating with consumers, although promotional activity remains key to foot traffic and sales.

What's driving the action?

Adairs has an online store and 130 stores in five formats: Adairs, Adairs Homemaker, Adairs Kids, Urban Home Republic, and outlets.

The retailer plans to open eight to 12 new stores a year over the next five years in Australia and New Zealand, and possibly South Africa.

The company expects FY17 sales to total $264.9m, at the very top of its prior guidance of $255m to $265m. Earnings before Interest and Tax (EBIT) are expected to come in between $30.5m and $31m, again close to the top end of its guidance of $27m to $32m.

Adairs' statement focused on a 3.8% fourth quarter increase in like-for-like sales, a calculation that strips out store closures and openings. Importantly, like-for-like sales improved in bed linen, which accounts for 40% of sales.

UBS notes the company's issues with this key category appear to be over, "with old stock largely cleared from stores. Adairs did benefit from Easter timing and cooler weather in the fourth quarter. However, the company saw strong sales in June, which is genuine like-for-like growth, in our view."

Adairs also put on record that it had experienced higher-than-usual variations in sales performance across centre types, product categories, store formats and geographies.

Goldman Sachs finds the variability was largely driven by broader retail conditions, but also that it pointed to opportunities for Adairs to improve retail execution at both the product level and store level.

Morgans suggests another factor in the second-half recovery is likely to have been Adairs' success in negotiating better rental terms. The company's store leases average five years, so Adairs typically renews 20% to 25% of its leases each year.

"We expect an increased focus on extracting better rental terms going forward, which should provide further cost productivity tailwinds in coming years," the broker said.

Holding steady in a fickle market

Adairs' offerings appeal to the mid-priced market for fashionable home furnishings, with competition coming from higher-priced retailers above – particularly international entrants – and from discount department stores at the lower end.

UBS says Adairs "is benefiting from a strong housing cycle in Australia and an increasing focus on higher-margin fast-fashion bedding and homewares products."

The company appears to have tapped into a mid-priced fashionable home furnishings market that generally sits below the international entrants, points out UBS.

But these entrants and discount department stores are increasing competitive pressure and this could be expected to increase over the medium-term.

UBS pinpoints the major near-term risks as being associated with the implementation of Adairs' new point-of-sale system. It also warns of possible inflation in the cost of imported products if the Australian dollar falls.

In the near term, Adairs faces a weakening macro-economic environment and would be hard-hit by any slowdown in the housing cycle.

But Goldman Sachs counters its economic team is tipping an improvement in the broader consumer environment in 2017-18, and such a development would boost Adairs' performance.

The concerns around competitive pressure from discount department stores may have been overdone, Goldman Sachs adds.

Morgans has identified risks in any possible depreciation of the Australian dollar, weak like-for-like sales growth, increased competition, weak product execution, and industry discounting, which would put pressure on margins.

Over the long term, Morgans says, the maturity of the homemaker category could put the brakes on growth, and new entrants – particularly internationals – could enter the market.

There is also the risk of failure in the emerging formats – Adairs Kids and Urban Home Republic – and in the expansion into offshore markets.

FNArena's market consensus forecasts shows Adairs fortunes should continue to improve in FY18, with dividend payout to lift to 7c per share, translating into a yield of 5.5% at yesterday's closing share price.

The consensus price target, derived from two brokers (Morgans and UBS), sits at $1.40, suggesting 9.4% upside ex-dividends.

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.

Caution Required On Goodman Group

Bottom Line 13/07/17

Daily Trend: Down WeeklyTrend: Down Monthly Trend: Up Support Levels: $7.50 / $7.21 / $6.78 Resistance Levels: $9.18 / $10.24 / $11.34

Technical Discussion

Goodman Group ((GMG)) is an Australia based integrated commercial and industrial property group. The Company is engaged in investing in industrial property, fund management, property services and property development, including development management. It owns, develops and manages real estate, including warehouses, logistics facilities, industrial estates, business parks and offices globally. It also offers property solutions for various industries, such as logistics, pharmaceutical, automotive, e-retail and retail. For the six months ending the 31st of December 2016 revenues decreased 14% to A$760.9M. Net income decreased 39% to A$556.8M. Revenues reveal the operating section for Continental Europe decreased 29% to A$389.5M whilst the operating section for the United Kingdom decreased 64% to A$23.3M. Broker consensus is "Hold". The dividend yield is 2.7%. Reasons to be bullish (caution short-term): → Management confident regarding the outlook for FY18. → Returns on assets in development are continuing to rise. → Management and development businesses sure strong active earnings. → Stabilisation of yields a possible catalyst for strength. → The company expects earnings per share to grow between 6% - 7% → Benefiting from the structural shift to e-commerce by consumers & retailers. → A strong balance sheet offers scope to choose inexpensive developments. → Geographical diversity.

It appeared that buyers were starting to wane during our last look at GMG with some choppy price action starting to take hold. This was an early warning sign which begged the question as to whether an interim high was about to be made. The following session saw sellers return which has resulted in a decline of just over 12% down to the recent pivot low made yesterday. The prior trend is exceptionally strong with this stock so this isn't major reason for concern although there is no doubt that impulsive price action has become the main theme on the way lower. In fact, the typical retracement zone has almost been tagged which in itself is reason for concern.

Remember, we must see a corrective pattern down into the target which at this stage simply hasn't transpired. One thing is certain, should impulsive price action take price down into the 50% - 61.8% retracement zone then a much deeper retracement is going to unfold. In other words, if we are to see a corrective pattern down then a bounce needs to materialise immediately. Anything other than an immediate rally would mean the wave count put forward here is incorrect which would obviously be less than ideal. This would result in a larger and more severe corrective pattern likely unfolding before the strong prior uptrend reignites. If we are looking for positives, then minor Type-A bullish divergence is in place on this daily chart although it's yet to trigger. If it does, then our wanted corrective pattern higher should kick into gear.

Trading Strategy

We've been noting the impulsive nature of the retracements in many stocks that we cover over the past few reviews which is exactly the situation here. This is reason to be cautious and it could well be that the next opportunity is going to be to the short side following a lacklustre bounce from current levels. If you're waiting to jump onto the strong longer-term uptrend, it should be several weeks as a minimum before an opportunity arises, and that's assuming a 3-wave movement completes in the target area as annotated just beneath $7.50. Either way, there is no opportunity at this stage.

Risk Disclosure Statement

THE RISK OF LOSS IN TRADING SECURITIES AND LEVERAGED INSTRUMENTS I.E. DERIVATIVES, SUCH AS FUTURES, OPTIONS AND CONTRACTS FOR DIFFERENCE CAN BE SUBSTANTIAL. YOU SHOULD THEREFORE CAREFULLY CONSIDER YOUR OBJECTIVES, FINANCIAL SITUATION, NEEDS AND ANY OTHER RELEVANT PERSONAL CIRCUMSTANCES TO DETERMINE WHETHER SUCH TRADING IS SUITABLE FOR YOU. THE HIGH DEGREE OF LEVERAGE THAT IS OFTEN OBTAINABLE IN

Two Threats To Conquer

In this week's Weekly Insights:

-Two Threats To Conquer -Conviction Calls: Citi, Bell Potter, Canaccord, and Morgans -Aristocrat Leisure: It's Not A Gamble -2016 - L'Année Extraordinaire -All-Weather Model Portfolio -Rudi On TV -Rudi On Tour

Two Threats To Conquer

By Rudi Filapek-Vandyck, Editor FNArena

Never underestimate financial markets' ability to surprise.

Events and outcomes during the FY17 financial year are an excellent case in point. Commodities and resources stocks were left staring into the abyss of eternal oblivion at the start of calendar 2016, but by December they were the star performers, destined to continue their rally, but all fell apart pretty quickly into the new calendar year.

Gold stocks who had become everyone's favourite all through 2015 and during the first half of 2016, quickly deflated, then rallied again, fell off a cliff, rallied again, fell, rallied, and then fell more.

Banks had turned into everyone's favourite whipping boy, but that rally in late 2016 made them a lot of friends, again. May once again proved a bridge too far and shareholders are since left licking their wounds.

And High PE growth stocks and yield/income providers such as Transurban ((TCL)), Sydney Airport ((SYD)) and Goodman Group ((GMG)) experienced a lot of turbulence after years of steady climbing share prices, thanks to sudden sell-offs in government bonds.

There was a collapse in the oil price, an unexpected outcome in the Brexit vote, a change in policy direction at the Federal Reserve and then the election of That President in the USA.

Quite amazing, really, that throughout all the turbulence, and the unexpected surprises contrary to market predictions, the Australian share market (ASX200) has managed to return 14.1% for the twelve months to June 30, 2017.

[Graph: UBS]

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The total return may look mightily impressive, in particular against the background of two low returning years prior, the broader context is a lot less so. The ASX has actually been one of the softer performers over the year, especially in the second half when dividends proved necessary to scrape in a positive return for the six months to June.

As a comparison, the global MSCI returned almost 10% just in the second half. For the June quarter, the ASX200 fell -2.4% to post its worst quarterly return since 1Q16 when the index declined -4.0%. In both cases a weaker oil price was partially to blame.

Further adding to the string of ongoing surprises, shares were hit by a sudden spike in volatility during the final days of June, just when it appeared that window dressing by institutions would allow the local market to finish the financial year on a strong and positive note.

As it turned out, central bankers in Europe and elsewhere stood up to crash the global party. Not that any of this will stop the industry from greasing the marketing machines in the weeks and months ahead. Double digit returns cannot be advertised in every year. Gotta make hay while the sun shines.

The FNArena/Vested Equities All-Weather Model Portfolio rediscovered its mojo in the second half, outperforming in all five months post January, pipping the broader market at the post for the half. It has been a great come-back on the back of having no exposure to banks and resources stocks.

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Investors would be wise to pay attention to the two major forces that have held back the share market's performance in the second half. In my view, those forces are a benign outlook for corporate earnings growth and the potential for higher bond yields.

The latter is spooking part of the investment community and one can hardly blame investors. Rising bond yields look scary and they can inflict a lot of damage in the share market, as witnessed, for example, in recent share price action for Newcrest Mining ((NCM)), Healthscope ((HSO)), Westfield Corp ((WFD)), TechnologyOne ((TNE)), CSL ((CSL)), Macquarie Group ((MQG)) and Carsales ((CAR)), to name but a few. Yes, indeed, the pull back in all of these share prices can largely be retraced back to rising yields on government bonds since June.

It is my personal view that 10-year government bonds globally should not continue to climb in the six months ahead, with central bankers merely trying to shake up market complacency in the absence of inflation. But one should never underestimate the potential for market mayhem as the central bankers' wake up call from June is now forcing large funds, hedge funds, and many others to reposition their portfolios. This is not by default a process that guaranteed will unfold smoothly and without any hiccups.

Attention must thus be paid to the potential for further weakness ahead.

Subscribers who've missed my assessment from Friday, can still read Rudi's View: My Name Is Bond via the Rudi's Views section on the FNArena website, or use the following link: https://www.fnarena.com/index.php/analysis-data/rudis-views/

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When it comes to profit forecasts, Australia is about to experience its best reporting season since August 2014. Forecast average EPS growth could come out as high as 17% next month. But that is not the number to focus on. The significant turnaround in fortunes for miners and energy producers is artificially pumping up the market average. Underlying, a large number of companies and whole sectors are seriously struggling.

Earnings forecasts in Australia started to top out in January and they have been in steady decline since. Today, as analysts are preparing for the reporting season in August, many more question marks are being asked about whether companies will be able to meet market expectations, or even their own guidance, without last minute accountancy tricks or one-off benefits.

More importantly, such question marks seem rife for the outlook beyond FY17 when weakness in domestic housing and/or consumer spending can have a pronounced impact.

All this is happening in a share market that is, on average, trading at premium valuation, meaning vulnerabilities can open up quickly in case of negative surprises from either central banks, bonds, governments, or simply reported profits.

Then again, one should never underestimate companies' abilities to provide compensation and/or upside surprise. Link Administration ((LNK)), Viva Energy ((VVR)) and Hansen Technologies ((HSN)) all announced well-received acquisitions in recent weeks. Beleagured Telstra ((TLS)) is rumoured to be working towards securitisation of its recurring NBN receipts. The BHP ((BHP)) board remains under pressure to release more shareholder value. Rio Tinto ((RIO)) is believed to be one of few only in the resources sector with ample cash flows to extra-spoil shareholders.

There will be plenty of dividends from miners and energy companies, but maybe not as much optimism looking forward as during the prior two reporting periods.

In general terms, companies that are not running out of puff and whose business models and sector dynamics can facilitate ongoing growth, even when things get tougher for large parts of the Australian share market, remain in my view excellently positioned to withstand increased volatility and challenges in the year ahead, even in the face of rising bond yields, as long as the latter don't trigger a share market rout or a rampant reflation trade a la late 2016.

It's the companies that land in struggle street or whose outlook is turning ex-growth that investors should be wary of. Despite a benign confession season thus far, August is going to reveal plenty of surprises either way.

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Every reporting season builds up its own character and market impact, through multiple surprises and disappointments. This is why forecasts about the share market's outlook are best made after August instead of in June.

However, unless the mood changes markedly during the local tsunami of corporate releases and updates throughout the four weeks of August, I am inclined to stick with a cautious and benign outlook for the Australian share market.

In practical terms, this means I am more sympathetic to the view as expressed by UBS strategists recently that the ASX200 by year-end may well not be far off from where the index is sitting today as opposed to others who publish forecasts a la 6400 by mid-2018.

The prospect of twelve percent upside over twelve months is by no means out of the question, and certainly 2016 has shown us all it can be done in a heartbeat, but somehow it makes a lot of sense to assume further gains will be harder, in the face of the challenges ahead.

Conviction Calls: Citi, Bell Potter, Canaccord, and Morgans

Shares in casino operator The Star Entertainment Group ((SGR)) have found it difficult to attract a lot of love and affection from investors over the year past. One glance at the twelve month price chart shows exactly that.

But is it justified? Star Entertainment enjoys a perfect score on the FNArena Sentiment Indicator of 1.0, meaning every single broker in the database with an opinion on the stock is rating the stock a Buy, or an equivalent of Buy. Consensus price target of $6.07 suggests the share price is some -20% too cheap (dividend payouts not included).

The latest to step into the limelight and sing the praises of the stock, Citi, didn't hold back either. Calling the stock "THE" value opportunity on the Australian share market, Citi has elevated The Star its Top Pick among Gaming stocks in Australia, predicting double-digit growth in FY18 will overwhelm investor scepticism and this should lead to a re-rate for the shares.

On Citi's assessment, the price should be more than 30% higher, at $6.65. Admittedly, this is the highest target among the brokers lined up on the FNArena website, but even the lowest target is more than 12% above where the share price currently trades.

A classic case of show me concrete results first? Or are the brokers missing something? August will probably deliver the answer.

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Tech sector analyst Chris Savage at Bell Potter has lined up his favourites ahead of the August reporting season. Favourites are always selected according to relative valuations, so don't expect any of my personal favourites to show up anytime soon. The best stocks such as Altium ((ALU)), WiseTech Global ((WTC)) and TechnologyOne ((TNE)) can hope for is a Hold recommendation, and that's exactly how Bell Potter is rating them at the moment, alongside Melbourne IT ((MLB)).

There are currently no Sell ratings for the sector on Savage's assessment. His Key Picks are Integrated Research ((IRI)), Appen ((APX)), Adacel Technologies ((ADA)) and Empired ((EPD)). Within this select group, Integrated Research is Bell Potter's Number One Favourite.

The stockbroker is anticipating a positive update from company management shortly, which should act as a catalyst for a share price that already is running upwards. Empired has had a bit of a wobbly existence on the ASX and has been chosen on the premise of a successful turnaround. Adacel issued a profit warning in early May, but this is clearly not impacting on Savage's outlook. Appen is everybody's favourite exposure to artificial intelligence (AI). More insights to be expected in August.

The above tech sector favourites have also been included in Bell Potter's "Stock Picks for FY18" which otherwise comprise of:

-Among Financials; Macquarie Group ((MQG)), National Australia Bank ((NAB)), Suncorp ((SUN)) -Among Diversified Financials; BT Investment Management ((BTT)), Challenger ((CGF)), Janus Henderson Group ((JHG)) -Among Discretionary Retail and Intellectual Property; Super Retail ((SUL)), Premier Investments ((PMV)), IPH Ltd ((IPH)) -Among Resources; Pantoro Ltd ((PNR)), Regis Resources ((RRL)), Fortescue Metals ((FMG)), FAR Ltd ((FAR)), Gold Road Resources ((GOR)), Galaxy Resources ((GXY)) -Among Agriculture; a2 Milk ((A2M)), Synlait Milk ((SM1), Huon Aquaculture ((HUO)) -Among Healthcare and biotech; Paragon Care ((PGC)), iSelect ((ISU)), Viralytics ((VLA)), Medical Developments ((MVP)), Mesoblast ((MSB)), Starpharma ((SPL)), Bionomics ((BNO))

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Canaccord Genuity, which specialises largely in small cap stocks here in Australia, just released its Australia Focus List, effectively the stockbroker's 11 favourite stock picks for the quarter ahead. These 11 stocks are: AMA Group ((AMA)), Beach Energy ((BPT)), Catapult Group International ((CAT)), Credit Corp ((CCP)), Galaxy Resources ((GXY)), Imdex ((IMD)), Impedimed ((IPD)), Infigen Energy ((IFN)), Kogan ((KGN)), Metals X ((MLX)) and Skydive the Beach Group ((SKB)).

Small cap industrials specialists at Ord Minnett have nominated Huon Aquaculture ((HUO)) as their Key Pick, while Collection House ((CLH)) is now their Bottom Pick.

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Stockbroker Morgans has removed Orora ((ORA)) and Speedcast ((SDA)) from its list of High Conviction Stocks. Explains the broker: "Our overall favourable view on both stocks remains undiminished, but some near-term headwinds present an opportunity to lock in profits. In an expensive market, investors have been unforgiving when it comes to unexpected earnings surprises."

Instead, Morgans has added Australian Finance Group ((AFG)) with market scepticism seen as overdone and the mortgage brokers network seen offering good value, an attractive dividend yield (8%-plus) and potential for market share gains, acquisitions and a positive surprise in August.

Other stocks that remain on the High Conviction List are ResMed ((RMD)), Westpac ((WBC)), Oil Search ((OSH)) and Bapcor ((BAP)).

Note to paying subscribers: all Weekly Insights updates since early February this year have included updates on Conviction Calls, with the sole exception of last week's (July 3). See Rudi's Views on the FNArena website to access the archive of past updates.

Aristocrat Leisure: It's Not A Gamble

Shares in poker machine manufacturer and (increasingly) online gaming software developer Aristocrat Leisure have been on an absolute tear in the past eighteen months. While it can be argued the underlying trend has been positive for years, with the share price climbing from below $3 in 2013 to $10 by early 2016, the shares have gone parabolic since and last month narrowly missed the $24 mark.

For most investors, this is as far as their interest stretches. A stock that continues doubling in price surely must now be overheated and ripe for a fall a la Bellamy's or Blackmores? Not so, says a growing pack of analysts who cover the stock. Last month Goldman Sachs expressed their admiration for the strong growth achieved, with the explicit notion there should be a whole lot more growth on the horizon.

As a matter of fact, analysts at Goldman Sachs were so much in awe, they asked themselves the question: can Aristocrat Leisure shares potentially reach $30? Having taken another good look in what exactly is supporting current growth, and what should be in the pipeline, the analysts' conclusion was: yes, sure, definitely possible. On their projections, it really doesn't require much in terms of upside surprises in the years ahead.

The sales desk at Citi has no such reservations. According to their Bull case scenario, Aristocrat Leisure shares are likely to reach $30 and they will do so on solid growth momentum which seems secured until at least 2022. Expanding market share, growing online popularity and successful new titles (Lightning Links, Dragon Link) can achieve just that, argues Citi, with Conviction.

On my observation, the growth story at Aristocrat has by now captured the attention of many in the local share market. Apart from some profit taking here and there, and the occasional wobble on bond market concerns, I suspect this will translate in continuous buying support. At $22, plus or minus, the twelve month's out Price-Earnings (PE) ratio is still below 22x with USD exposure further adding to the strong growth attraction. Given the robust growth outlook on consensus market projections (55.1% EPS growth in FY17, followed by 17.4% in FY18, and more beyond) this certainly continues to look attractive, in particular with low expectations for the broader market, and falling, post August.

The FNArena All-Weather Model Portfolio likes industrial companies with a solid multi-year growth outlook and Aristocrat Leisure has been included since last year. We are not too worried about short term weakness or whether the shares will actually reach the $30 mark or not.

2016 - L'Année Extraordinaire

It was quite the exceptional year, 2016, and I did grab the opportunity to write down my observations and offer investors today the opportunity to look back, relive the moments and draw some hard conclusions about investing in the world today.

If you are a paid subscriber to FNArena, and you still haven't downloaded your copy, all you have to do is visit the website, look up "Special Reports" and download your very own copy of "Who's Afraid Of The Big Bad Bear. Chronicles of 2016, A Veritable Year Extraordinaire" (in PDF).

For all others who still haven't been convinced, eBook copies are for sale on Amazon and many other online channels. You'll have to visit a foreign Amazon website to also find the print book version.

All-Weather Model Portfolio

In partnership with Queensland based Vested Equities, FNArena manages an All-Weather Model Portfolio based upon my post-GFC research. The idea is to offer diversification away from banks and resources stocks which are so dominant in Australia, while also providing ongoing real time evidence into the validity of my research into All-Weather Performers.

This All-Weather Model Portfolio is available through Self-Managed Accounts (SMAs) on the Praemium platform. For more info: info@fnarena.com

Rudi On TV

This week my appearances on the Sky Business channel are scheduled as follows:

-Tuesday, 11.15am Skype-link to discuss broker calls -Thursday, interview on Switzer TV, between 7-8pm -Friday, 11.15am Skype-link to discuss broker calls

Rudi On Tour

- I shall be participating as debate monitor at the upcoming National Conference of the Australian Investors Association (AIA) at the Marriott, Surfers Paradise, 30 July-2 August

- I will be presenting in Adelaide on November 14th to members of Australian Investors Association and other investors, 7pm on November 14th inside the Fullarton Community Centre, 411 Fullarton Rd, Fullarton. Title of presentation: Investing In A Slow Growing World - An Update

(This story was written on Monday 10th July, 2017. It was published on the day in the form of an email to paying subscribers at FNArena).

(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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Rudi's View: Bigger Picture - Trends

By Rudi Filapek-Vandyck, Editor FNArena

The below is merely a philosophical exercise, but one that hopefully plays a contribution in investors' ongoing quest to devise the best strategy for optimal investment returns in the years ahead.

All investors, no matter their age, level of experience or specific goals and mandate, like to think they are making decisions today for the long run. But in all cases shorter term considerations play an influential part.

So here's an attempt to keep things simple, devoid from short term noise and with lots of room to take different angles and opposing views and predictions.

Something to think about.

Below are four longer term price charts which I believe show the three key trends for ASX-listed stocks; the long term sustainable uptrend, the sideways pattern, and lastly, the downtrend channel. The latter is represented by two charts; one that is showing a rally from the bottom and one that is not.

As the old saying goes, a five year old child should be able to answer the most basic questions about each of these charts. For adults, the advice is KISS, otherwise known as Keep it simple, stupid! To make it easier to focus on the underlying dynamics, all charts show monthly price movements.

Also, to avoid early mental bias when looking at these price charts, I have removed specific company information. Instead, readers can find the names and stock codes of the companies shown at the bottom of this story. Don't look now. The info will still be there by the time you reach the final chart.

Let's start with the long term sustainable uptrend, which looks as follows:

Let's be honest, wouldn't anyone just LOVE to have lots of portfolio exposure to such long-winded uptrends? This looks like set & forget in its ultimate beauty, like a Picasso on the wall or an old photo album with parents and siblings.

Here the sad observation is not many investors stay the course or get on board. Instead they fret about things like "has it run too hard already" or "is it too expensive"? It's amazing how many investors would have been put off throughout the period because they couldn't get in at 50c cheaper, or because the Price-Earnings (PE) ratio looked too high. Meanwhile, the trend just kept going. It is still going today.

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Next up is the sideways pattern, which is what happens when prior up trends are no longer supported and management at the company has to pull all available levers to protect shareholders from too much downside.

Every day investors and commentators can debate whether the stock is cheap/good value/old glory/riskier than what it seems, etc but beyond all the pros and cons, the observation remains that a sideways channel has formed and the share price is simply moving between bottom and ceiling, up and down, and then again.

You'd hope these stocks pay a good dividend, or otherwise that shareholders climb on board near the bottom of the channel. Of course, the more active traders among us might device specific Buy & Sell strategies based around the existence, and endurance, of the sideways channel.

We can all speculate about when/whether the share price shall move outside of the channel, either way. Right now, it seems to me there's little indication on that chart any break-out is imminent.

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Downtrends are the most obvious value trap in the share market. Falling share prices make them look cheap, thus more attractive. One can only imagine how much money has been poured into the stock below, for those exact reasons. Is this the right time to remind us all that a recent study by Goldman Sachs showed that 60% of all stocks that fall in price, actually deserve to become cheaper?

Stocks in a long term downtrend are the stark reminder that holding on to a failed investment is not the right cure. Time does work to the benefit of the patient investor, but not in this case. Here any dividends are merely a band-aid; worst case they act as an instrument for self-delusion that all shall be right in the end.

Of course, every trend can, and probably shall come to an end, eventually. And this would apply more to down trends than to the two previous alternatives. Which is why we have a second chart which shows exactly that. All kudos to those investors who jumped on board near the bottom. But do we have a sustainable new trend as yet?

One easy to make observation is that past performances would have been best served by lots of exposure to trend number one. One pleasant additional observation, from my personal perspective, is that most stocks included on my list of All-Weather Performers are supported by price chart version number one.

As things stand, the price chart for the long term sustainable uptrend is provided by CSL ((CSL)), but it could just as easily be Amcor ((AMC)), InvoCare ((IVC)), REA Group ((REA)), TechnologyOne ((TNE)), et cetera. Paid subscribers can look up the full list, including past performance and research on the topic via the dedicated section on the website.

The sideways pattern shows the CommBank share price since 2011, but it might have been any other bank, really. Or Wesfarmers ((WES)), or McMillan Shakespeare ((MMS)) or G8 Education ((GEM)).

The two down trend examples represent Flexigroup ((FXL)) and BHP ((BHP)) respectively.

As said in the opening sentences of this story: these observations are merely bigger picture, underlying long term directional picture, but surely all of the above should be part of future considerations?

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

P.S. I - 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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